Economic regulation at Gatwick from April 2014: notice of the proposed licence

CAP 1139

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Executive Summary

1. This document gives notice under sections 15(1) and (3) of the Civil Aviation Act 2012 (the Act) that the CAA proposes to grant a licence to Gatwick Airport Limited (the Licensee or GAL) in relation to the core area of London Gatwick Airport. The CAA is issuing this notice pursuant to its powers and duties in the Act. This document sets out the conditions proposed to be included in the licence and the CAA's reasons for including those conditions.

GAL's licence

2. The proposed licence consists of the following parts:

- Part A: Scope and Interpretation. This part of the proposed licence provides details of the airport, the airport operator, and the airport area for which the licence is granted. It also specifies the date on which the licence comes into force, as well as clarifying points of interpretation in the licence.
- Part B: General Conditions (Payment of fees and licence revocation). This part of the proposed licence requires GAL to pay to the CAA any charges that are set under a scheme made under section 11 of the Civil Aviation Act 1982 (the 1982 Act). It also sets out the circumstances under which the licence may be revoked.
- Part C: Commitments Conditions. These are the conditions that make GAL's commitments part of the licence, allow the CAA to enforce GAL's commitments in passengers' interests, restricts GAL's ability to modify the commitments and places restrictions on the pass through of second runway costs in the absence of a licence amendment.
- Part D: Financial Conditions. This part of the licence sets out requirements for the certificate of adequate resources, restrictions on business activities, ultimate holding company undertakings and the banking ring fence.

The monitoring regime for GAL

3. The monitoring regime around the commitments will involve the following tasks.

- Monitor the blended price actually charged under the various contracts to identify whether it is consistent with the CAA's view of a fair price of retail price index (RPI)-1.6% per year rather than GAL's commitment of RPI+0%.
- Monitor service quality performance and undertake an investigation if GAL fails an individual metric for more than six months.
- Require GAL to undertake a shadow regulatory asset base (RAB) calculation in case tighter regulation needs to be reintroduced (although there would be no presumption that the shadow RAB number would be used as the basis for a future price cap).
- Undertake a review of the commitments and contracts framework in the second half of 2016 to identify whether as a whole they are operating in passengers' interests, including a request for stakeholders' views.

4. If the CAA identifies concerns during its monitoring, under a licence the CAA can undertake an investigation and undertake enforcement action or introduce additional licence conditions, as appropriate.

Delivering the CAA's statutory duties

5. These proposals are those the CAA considers are best calculated to further its relevant statutory duties, which are found in the Act. The CAA's primary duty is to further the interests of users (passengers and owners of air freight) regarding the range, availability, continuity, cost and quality of airport operation services; where appropriate, by promoting competition as well as a range of other regulatory objectives and principles to which the CAA must have regard.

6. In assessing users' interests, the CAA has taken account of airlines' views (among others), recognising that airlines' interests often align with those of users. However, this is not always the case, and the CAA has also reviewed a wide range of direct research about users'

views and preferences. The CAA has been advised by its Consumer Panel.

7. In assessing users' interests, the CAA must balance the interests of present users in lower airport charges with the interests of future users in GAL's ability to continue to be able to invest in modern infrastructure and services in a timely manner. (Of course, present and future users will often be the same people.) Under section 1(5) of the Act, if there is a potential conflict between the interests of different classes of users or between their interests in the various different parameters set out in section 1(1), the CAA is directed to carry out its functions in a way that will further such interests as it thinks best.

8. The CAA considers that its proposed licence, which incorporates GAL's commitments, together with a monitoring regime, is the best way to further its duties, particularly the primary duty to users, for several reasons.

- While the price in the commitments is higher than the CAA's view of a fair price, CAA's monitoring and the threat of additional licence conditions create incentives for GAL to moderate price increases and deliver growth at the airport and further the interests of passengers.
- Licence-backed commitments will provide a better framework to diversify the service offering and to incentivise volume growth. This is because the commitments encourage bilateral contracts which can allow service quality, capital investments, operational practice, volume commitments and price to be better tailored on an integrated basis to the needs of individual airlines and their passengers. RAB-based regulation allows for bilateral contracts only on a limited basis, and cannot provide the same degree of tailoring.
- Licence-backed commitments should promote competition by facilitating innovation and diversity of the services offered. These are important, although not sufficient in themselves, for effective competition between airports. Although existing and future capacity limits reduce competition between London airports, it is nevertheless an expansion of choice for at least some users if airports are enabled to diversify their service offerings.

- Embedding the commitments within a licence provides a timely and effective backstop protection for users in the form of a licence enforcement regime, for instance if there are reductions in service quality or price increases that are against users' interests.
- Licence-backed commitments will encourage GAL to improve its efficiency as the airport operator can retain savings during the commitment period. The longer time period of the commitments should provide GAL with greater incentives to reduce operating expenditure and outperform commercial revenue assumptions.
- Licence-backed commitments will facilitate efficient investment as GAL will have flexibility to tailor its investment to the needs of airlines, while the licence will provide users with timely and effective backstop protection to ensure that investment is undertaken in users' interests.
- A specific licence condition has been inserted which requires the licence to be amended before the main costs of a second runway can be passed through to users. This will ensure that the development of any second runway was undertaken in a manner that furthers users' interests in the cost and quality of airport operation services (amongst other interests) and promotes competition in airport operation services.
- Licence-backed commitments will prospectively ensure that an efficient GAL has adequate financial resources and can finance its provision of airport operation services. The CAA has checked GAL's potential financial ratings and assumed that GAL would not have proposed commitments that it could not finance.
- Licence-backed commitments will provide protection on operational resilience, by allowing the CAA to undertake licence enforcement action if there are problems with operational resilience.
- Licence-backed commitments will provide protection on financial resilience through commitments and licence obligations.

9. The CAA considers that its final views are consistent with the better regulation principles, to which the CAA has a statutory duty to have regard, in that licence obligations have been introduced in a proportionate manner, where they are necessary and the monitoring regime should ensure transparency, consistency and accountability.

Next steps

10. There are a number of steps before GAL's licence comes into force on 1 April 2014:

- 10 January 2014: publication of this notice of the proposal to grant a licence and proposed licence conditions to GAL under section 15(1) of the Act. At the same time the CAA is publishing its decision on the market power test (MPT) in relation to Gatwick and an operator determination in relation to the aircraft maintenance facilities at Gatwick.
- 14 February 2014: publication of the notice granting the licence and a copy of the licence under section 15(5) of the Act. The notice will specify, among other things, the date on which the licence will come into force, namely 1 April 2014. GAL and any provider of air transport services whose interests are materially affected by the CAA's decision will have six weeks from the date of publication of the notice to seek permission to appeal to the Competition Commission (CC)/Competition and Markets Authority (CMA).[1]
- 1 April 2014: the licence and, in the absence of a relevant appeal, the Q6 price control will come into force. If permission to appeal is sought and an application is also made to the CC/CMA to suspend the effect of the decision to include a condition within six weeks of the notice of the decision to grant the licence being published, that condition is automatically suspended for 10 weeks from the date of publication of the notice of the decision to grant the licence. The CC/CMA's decision on the application for permission to appeal and the application to suspend that condition must be taken before the end of that period.

[1] The CMA will take over the functions of the CC along with the competition and certain consumer functions of the Office of Fair Trading (OFT). The CMA is currently in operation as a shadow body but will take over any existing CC casework when it becomes fully operational on 1 April 2014.

- April 2014: The CC/CMA has ten weeks from the date the notice of the decision to grant the licence was published (not from the receipt of the stakeholder's decision to seek permission to appeal) to decide whether to give the stakeholder leave to appeal. The CC/CMA has 24 weeks (again, from the date the notice of the decision to grant the licence was published) to determine the appeal. The CC/CMA may grant itself an 8-week extension to this deadline or an indefinite extension to this deadline if there is a relevant appeal to the Competition Appeal Tribunal (CAT) on the market power determination.

CAA

January 2014

CHAPTER 1

Introduction

1.1 This introduction sets out:

- the notice which the CAA is publishing under section 15 of the Act;
- the provisions for respondents to make representations;
- the steps before the grant of the licence;
- the process that has shaped the CAA's proposed licence conditions;
- the statutory context to this process;
- GAL's commitments proposals; and
- the structure of the remainder of the document.

Notice under section 15 of the Act

1.2 This document gives notice under sections 15(1) and (3) of the Act that the CAA proposes to grant a licence to GAL in relation to the core area of London Gatwick Airport (Gatwick). The CAA is making this notice pursuant to its powers and duties in the Act. The majority of the provisions in Part 1 of the Act came into force on 6 April 2013 and replaced the framework for airport economic regulation under the Airports Act 1986 (AA86) that has governed all previous quinquennial reviews.

1.3 The airport area for which the licence would be granted is located at London Gatwick Airport and comprises of:

- the land, buildings and other structures used for the purposes of the landing, taking off, manoeuvring, parking and servicing of aircraft at the airport except the aircraft maintenance areas known as Hangar 6 Maintenance Area 1 and Hangar 7 Maintenance Area 2; and
- the passenger terminals.

1.4 This document sets out the conditions proposed to be included in the licence and the CAA's reasons for including those conditions.

1.5 Interested parties have until 24 January 2014 to make any representations on the proposal to grant the licence, including the proposed licence conditions. The CAA cannot commit to take into account representations after this date. The CAA reserves the right not to take into account information, or to place less weight on information that is provided after 24 January 2014 that could have been provided earlier.

1.6 The CAA proposes to grant any licence by 14 February 2014, so that it may come into force on 1 April 2014.[2] When it grants any licence, the CAA will give reasons for any differences between the proposed licence conditions in this document and the licence conditions included in the licence where those differences are not significant. If the CAA considers it necessary to make significant changes to the proposed licence conditions as a result of representations made in this consultation, the CAA will issue a further notice under section 15 of the Act proposing licence conditions that reflect those changes.

1.7 The CAA has already consulted extensively on the proposed licence conditions and the supporting analysis in its initial proposals in April 2013, in a letter to stakeholders in May 2013, in a consultation on a licence condition incorporating the commitments into a licence in July 2013, on in its final proposals in October 2013[3] and on specific amendments on licence conditions also in October 2013. The CAA has taken into account representations from all stakeholders in those consultations in developing the proposed licence conditions specified in this notice. During this process stakeholders have provided extensive representations on the individual RAB-based calculations and the CAA's price control policies. While new information may always come to light on these issues, for example as outturns become available or forecasts are updated, the CAA is mindful that this could create a never ending process. The CAA was also clear in its initial and final proposals and with stakeholders individually that this

[2] A licence may not come into force before 6 weeks after the notice of the decision to grant the licence was published.

[3] All consultations, responses and associated documentation can be found on the CAA website at: http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15152

document would constitute the CAA's decision on economic regulation. The CAA considers that, at this late stage, and following extensive consultation on the substantive issues, it is in users' interests to see an orderly process that ensures regulatory licences come into force on 1 April 2014. Late submission of materials, or submissions that could have been submitted at an earlier stage in the consultation process, might put this goal at risk. The CAA therefore expects stakeholders to focus their responses to this consultation on the technical aspects of the licence conditions, i.e. how they would operate, rather than the policies that stand behind them.

1.8 Alongside this document the CAA has also published its market power determination (MPD) in relation to Gatwick.[4] Under the MPD the CAA has concluded that the market power test is met by GAL in relation to the core area of Gatwick and so GAL will require a licence.

1.9 The CAA has also carried out an operator determination[5] pursuant to section 10 of the Act that GAL is not the operator of the aircraft maintenance facilities as it does not have overall responsibility for the management of these facilities in respect of the type, cost and quality of the services provided or access to or development of those facilities. These facilities will therefore not be included in the airport area in the licence. The CAA has also not included the cargo processing areas from the airport area in the licence as the CAA has not determined that the MPT was met by GAL in these areas.

1.10 This notice sets out the CAA's reasons for the proposed licence conditions. In coming to its decision on the proposed licence conditions the CAA has taken into account the views of stakeholders based on their submissions to the CAA. The CAA has endeavoured to check the accuracy of all these attributed statements. Should any stakeholder consider that the attributed statement does not reflect their previous submissions to the CAA, it is open to the stakeholder to raise this in their response to this document.

1.11 References in this document to 'the airlines' mean views submitted to the CAA by the representative body for airlines for the purposes of

4 This determination can be found at: http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=12275

5 This determination can be found at: http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15152

Constructive Engagement (CE). In the case of Gatwick, it means the Airline Consultative Committee (ACC). The CAA acknowledges that the views of individual airlines may differ on particular issues.

1.12 This is a redacted version of the CAA's notice. Some information has been removed at the request of GAL and the airlines on the basis that it is commercially confidential. Redactions are clearly marked. In accepting redactions for the purposes of this document, the CAA reserves its right to revisit its position for subsequent publications.

1.13 The price base used in this document is 2011/12 prices unless otherwise stated.

Representations

1.14 If you have any representations on the proposal to grant the licence and the proposed licence conditions please could these be emailed to airportregulation@caa.co.uk. If you would like to discuss with the CAA any aspect of this document, please contact Tim Griffiths (tim.griffiths@caa.co.uk).

1.15 Representations must be received by no later than 24 January 2014.

1.16 The CAA will publish representations on its website shortly after the close of the consultation period. If there are parts of your representation that you consider commercially confidential, please mark them clearly as such. Please note that the CAA has powers and duties with respect to information disclosure that can be found in section 59 of, and Schedule 6 to, the Act and in the Freedom of Information Act 2000.

Next steps

1.17 There are a number of steps to the implementation of the Q6 price control on 1 April 2014.

- 10 January 2014: Publication of this notice of the proposal to grant a licence and proposed licence conditions to GAL under section 15(1) of the Act (this document). At the same time the CAA is publishing an operator determination and its decision on the MPT in relation to Gatwick.
- 14 February 2014: copy of the licence and the accompanying grant notice under section 15(5) of the Act to be published, specifying, among other things, that the licence will come into force on 1 April 2014. GAL and any provider of air transport services whose interests are materially affected by the CAA's decision will then have six weeks from the date of the publication of the grant notice to decide whether or not to seek permission to appeal to the CC against any of the licence conditions.[6] As of 1 April 2014 the responsibilities of the CC will be taken over by the CMA.
- 1 April 2014: the licence and, in the absence of any application to seek permission to appeal, the Q6 price control will come into force. If permission to appeal is sought and an application is made to the CC/CMA to suspend a condition within six weeks of the publication of the notice granting the licence, that condition is automatically suspended for 10 weeks from the date of publication of the notice granting the licence. The CC/CMA's decision on the application for permission to appeal and suspend the condition beyond that 10-week period must be taken before the end of that period.
- The CC/CMA has ten weeks from the date of the publication of the notice granting the licence (not from the receipt of the stakeholder's decision to seek permission to appeal) to decide whether to give the applicant leave to appeal. The CC/CMA has 24 weeks (again, from the date of publication) to determine the appeal. The CC/CMA may grant itself an 8-week extension to this deadline.
- Interested parties can also appeal the CAA's determination on whether the MPT is met to the CAT within 60 days of the publication of the CAA's reasons for the determination. The CC/CMA may extend the period for considering an appeal on licence conditions if there is an appeal to the CAT which it considers relevant to the appeal on licence conditions.

[6] The CC is consulting on the rules that will apply to the making and determining of appeals.

The process that has shaped the CAA’s proposed licence conditions

1.18 The CAA’s proposed licence conditions have been informed by a number of factors.

- Previous significant CAA consultations in July 2011 and May 2012 designed to establish the key issues of concern to stakeholders and explore the interpretation of the CAA’s new duties under the Act.[7]
- A process of CE between April 2012 and December 2012, overseen by the CAA, whereby GAL and the airlines discussed the main building blocks that could be used to calculate future charges. This process culminated in a report to the CAA approved by the Joint Steering Group (JSG).
- An initial business plan (IBP) (April 2012) and revised business plan (RBP) (January 2013) from GAL setting out its view on the main building blocks that could be used to calculate future charges in the period April 2014 to March 2019. The RBP included GAL's proposals for airport commitments as an alternative to licence regulation.
- The CAA's initial proposals for GAL published in April 2013 which were based on a RAB-based price control but stated that GAL's commitments together with a basic licence could be the preferred form of regulation if issues associated with the terms of the commitments could be addressed.[8]

7 CAA, July 2011, Setting the Scene for Q6, http://www.caa.co.uk/default.aspx?catid=2162&pageid=12352 and CAA, May 2012, Q6 Policy Update, http://www.caa.co.uk/docs/5/Q6PolicyUpdate.pdf

8 CAA, April 2013, CAP 1029: Economic Regulation at Gatwick from April 2014: Initial Proposals, http://www.caa.co.uk/docs/33/CAP%201029%20Economic%20regulation%20at%20Gatwick%20from%20April%202014%20initial%20proposals.pdf

- Written representations from stakeholders to the CAA's initial proposals, which included revised commitment proposals from GAL, which sought to address issues highlighted by the CAA in the initial proposals.[9] Some stakeholders have shared with the CAA consultancy studies they have commissioned.[10]
- Further submissions from the airlines and GAL in response to a CAA request to reach agreement on key issues on the service quality and capital expenditure regimes.
- A stakeholder session with the CAA Board in July 2013 at which both GAL and representatives from the Gatwick airline community explained their respective positions on the regulation at Gatwick.[11]
- A consultation in July 2013 on a draft licence that could be associated with GAL's revised commitment proposals, if the CAA considered that this was the preferred form of regulation.[12]
- GAL's final commitment proposals received on 20 September 2013,[13] which responded to issues raised by the CAA and stakeholders in the CAA's consultation on the draft licence which could be associated with GAL's revised commitment proposals.[14]
- A consultation in October 2013 on the CAA's final proposals, including proposed licence conditions.

9 The responses to the initial proposals are published at: http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14902

10 These reports are published at: http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

11 CAA, July 2013, Minutes from Board stakeholder sessions for Gatwick, http://www.caa.co.uk/docs/78/CAA%20Board%20&%20Gatwick%20Meeting17072013.pdf

12 CAA, July 2013, GAL – proposed licence conditions in relation to price commitments, http://www.caa.co.uk/docs/78/GALProposedLicenceCondition.pdf

13 GAL, September 2013, London Gatwick's Final Commitments proposal, http://www.caa.co.uk/docs/78/20SeptemberFinalCommitmentsProposals.pdf

14 Responses to these commitments are at: http://www.caa.co.uk/default.aspx?catid=78&pagtype=90&pageid=67

- Written representations from stakeholders to the CAA's final proposals, which included revised commitments proposals from GAL. Further written representations from stakeholders responding to other stakeholder responses and highlighting new information on traffic growth, the CC's provisional decision on the Northern Ireland Electricity appeal and the progress of bilateral negotiations.
- Several independent studies commissioned by the CAA on the efficiency and appropriateness of GAL's business plan projections and the form of regulation (see figure 1.1). In a number of cases the CAA commissioned updates to these reports to address the points raised by stakeholders in their responses to the initial proposals.
- Advice from the CAA Consumer Panel.[15]

Figure 1.1: Independent consultancy studies commissioned by the CAA

Topic	**Consultant**
Cost of capital	PricewaterhouseCoopers
Scope for future efficiency gains at Heathrow, Gatwick and Stansted	Cambridge Economic Policy Associates
Q6 capital expenditure (capex) review	Davis Langdon
Assessment of maintenance and renewal costs at Heathrow and Gatwick	Steer Davies Gleave
Assessment of commercial revenues at Heathrow and Gatwick	Steer Davies Gleave
Potential framework for price monitoring at Gatwick and Stansted	First Economics
Advice on the calculation of long-run incremental costs	Europe Economics
Other operating expenditure at Heathrow and Gatwick	Steer Davies Gleave
Central support costs	Helios
Comparing and capping airport charges at regulated airports	Leigh Fisher
Employment cost study at Heathrow, Gatwick and Stansted	IDS Thomson Reuters
Q5 capex and consultation review, Gatwick	URS
Review of distribution of economic rents	SLG economics

15 The minutes of the CAA Consumer Panel meetings are published at: http://www.caa.co.uk/default.aspx?catid=2488&pagetype=90&pageid=14123

Topic	Consultant
Review of pension costs for Gatwick Airport	Government Actuary's Department

Source: CAA

Note: These consultancy studies have been published on the CAA's website.

Statutory context to this process

Outline of the CAA's statutory duties

1.19 The Act creates a new framework to govern the application of economic regulation to the airport sector. In essence it modernises the previous arrangements and brings the CAA's duties and powers into line with modern regulatory best practice. This includes the CAA having a single primary duty focused on the interests of passengers and those with rights in cargo. The scope of this duty concerns the range, availability, continuity, cost and quality of airport operation services[16] and the CAA must carry out its functions, where appropriate, in a manner that will promote competition in the provision of airport operation services. The CAA must also have regard to a range of regulatory objectives and principles (figure 1.2). The Act also enables the CAA to regulate through a flexible and proportionate licensing approach.

Figure 1.2: The CAA's general duties under the Act

S1	CAA's general duty
(1)	The CAA must carry out its functions...in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services.
(2)	The CAA must do so, where appropriate, by carrying out the functions in a manner which it considers will promote competition in the provision of airport operation services.
(3)	In performing its duties under subsections (1) and (2) the CAA must have regard to: (a) the need to secure that each holder of a licence...is able to finance its provision of airport operation services in the area for which the licence is granted, (b) the need to secure that all reasonable demands for airport operation services are

[16] Airport operation services are defined in the Act at section 68.

S1	CAA's general duty
	met, (c) the need to promote economy and efficiency on the part of each holder of a licence...in its provision of airport operation services at the airport to which the licence relates, (d) the need to secure that each holder of a licence...is able to take reasonable measures to reduce, control or mitigate the adverse environmental effects of the airport to which the licence relates, facilities used or intended to be used in connection with that airport…and aircraft using that airport, (e) any guidance issued to the CAA by the Secretary of State..., (f) any international obligation of the United Kingdom notified to the CAA by the Secretary of State..., and (g) the principles in subsection (4).
(4)	Those principles are that - (a) regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent, and (b) regulatory activities should be targeted only at cases in which action is needed.

Source: The Act

Note: In performing its duties under sections 1(1) and 1(2) of the Act the CAA must have regard to any international obligations of the UK notified to it by the Secretary of State. On 12 April 2013 the CAA was notified of the following international obligations, as they affect charges on airlines: Article 15 of the Chicago Convention; air services agreements in force between the European Union (EU) and its member states and any third country or countries; and air services agreements in force between the UK and any third country or countries. These same obligations applied to the CAA in previous price control reviews conducted under the AA86.

1.20 The CAA is also under a duty, by virtue of section 73(2A) of the Regulatory Enforcement and Sanctions Act 2008, not to impose or maintain unnecessary burdens while performing its regulatory functions under Chapter 1 of Part 1 of the Act.

Who should be regulated?

1.21 The Act prohibits an operator of a dominant airport area at a dominant airport from charging for airport operation services unless it has a licence granted by the CAA. An airport area is dominant if the CAA determines (and publishes) that the MPT is met in relation to the area by the relevant operator. The MPT has three parts:

- Test A: the relevant operator has, or is likely to acquire substantial market power (SMP) in a market, either alone or taken with such other persons as the CAA considers appropriate;
- Test B: that competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that SMP; and
- Test C: that, for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects.

1.22 At the same time as publishing this document, the CAA has published an operator determination for the purposes of section 10 of the Act as well as its determination in relation to the MPT in relation to Gatwick.[17] The CAA considers that the MPT is met in relation to the core area[18] (except the cargo processing areas) of Gatwick and this is likely to endure over at least the Q6 period.

Licence regulation

1.23 Where the MPT is met, the CAA may include in a licence such conditions that it thinks are needed to prevent the risk of abuse of market power as well as any other condition that it thinks is necessary and expedient[19] to secure its statutory duties under section 1 of the Act, including those which further the interests of users of air transport services and (where appropriate) promote competition in the provision of airport operation services. The CAA must also have regard to a range of matters and regulatory principles.

1.24 A licence must specify the airport area and the airport for which it is granted and it must include any price control conditions that the CAA decides are required, as well as provisions for revoking the licence.[20] In addition, the licence may include obligations requiring payment of

17 the CAA's determination can be found at: http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=12275

18 These are defined in section 5(4) of the Act as the land, buildings and other structures used for the purposes of the landing, taking off, manoeuvring, parking and servicing of aircraft at the airport, passenger terminals and the cargo processing areas.

19 Section 18 of the Act.

20 Sections 17 and 19 of the Act.

fees to the CAA.[21] Licence conditions can also include provisions relating to activities carried on outside the airport area for which the licence is granted.

1.25 In January 2012, and at the request of the Secretary of State to assist Parliamentary scrutiny of the Act[22], the CAA published an indicative licence setting out the types of licence conditions that it might include.[23] The CAA has subsequently consulted on potential licence conditions as part of the initial proposals, in the July 2013 consultation on the conditions to be included with GAL's commitments and the final proposals. The conditions the CAA considers are required in the GAL licence are set out in Chapter 2.

1.26 GAL and airlines have rights to appeal the CAA's final decision on the inclusion, or absence, of licence conditions to the CMA subject to certain qualifying criteria being met.[24] In the event an appeal is made that meets the qualifying criteria the CAA's decision will stand until the CMA determines the appeal – unless it has granted interim relief or the appeal relates to specific financial arrangements. While CMA appeals should normally be determined within 24 weeks, this can be extended if a relevant appeal to the CAT is ongoing.[25]

GAL's commitment proposals

1.27 GAL put forward proposals for airport commitments as an alternative to licence-based regulation. These commitments, that GAL is proposing to include in its Conditions of Use (COU), set out limits on airport charges, a service quality regime and commitments on consultation, investment, and operational and financial resilience.

1.28 Under Test C of the market power test, the CAA has determined that

21 Section 20 of the Act.

22 Letter from Department of Transport to CAA, August 2011: http://www.caa.co.uk/docs/5/20110812S16Letter.pdf

23 CAA, November 2011, Indicative Airport Licence: http://www.caa.co.uk/docs/5/IndicativeLicence.pdf

24 Section 24 of the Act. The appeal body is currently the CC but will be the CMA from April 2014.

25 Details of the CMA appeal process are set out in Schedule 2 to the Act.

commitments alone would not provide sufficient protection for users and the benefits of a licence are likely to outweigh the adverse effects. In the final proposals the CAA consulted on its proposals for GAL's commitments to be backed by a licence and monitoring regime. Appendix I sets out the CAA's further assessment of the form of regulation and confirms the CAA's view that commitments backed by a licence and monitoring regime would be the most appropriate form of regulation for GAL. This document therefore sets out the CAA's proposals for licence conditions to be associated with GAL's commitments, together with the CAA's proposed monitoring regime.

Structure of the remainder of this document

1.29 Following this introduction, the remainder of this document is structured as follows:

- Chapter 2: Reasons for the proposed licence conditions;
- Chapter 3: Proposed licence and conditions;
- Chapter 4: Proposed monitoring regime;
- Appendix A: Introduction to the calculation of the fair price;
- Appendix B: Traffic;
- Appendix C: Capital expenditure;
- Appendix D: Operating expenditure;
- Appendix E: Commercial revenues;
- Appendix F: Other regulated charges;
- Appendix G: Q6 RAB
- Appendix H: Cost of capital, calculation of the fair price and financeability
- Appendix I: Form of regulation
- Appendix J: Rolling forward the Regulatory Asset Base; and
- Appendix K: Glossary.

1.30 In addition, the CAA is publishing a Technical Appendix on the weighted average cost of capital (WACC) simultaneously with this decision document.[26]

1.31 The CAA received many responses to its final proposals. It has carefully read and considered all the points made in each response. This document contains summaries of, and answers to, many of those points. Respondents should be assured that each point raised has been carefully considered, whether or not it is addressed specifically in this document.

[26] Available from www.caa.co.uk

CHAPTER 2

Reasons for the proposed licence conditions

Introduction and structure of chapter

2.1 This chapter sets out the conditions proposed to be included in the licence and the reasons for those conditions. It consists of the following sections:

- Part A: Scope and interpretation;
- Part B: General Conditions (Payment of fees, Licence revocation);
- Part C: The Commitments Conditions; and
- Part D: Financial Conditions.

2.2 In reaching its decisions on what licence conditions to propose including, the CAA has considered stakeholders' views in response to previous consultations. Where appropriate and for consistency the CAA has also taken into account responses to relevant consultations on proposals for the operators of Heathrow and Stansted airports.[27]

2.3 The CAA received eight[28] responses to the licence conditions proposed in its final proposals.

Part A: Scope and Interpretation

The proposed scope of the licence

2.4 This part of the proposed licence provides details of the airport, the airport operator, and the airport area for which the licence is granted. It also specifies the date on which the licence comes into force, as

[27] Such as responses in relation to the revocation provisions. These responses can be found at: http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15151 and http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15153

[28] GAL, ACC, Gatwick Airport Consultative Committee (GATCOM), Virgin Atlantic Airways Limited (Virgin) British Airways plc (BA), easyJet plc, and International Airline Passengers Association (IAPA). Thomas Cook also responded to the consultation but made no specific comments on the individual licence conditions.

well as details on interpreting the licence.

2.5 The airport is London Gatwick Airport. The airport area covered by the proposed licence consists of:

- the land, buildings and other structures used for the purposes of the landing, taking off, manoeuvring, parking and servicing of aircraft at the airport, excluding the aircraft maintenance facilities known as Hangar 6 Maintenance Area 1 and Hangar 7 Maintenance Area 2 (the aircraft maintenance facilities); and
- the passenger terminals.

Reasons for the proposed scope of the licence

CAA final proposals

2.6 The CAA is required under section 17 of the Act to include the details of the airport and airport area. These details are not licence conditions. All other details are included to provide clarity and certainty.

2.7 In proposing the airport area for the licence, the CAA considers that, in line with its duties under section 1 of the Act to have regard to carrying out its functions in a targeted and proportionate manner, the airport area should be linked to the scope of the relevant market and limited to the area in which GAL is found to have SMP. The CAA has therefore taken the airport area considered in the MPT as its starting point.

2.8 The CAA's MPT concludes that GAL has SMP in the market for airport operation services to passenger airlines and that these are delivered from the core area of the airport.[29] The CAA therefore proposes to include in the airport area covered by the licence all those parts of the core area of the airport, except for any specific areas where the CAA has made an operator determination, under section 10 of the Act, that GAL does not have overall responsibility for the management of that area.

2.9 In its response to the initial proposals, GAL said it did not consider

[29] These are defined in section 5(4) of the Act as the land, buildings and other structures used for the purposes of the landing, taking off, manoeuvring, parking and servicing of aircraft at the airport, passenger terminals and the cargo processing areas.

that it was the operator of the cargo processing areas or the aircraft maintenance areas for the purposes of the Act.

2.10 The MPT did not find that GAL has SMP in the cargo market and, as the airport area is linked to the scope of the relevant market and limited to the area in which GAL is found to have SMP, the cargo processing areas are not included in the airport area covered by the licence.

2.11 With regard to the aircraft maintenance areas, the CAA has published an operator determination[30] (dated 10 January 2014) under section 10 of the Act. An operator determination assesses whether an operator has overall responsibility for the management of an area including the extent of control over the type, quality and price of services offered in that area, access to that area and development of the area. The CAA found that GAL does not have 'overall responsibility for the management' of the aircraft maintenance facilities, in the sense that it does not have control of the type, price, quality of services provided there nor sufficient control over access to or development of those facilities.[31] Consequently, the aircraft maintenance facilities are not included in the airport area for the purpose of the licence. The reasons for this decision are set out in the operator determination.

2.12 The CAA notes that under section 18 of the Act, as well as the conditions it considers necessary or expedient to guard against the risk of abuse of SMP, it may include in the licence other such conditions as it considers necessary or expedient having regard to its general duties under section 1. Under section 21(1)(f) of the Act it may also include provisions relating to activities carried on outside the airport area for which the licence is granted. These give the CAA the power, where appropriate and necessary, to go wider than the relevant market and the airport area when including conditions in the licence.

30 This determination can be found at: http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15152

31 See the matters listed in section 9(4) of the Act.

Part B: General Conditions

Payment of fees

The proposed licence condition

2.13 The proposed licence condition requires GAL to pay to the CAA any charges that are set under a scheme made under section 11 of the 1982 Act. GAL must pay these charges from the date on which the licence comes into force.

2.14 Payment of fees would be enforceable using civil sanctions as well as the enforcement powers in the Act.

2.15 Under the 1982 Act the CAA has an obligation, before making a charging scheme, to consult persons affected by the scheme and the Secretary of State.

Reasons for the proposed licence condition

CAA final proposals

2.16 The final proposals explained that the Act allows the CAA to require the licence holder to pay charges to the CAA in respect of its functions under Chapter 1 of the Act. These charges are required to enable the CAA to recover the costs of carrying out those functions. The CAA has general powers to determine charges under a scheme or regulations made under section 11 of the 1982 Act. The CAA has not received any evidence through the consultation process that a scheme of charges under the1982 Act would not be appropriate and it therefore proposed to continue to rely on that scheme.

Stakeholders' views

2.17 There were no comments on this proposal.

CAA's response to the stakeholders' views

2.18 The CAA has included the condition on the payment of fees as consulted on in the final proposals with no further changes. The CAA is consulting separately on its scheme of charges from 1 April 2014, including charges to be paid by holders of a licence issued under the Act. The consultation runs until 13 February 2014 and the CAA will publish its decision on charges during March 2014.

Licence revocation

The proposed licence condition

2.19 The proposed licence condition specifies that the grounds on which the CAA can revoke GAL's licence would be:

- where the licence is no longer required, including:
  - the Licensee requests or agrees to revocation;
  - the Licensee is no longer the operator of all of the airport area, or
  - either the airport and/or airport area is no longer dominant; or
- where the Licensee has materially failed to comply with regulatory requirements such as a failure to comply with an enforcement order[32] or to pay a penalty[33] (following any appeal proceedings under the Act and allowing at least 3 months for the Licensee to comply before starting revocation proceedings under section 48 of the Act).

Reasons for the proposed licence condition

CAA final proposals

2.20 The final proposals explained that the CAA is required under section 17(4) to include provisions about the circumstances in which it may be revoked. The licence is issued in perpetuity so provisions are needed to revoke it if it is no longer required, for example because the airport or the airport area is no longer considered to be dominant.

2.21 The CAA considered that licence revocation is a serious matter as the prohibition on charging in section 3 of the Act means it would not be lawful for GAL to charge for any airport operation services if it has no licence. In all likelihood, this means that GAL would have to cease operations.

2.22 The CAA also considered that it should have the ability to revoke the licence if the behaviour of the licensee with regards to its regulatory obligations is such that the CAA no longer considers it is fit to hold the licence. However, this should be treated as the ultimate sanction for a

32 Within the meaning of section 33 of the Act, or an urgent enforcement order within the meaning of section 35 and 36 of the Act.

33 Within the meaning of sections 39, 40, 51 or 52 of the Act.

licence breach by a regulated company and should be used only as a last resort when all other channels have been exhausted. Other than in extreme circumstances, the CAA did not consider that revocation as a sanction was likely to be in the best interests of passengers and cargo owners. There are checks built into both the Act and the licence that give several opportunities for GAL to correct any failures and GAL is able to appeal the CAA's decision at each stage.

Stakeholders' views

2.23 There were no further comments on these proposals following the final proposals.

CAA's response to the stakeholders' views

2.24 The CAA has included the condition on revocation as consulted on in the final proposals with no further changes.

Part C: The Commitments Conditions

The commitments condition

The commitments as licence conditions

Proposed licence condition

2.25 The proposed commitments condition requires GAL to include its December 2013 commitments in the Gatwick Airport COU, but makes clear that they are also licence conditions, subject to the enforcement and modification powers in the Act. The commitments are defined in the licence in relation to where they are set out in the COU.

2.26 GAL is required to comply with the commitments in a manner which, so far as reasonably practicable, furthers the interests of passengers.

2.27 The proposed condition specifically excludes any obligations on third parties from the definition of commitments in the licence because GAL’s licence cannot impose obligations on third parties. This means that these elements of GAL's commitments are not considered to be licence conditions and therefore can only be enforced by GAL through contractual mechanisms.

2.28 In addition, the licence makes it clear that if the CAA makes a licence modification under section 22 of the Act which impact on the commitments, GAL must make any necessary consequential changes to the COU.

Reasons for the proposed condition

CAA's final proposals

2.29 In the final proposals, the CAA said the proposed condition would ensure that the commitments remain in the COU until such time as the CAA makes a licence modification under section 22 of the Act to modify or remove them. It explained that including the commitments in the COU means they would be directly enforceable by the airlines through normal contractual processes. Specifying that the commitments are also licence conditions would mean the CAA would be able to intervene if necessary through the enforcement mechanisms in the Act. For example, the CAA could modify the licence if the commitments approach was not working as intended. The CAA could also enforce the conditions in the commitments, including through an urgent enforcement order, if there was detriment to passengers that was not being addressed by GAL or being challenged by the airlines.

2.30 The CAA made it clear in the proposed licence condition that it would not consider obligations on third parties or GAL's pricing principles to form part of the commitments.

2.31 The CAA considered that, as GAL has been found to have substantial SMP, it cannot rely wholly on GAL being incentivised by normal competitive market forces to take account of the interests of users. It is therefore important to ensure that the interests of users are explicitly protected in the licence, both to incentivise the right behaviour from GAL and to ensure that the CAA has the right means to enforce compliance in a targeted and proportionate manner. The CAA therefore included an obligation on GAL which required it to comply with the commitments by furthering the interests of users. The CAA has qualified the obligation so that GAL must comply so far as reasonably practicable. The CAA considers that this gives adequate qualification to the obligation and in contemplating any investigation or enforcement action the CAA would take all relevant circumstances into account including existing contractual arrangements. The CAA agreed with the ACC that it should be clear that this obligation extends to compliance with the commitments themselves and considered this is already explicit in the condition as it specifies that the commitments are licence conditions.

2.32 In the final proposals, the CAA said that it would monitor the performance of the commitments to ensure they are promoting passengers' interests, although it would give the regime and airport operator/airline relationships a chance to bed down. The CAA therefore committed to carrying out a formal review of the performance of the commitments in 2016.

2.33 Further discussion on the CAA's reasons for choosing a commitments-based licence can be found in the discussion on the form of regulation in Appendix I.

Stakeholders' views

2.34 GAL reiterated its position that it considered that the CAA could fulfil its statutory duties by relying on the commitments without a licence, contrary to the CAA's view. However, to allay the CAA's concerns about furthering passengers' interests, GAL enhanced the role of the Gatwick Passenger Advisory Group (PAG) as a consultee under the commitments.

2.35 GAL reiterated its objections to the requirement to comply with the licence conditions (and so with the commitments) in a manner designed to further the interests of passengers. It argued that the commitments had been designed to further the interests of passengers and the appropriate time for the CAA to consider whether the commitments will further the interests of users is in considering whether or not to adopt them. It considered that this condition effectively transposed the CAA's own primary duty onto GAL without the qualifying duty to have regard to various matters, such as the need to ensure financeability.

2.36 The airlines had a number of concerns about the commitments themselves (outlined in more detail below) which made them question whether the CAA should be adopting this form of regulation. This is discussed in more detail in Appendix I. The airlines welcomed the principles in the licence conditions themselves but had a number of comments on the drafting.

2.37 In particular the airlines reiterated their suggestion that the condition relating to complying with the condition in a manner designed to further the interests of passengers should be clearer. They considered that GAL should be required to comply with the commitments themselves in the same manner. Although the commitments are incorporated into the licence, the airlines thought there was some ambiguity caused by the drafting of Condition 3.

2.38 The airlines also suggested that the licence should reflect that the commitments were spread throughout the COU. Also, as GAL is no longer proposing to include its pricing principles in the COU, these do not need to be explicitly excluded from the definition of commitments. GAL also highlighted these changes and had included suggested changes in a marked up version of the licence.

CAA's response to the stakeholders' views

2.39 The CAA remains of the view that it cannot fulfil its statutory duties by relying on the commitments alone without a licence. The reasons for this view are set out in detail in Test C of the CAA’s MPT in relation to Gatwick and Appendix I of this document. For the reasons given there, the CAA does not agree that the commitments alone will fully protect the interests of passengers in the range, availability, continuity, costs and quality of airport operation services and where appropriate promote competition. GAL, as an operator with SMP, will not have the same competitive incentives as an operator in an effectively competitive market. As a commercial operator, it cannot be wholly relied on to always have the interests of passengers at the heart of its decision-making over and above the interests of its shareholders. Similarly, the CAA does not consider that the interests of the airlines will always align with those of their passengers.

2.40 In the final proposals the CAA considered that its duties under section 1 of the Act to further the interests of passengers and cargo owners require it to ensure that those users have the ability to seek redress, either directly or through a third party whose interests are wholly aligned with those of the end users. The CAA considered that it is best placed to take on this latter role through step-in rights in a licence to enforce the commitments. The CAA does not think that individual passengers will be able to enforce the commitments as they are not privy to those contractual arrangements. The CAA considers it is best placed to enforce their interests pursuant to the general duty that it was given by Parliament in the Act. Furthermore, the use of commitments in lieu of regulation is an untried and untested mechanism for the regulation of an airport operator with SMP and the CAA would not be fulfilling its own statutory duties if it did not ensure that it had the ability to step in quickly and proactively to protect the interests of passengers if the commitments were not working as intended. However, the CAA has not found that GAL has SMP in the cargo market: in 2012 there were only 8 dedicated cargo flights operating out of Gatwick.[34] Most cargo is carried as bellyhold on passenger flights so the CAA considers that the interests of passengers and those of cargo owners are aligned.[35] The CAA has not included the cargo processing areas in the licensed airport area and it considers that it would be disproportionate, in the absence of a positive MPT test for cargo, to hold GAL to account for cargo through the licence. The CAA has therefore only included a requirement for GAL to comply with the licence and the commitments in a manner designed to further passengers' interests.

2.41 The requirement to comply with the licence in the interests of passengers is an essential element of the licence condition that allows the CAA to intervene on passengers' behalf if the airlines choose not to do so. Without this obligation, the terms of the commitments would only be enforceable as a contractual arrangement between GAL and the airlines through the dispute mechanisms in the COU and through the courts. This obligation is therefore necessary to provide a direct route of enforcement by the CAA, including through the use of its powers to modify, impose interim relief and penalties in order to add value in terms of enforcement in the interests of passengers.

2.42 The CAA notes GAL's concerns that it is not reasonable to impose part of the CAA's primary duty onto GAL in the licence without qualifying this with the other duties, particularly regarding promoting competition and having regard to the need to secure that GAL is able to finance its provision of airport operation services in the airport area included in the licence. The CAA remains of the view that these elements are encompassed in requirement that GAL must comply "so far as reasonably practicable". In any investigations into potential non-compliance, the CAA must take a proportionate and targeted approach and will balance all of its duties, including GAL's ability to

[34] CAA statistics.

[35] In 2012 there were 98,000 tonnes of freight at Gatwick, 99.9% of which was carried on passenger aircraft, CAA statistics 2012.

finance its activities, when considering whether GAL has furthered the interests of passengers.

2.43 The CAA notes the airlines' concerns that the condition only requires GAL to comply with the licence conditions in a manner designed to further the interests of passengers, without explicitly including a requirement to comply with the commitments in the same manner. The CAA considers that as the commitments are licence conditions as well as conditions of the COU, they are subject to the full powers of the Act, including the enforcement provisions in sections 31-47 of the Act and the modification provisions in section 22 of the Act. However, for the avoidance of doubt GAL must comply with the commitments in the same manner as it would the licence (for those commitments that are also licence conditions). The CAA considers it would add greater clarity to include explicit obligations in the licence in relation to both compliance with, and modification of, the commitments. In line with this the CAA has included a specific obligation in the licence that requires GAL to make any necessary amendments to the contractual terms in the COU to transpose any modifications made to the licence conditions under section 22 of the Act.

2.44 Since the final proposals, GAL has made a number of amendments to the commitments in response to the airlines' comments, as explained below. The licence therefore requires GAL to comply with the revised commitments submitted to the CAA on 5 December 2013. The CAA will review the performance of the commitments in the second half of 2016 to ensure they are furthering passengers' interests.

A self modification provision

Proposed licence condition

2.45 The licence condition includes a self modification provision which allows GAL and the airlines to agree and make changes to the specified parts of the commitments in accordance with the change mechanisms set out in the COU, without having to rely on the CAA making a modification under section 22 of the Act.

2.46 The specified mechanisms in the commitments are provisions that allow changes to the indicative gross yield price profile (at paragraph 6.1 of Schedule 2 to the COU) and changes to the airline service standards and core service standards (at paragraph 5 of Schedule 3 to the COU). In both cases, the changes must be agreed by GAL and airlines that represent at least 67% of passengers and which are paying charges under the published tariff or under bilateral contracts which use the gross yield profile as a reference point (or for changes to service standards, those airlines which have not waived or replaced core service standards) and representing at least 50% of airlines responding to the consultation.

2.47 In addition, the commitments allow for changes to be made to:

- the gross yield price profile for the recovery of costs of any second runway (paragraph 6.2 of Schedule 2 to the COU). These changes do not require the agreement of the airlines but the CAA has included an additional provision in the licence that limits this automatic pass through to £10 million per year;
- the gross yield price profile for increases or decreases in security costs and the cost of installing new hold baggage screening equipment (at paragraph 1.17 of Schedule 2 to the COU) (these are automatic changes that do not need the agreement of the airlines); and
- the “Gatwick Airport Core Service Standards Handbook” which is annexed to the COU where changes are agreed between GAL, the Gatwick Airline Operators Committee (AOC) and the Gatwick ACC (Appendix 1 to Schedule 3 to the COU).

Reasons for the proposed condition

CAA's final proposals

2.48 The CAA stated it was broadly content that GAL's self modification proposals set out within the commitments will allow GAL and the airlines to make agreed changes to the commitments efficiently, thereby reducing the burden of making agreed changes for both GAL and the airlines. However, the CAA considered that a self modification provision was also required in the licence itself to meet the requirements of the Act.

2.49 This is because, as the commitments are licence conditions, the Act requires that any modifications to them must be made either under the modification provisions in section 22 or under a self modification provision included in the licence condition under section 21(3). The CAA considers that, where changes have been properly debated and agreed already, the procedural requirements of section 22 are unnecessary and would place additional burdens on all parties. The CAA also considers that it is not necessary to retain the right of appeal for changes that have been agreed by all parties.

2.50 The Act is prescriptive about what must be included in the self modification provision: it must set out the types of modifications that can be made and the circumstances and periods in which they can be made. The provision included in the licence condition fulfils these requirements by allowing any modifications to be made in accordance with the modification provisions set out in the commitments.

2.51 The CAA considered that the threshold for airline support[36] for making changes to the price and service quality regimes would be sufficient to prevent a single airline or one or two airlines being able to push through changes to the regime that would not be in the interests of passengers in general. The CAA considered that the modification provision should therefore not act against passengers' interests.

Stakeholders' views

2.52 GAL made no comments on these provisions in the final proposals. The airlines suggested that the licence conditions C1.4 and C1.5 should point explicitly to the individual self modification provision in the COU for greater certainty.

2.53 Virgin did not agree with the proposal that changes could be made to the change mechanism with the agreement of airlines representing only 67% of passengers, as this could lead to a single sector (i.e. the low cost carriers) imposing changes on all carriers at the airport. Instead, it suggested that consensus should be reached with all airlines at the airport. Earlier in the process in its response to the August 2013 commitments, Virgin suggested that agreement should be reached with 90% of airlines responding and airlines in favour need to represent at 90% of passengers.

2.54 GAL suggested that there should also be a modification provision relating to the measurement of Core Service Standards as these also continue to evolve. It noted Virgin's suggestion that any changes should need the agreement of all airlines but suggested that, in its experience, 100% agreement is unachievable. Instead, GAL has

[36] Those representing at least 67% of passengers.

added an extra requirement that the changes must also be agreed with at least 50% of airlines responding in writing.

CAA's response to the stakeholders' views

2.55 The CAA agrees that it would add clarity to include links to the specific self modification provisions in the COUs. The condition therefore now includes links to:

- paragraph 6.1 of Schedule 2 (price commitments);
- paragraph 6.2 of Schedule 2 (pass through of any second runway costs (up to a limit of £10 million per year – see section on second runway costs below);
- paragraph 5 of Schedule 3 (service commitments); and
- the final paragraph in Schedule 3 Appendix I (core service standards).

2.56 The CAA does not consider that it would be efficient or effective for GAL to have to obtain the agreement of all, or nearly all, airlines at the airport as one minority stakeholder could hold up or veto changes that all other airlines needed and that, overall, were in the interests of passengers. The CAA considers GAL's additional test offers a suitable safeguard against Virgin's concerns and has not sought to require GAL to make further changes beyond those for a second runway.

Restrictions on the pass through of second runway costs

Proposed licence condition

2.57 The commitments include a provision that allow for the recovery of the reasonable capital, operating and financing costs of developing a second runway and associated infrastructure (including applying for planning permission). There are two caveats in the pass through that commits GAL to:

- only pass through costs if, following the final report of the Airports Commission, the government supports a second runway at Gatwick; and
- follow any policy guidance issued by the CAA with regards to amending the gross yield profile in relation to the recovery of these costs.

2.58 As noted in the section on the self modification provision above, the licence includes a condition that would only allow the automatic pass through of costs associated with a second runway, up to a maximum of £10 million per year (the recovery of such costs would also need to follow CAA guidance and the second runway would require government support). The licence also includes a requirement that any amendments to the gross yield profile for the pass through of any second runway costs over that £10 million per year threshold would need to be made by means of a modification under section 22 of the Act.

2.59 This condition also clarifies that the CAA may issue guidance on the recovery of second runway costs and sets out the process for GAL to seek modifications under section 22.

Reasons for the proposed condition

CAA's final proposals

2.60 The commitments offered at the time of the final proposals were limited to having regard to CAA policy on second runway costs rather than follow CAA policy. The CAA had concerns that this could allow GAL not to follow CAA guidance if it considered it had reasons not to.

2.61 Given the potential scale of cost pass through the CAA considered that this term imposed risks that would not be in passengers' interests and that any pass through of costs must be subject to CAA policy. GAL has estimated the total cost of a second runway and associated infrastructure to be £5 billion to £9 billion and has indicated that the second runway could be open by 2025. This compares to annual revenue from airport charges of around £300 million. In previous versions of the commitments it appeared that GAL was able to recover the planning and development costs of a second runway spread equally over ten years, potentially leading to a substantial increase in airport charges.

2.62 The CAA noted that any guidance it issued relating to the financing of new runway developments would be consistent with its duties to further passengers' interests and also have regard to the ability of a licence holder to finance its provision of airport operation services in the licence area. The CAA would consult all interested parties before issuing the guidance.

Stakeholders' views

2.63 In their interim responses, the airlines objected to GAL's proposals on the grounds that the open-ended approach to the pass through of costs for a potential second runway would create significant risks for passengers, with no guarantee that the costs will be efficient or controlled. There would be no requirement for GAL to consult the airlines or ability for the CAA to determine if the costs were efficient.

2.64 The airlines considered that it was not reasonable for GAL to determine such potentially large increases in charges outside of the licence modification process. They suggested that the second runway cost pass through be removed from the commitments and a new condition be included in the body of the licence stating that any amendments to the indicative price path in the commitments relating to second runway costs must be made under the modification provisions in section 22 of the Act. This would allow the airlines and GAL the right of appeal to the CC/CMA against the CAA's decision.

2.65 In light of stakeholders' views the CAA wrote to GAL and other consultees on 28 October 2013, suggesting that it includes an additional condition in the licence that would only allow GAL to pass on efficient costs that are consistent with CAA policy. In addition, it proposed that any cost pass through should require the approval of the CAA, following consultation with stakeholders.

2.66 The airlines considered that this proposal did not go far enough, as it did not allow for either the airlines or GAL to appeal the CAA's decisions to approve (or reject) the proposed changes. GAL stated that the CAA had committed to consult on its guidance before it was published and the proposed condition would pre-empt that consultation.

CAA's response to the stakeholders' views

2.67 The CAA accepts the airlines' arguments that the potential costs of a second runway could increase their charges significantly and therefore GAL should not be able unilaterally to pass those costs on without any right of challenge from either the CAA or the airlines. The CAA has therefore concluded that the bulk of the planning and development costs should only be added to charges through a section 22 modification made by the CAA, giving airlines and GAL the right of appeal to the CMA.

2.68 The CAA has allowed for the automatic pass through of costs of up to £10 million per year (subject to following CAA policy). The CAA considers this to be a reasonable amount to allow GAL flexibility, particularly in the early stages of development of the second runway, without having to seek a series of section 22 modifications for smaller amounts.

2.69 The CAA has included a provision in the licence that it may, following consultation, publish the guidance that GAL has committed to follow. This gives greater certainty that this guidance is a regulatory requirement and clarity about the need for consultation before it is issued.

2.70 The CAA has included the key requirements for GAL to request the CAA to make the necessary section 22 amendments, ensuring that GAL's reasons for any changes are in line with the guidance. This will give greater clarity and certainty to GAL on how the CAA will assess whether to take its request forward.

2.71 The CAA has also considered whether it should specify that any modifications under section 22 to change the gross yield profile must be made before the design had been locked in through the planning process. The reason for this would be because it might be harder for the CAA and airlines to challenge the efficiency of the design and development plans if the section 22 modifications were sought after the design had been finalised.

2.72 The CAA has not included such an obligation. The CAA considers that there are too many uncertainties at this stage to be sure of the optimum time for making any amendments. If this was done too early, GAL could be constrained unnecessarily by the amount assumed in early plans or, conversely, the true efficient costs might not be apparent.

2.73 The CAA considers that there will be sufficient opportunities for airlines and the CAA to express their views on the efficiency of the design and subsequent costs before they become locked in, including, but not limited to, the planning enquiry stage itself. Furthermore, requiring GAL to seek the CAA's intervention to make section 22 changes and the additional right of appeal to the CMA will incentivise GAL to engage with the CAA and the airlines to ensure its proposals will be acceptable and costs can be recovered. Finally, in 2014 the

CAA will consult on and publish guidance on the treatment of second runway costs. Such guidance could include more detailed requirements for early engagement with stakeholders on design and costs.

The provisions in the commitments

Price of core services

The proposed condition as set out in the December 2013 commitments

2.74 The December 2013 commitments include an indicative gross price profile based on published charges of RPI+1% per year and a net yield profile based on the blended charges (taking into account published charges and bilateral contracts) of RPI+0%. GAL will ensure that the difference between the indicative and actual yield profile is zero after seven years. Given the difference between the fair price (which is RPI-1.6% per year over five years) and the commitments blended price, the CAA considers that it should monitor the price in the commitments and if it is not consistent with the fair price of RPI-1.6% per year, then the CAA will consider additional licence conditions to cap prices or prevent GAL from altering the structure of charges. Further details of this are set out in chapter 4.

2.75 GAL has also included a pass through of changes in security costs above a threshold of £1.75 million per year and the pass through of costs of hold baggage screening following agreement with airlines.

Reasons for the proposed condition

CAA's final proposals

2.76 The price in the September 2013 commitments at the time of the final proposals was RPI+1.5% per year based on published charges and RPI+0.5% per year based on blended charges. This compared to a RAB-based fair price, as calculated by the CAA, of RPI+1.6% over five years and RPI+0.3% over seven years. The CAA considered that the most appropriate comparison was between the blended price in the commitments, as this would be the average price paid by airlines, and a 5-year RAB-based price control, as this was the most likely regulatory alternative. On this basis the commitments would reduce average charges by 3% over the next five year period. The commitments would also lock in the benefits of lower charges in the first two years of the next control period, which have a risk of being eroded over time as new cost pressures emerge. The commitment blended price was also comparable to the seven year fair price (RPI+0.5% per year compared to RPI+0.3% per year). On this basis the CAA considered that the price in the commitments was reasonable.

Stakeholders' views

2.77 Stakeholders raised a number of concerns with the calculation of the fair price, which are set out in Appendices A to H, and the comparability between the fair price and the price in the commitments, which are set out in Appendix I.

2.78 Airlines also raised concerns that the pass through of security costs was too one sided, allowing for increases in security costs to be passed through but not decreases. They were also concerned that the pass through only looked at increases in one year against the amount paid in the previous year. This would allow GAL to charge more even if the total cost of security is less over the duration of the commitments than in Q5. The airlines considered that the only increase in security costs that should be allowed is that which is an increase on the amount paid in 2013/14 and an increase on the previous highest amount paid in any year of the commitments.

CAA’s response to the stakeholders' views

2.79 The CAA has set out in detail its response to stakeholders' concerns on the calculation of the fair price in Appendices A to H. The CAA continues to consider it is appropriate to compare the blended price in the commitments with the 5-year fair price, as a 5-year RAB-based price is the most likely counterfactual and the blended price reflects the average price to all passengers. The CAA acknowledges that the terms of a RAB-based price control and the commitments differ, although the CAA considers that with the addition of a licence, both approaches provide adequate protection to passengers. The 5-year fair price of RPI-1.6% per year is below the December 2013 commitments blended price of RPI+0%. The CAA does not consider it appropriate to introduce licence conditions to cap charges as the bilateral contracts currently being discussed with airlines have the potential to deliver a blended price in line with the fair price. The CAA will monitor prices and if they are above the CAA's fair price benchmark then the CAA reserves the right to introduce licence conditions to restrain charges or place constraints on GAL from altering its structure of charges.

2.80 On the security cost pass through GAL has now amended the commitments to allow for both increases and decreases in costs from changes in security requirements to be passed through. The airlines have stated that changes in security requirements should only be passed through if security costs are higher than the 2013/14 base year. The CAA does not consider that this is correct. GAL security costs will vary year by year, in particular as a result of changes in the level of efficiency. The security cost pass through allows security requirement cost increases and decreases to be passed subject to a deadband. The CAA considers that this is the correct approach and is consistent with the approach used for the Heathrow price control. If only cost increases were passed through which were above the base year then GAL would be exposed to the risk that it would lose some of the efficiency gains that it had made since the base year as these would be used to offset the increased cost of security requirements. The CAA therefore considers that no further action is needed.

Premium service charges

The proposed condition as set out in the December 2013 commitments

2.81 GAL must provide Core Services to all operators at the Core Service Charges rate (both defined in the COU). GAL has also included a provision at paragraph 10 of Schedule 2 to the COU that allows it to offer enhancements or additions to the Core Services either under bilateral contracts or at charges separate from the Core Service Charges.

Reasons for the proposed condition

CAA's final proposals

2.82 The September 2013 commitments offered at the time of the final proposals included a provision allowing GAL to levy Premium Service Charges for commercial passenger flights receiving Premium Service Products, although neither of these terms were defined. The CAA considered that for most airport operation services any premium charges would be covered by the non-discrimination provisions in the Airport Charges Regulations (ACRs) and the Groundhandling

Regulations (AGRs) or the fair, reasonable and non-discriminatory provisions for ancillary services under the commitments. However the CAA acknowledged that the scope of premium service was unclear and in the absence of a licence there may be potential for GAL to introduce charges that act against passengers' interests.

Stakeholders' views

2.83 The airlines raised concerns in their interim responses that the premium services were not adequately defined in the commitments and therefore GAL would be able to redefine a service that is currently considered to be a core service. GAL would therefore be able to impose premium charges on top of price commitments, outside contracts and without agreement. In particular, airlines were concerned that GAL would be able to charge for services currently covered under the Core Service Charges by introducing Premium Service Charges without agreement. The airlines considered that any airline could enter into a bilateral contract with GAL to have different services and there was no need for provision in the COU for additional services outside of bilateral contracts.

2.84 Airlines therefore considered that GAL should include a list of core services that could only be changed through the modification processes in the licence or the Act.

2.85 The CAA wrote to GAL on 28 October 2013 suggesting an additional requirement in the licence that defined Premium Service Charges as those not currently covered by airport charges. GAL responded to the airlines' interim responses and the CAA's proposal that one of the key aspects of the commitments was the flexibility for airlines to differentiate their product offering at Gatwick, including premium offerings. GAL said it would normally offer such services under bilateral contracts but wished to retain the flexibility to provide additional services under a published tariff to those airlines that did not have a bilateral contract. GAL confirmed that it was never its intention to try to shift services from core to premium as suggested. To clarify its proposals GAL amended the commitments to make it clear that any premium services will be offered in addition to Core Services either in bilateral contracts or under the COU. It also amended the definitions of Core Services and Core Service Charges to ensure that these services cannot be considered premium services in the future.

CAA's response to the stakeholders' views

2.86 The CAA considers that the changes proposed by GAL in the December 2013 commitments offer adequate protection to airlines with regards to Core Services and Core Service Charges, whilst retaining the flexibility for airlines to opt for additional services either within a bilateral contract or as a published price.

Investment and consultation

The proposed condition as set out in the December 2013 commitments

2.87 GAL has included in the commitments a minimum capex spend of £100 million per annum on average for each year of the contract term to ensure compliance with all applicable safety and environmental requirements and to maintain and develop the airport infrastructure to achieve the promised service standards. GAL retains sole responsibility for managing the capital investment and there is no binding programme of specific work and no triggers for non-expenditure on specific projects.

2.88 GAL will consult with airlines at a number of levels through appropriate groups and the PAG. The capex programme will be split into three main groups:

- major development projects over £10 million;
- minor development projects under £10 million; and
- asset stewardship programme – airfield, commercial, IT, facilities and compliance/risk.

2.89 GAL has committed to publishing five-yearly revisions to its 2012 Masterplan with timing dependent on government airport policy consultation or decisions. GAL will also publish annually a rolling five yearly capital investment plan, setting out the principle business drivers for the airport operator’s strategy, the forecast traffic demand and the capacities the airport operator intends to provide, as well as the forecast cost of the programme and the resulting effect on the airport operator’s asset base.

2.90 In forecasting the cost of the programme, GAL has committed to summarise expenditure on each major project and the aggregate expenditure on the asset stewardship programme and the minor development projects, at a level of detail that reflects the planning horizon and status of each project. It will also provide an explanation of any material differences between the latest forecast compared to the previous year's forecast and the CAA's price review forecast.

Reasons for the proposed condition

CAA's final proposals

2.91 The CAA noted in the final proposals that the September 2013 commitments did not include a commitment to any outputs from the capital plan apart from a maintenance of the service quality regime and a commitment to a minimum spend of £100 million per year over the term of the commitments. GAL's proposed spend under a RAB-based framework is around £200 million per year and many of the schemes in that programme produce outputs that are not reflected in the service quality regime, for example the early bag store will provide the ability for early check-in; the international departure lounge (IDL) schemes will provide increased circulation space and new children's and outside areas; the check-in schemes will provide new bag drop facilities; the north terminal arrival scheme provides a much enhanced arrival area etc. While GAL has committed to provide an explanation as to any material differences between the latest capital investment programme (CIP) forecast and both the prior year forecast and the forecast incorporated in the CAA's 2013 price control review, it has not committed to any programme of specific capex. The CAA is therefore concerned that GAL could significantly reduce capex and not deliver the outputs that the CAA considers are in passengers' interests.

Stakeholders' views

2.92 The airlines were concerned that they would have limited ability under the commitments to challenge GAL on its investment plans and felt that there was an inadequate requirement for GAL to consult airlines on its proposals properly. They suggested that as a minimum the commitments should be clear that GAL will follow the principles of adequate consultation mandated of public authorities.

2.93 In addition, the airlines sought greater clarity on a number of terms included in this provision, including definitions of the Masterplan and the various Tollgate stages, and a clearer link to specific paragraphs of the CAA's final proposals for the comparison of forecast costs against the CAA's price control forecast. They also suggested that the commitments should reflect the current arrangements of monthly sub-committee meetings.

2.94 GAL responded that it was highly incentivised to deliver the capital investment programme that it had set out in its business plan to help it compete for passengers and airlines. It noted that it has committed to maintain the airport to comply with all relevant environmental, health and safety standards and committed at least £700 million over the course of the commitments to deliver the core service standards. It noted that its programme includes a range of projects that are necessary to deliver the commitments, and that are agreed with airlines to deliver benefits to passengers and airlines, as well as other projects that are commercial revenue generating projects that do not require increases in charges. It has included a consultation process in Schedule 4 of the COU covering a long term Masterplan, a rolling 5-year CIP and individual major developments.

2.95 GAL has subsequently updated the commitments to include definitions of the Masterplan and the Tollgates and has added a commitment to consult the PAG on the CIP and on major development projects.

CAA's response to the stakeholders' views

2.96 The CAA acknowledges that GAL’s commitments provide it with some flexibility with regard to the investment programme and considers that provisions in the commitments, together with the licence requirement to comply with the commitments in passengers' interests should help to ensure that GAL undertakes its capital investment programme in passengers’ interests. However, the CAA remains concerned that the commitments do not include specific outputs from the capex programme beyond those in the service quality regime. The CAA will review GAL’s capex performance to assess whether it is operating in passengers' interests, including seeking views on GAL’s consultation processes, as part of its review of the commitments regime in 2016.

2.97 The CAA welcomes GAL's commitment to consult with airlines at different levels and with the PAG and would expect GAL to carry out any consultation to ensure that stakeholders are fully informed of its plans and that it makes it clear how it has taken their views into account.

Service Quality Regime

The proposed condition as set out in the December 2013 commitments

2.98 The commitments include a service quality rebate (SQR) scheme based largely on the one used in Q5, but with a new outbound baggage measure and reweighting of attributes (both agreed with airlines). Monthly rebates will be the same as those in Q5 and would be increased by 25% if service quality failures persist for more than six months, although they would fall to zero if there are more than six failures for a metric in one financial year. The commitments also allow for airline service quality penalties on check-in and arrivals bag performance, which would be funded by netting off airport rebates.

Reasons for the proposed condition

CAA's final proposals

2.99 The service quality regime in the September 2013 commitments included monthly rebates at the same level of those included in the Q5 settlement. The CAA was concerned that the limits placed in the commitments on the total rebates payable, the absence of rebates if failures continue for more than six months in a financial year and the offsetting impact of airline service quality failures might reduce GAL's liability for repeated service quality failures, which may act against passengers' interests.

2.100 The September 2013 commitments did not include the core service standards for airfield availability and pier service. The CAA considered that these standards should be agreed with airlines before introduction. Some of the details of the measurement of core service standards were either undefined (for example the details of the scope and location of the monthly publication airport wide service quality measurements) or additional caveats had been introduced (for example, security queues did not contribute towards the standard if airlines did not comply with stand planning rules). The CAA also noted that only GAL could initiate changes to core and airline standards.

2.101 The service quality regime included airline service quality penalties on check-in queues and arrivals bag performance. The CAA supported coordination on service standards across the airport campus where this would not distort the functioning of an effective market, but the

CAA noted that it does not have the locus in the Act to set standards on airlines.

2.102 The CAA made clear in its final proposals that, as part of its regime for monitoring the performance of the commitments, it would expect GAL to publish its performance against airport wide standards, including rebates paid. The CAA also said it would expect GAL to measure service quality in a way that furthered passengers' interests and to consult airlines on any changes to the approach taken in Q5.

Stakeholders' views

2.103 In their response to the final proposals, the airlines said they had reached agreement with GAL on a number of elements of the service quality regime but that there were some outstanding issues, including:

- the core service level for outbound baggage;
- a GAL proposal that core service rebates would not be paid to airlines that fail to achieve airline standards and that future rebates will not be paid if there are outstanding rebates from such airlines to GAL; and
- publication of passengers with reduced mobility (PRM) and pre-notification figures where the airlines said they should not be judged on pre-notification figures as passengers can request assistance without pre-notification. They suggested it would be better to publish performance against the service level agreement negotiated with GAL.

2.104 Since the final proposals, GAL and the airlines have agreed the outstanding core service levels apart from the pier service levels but GAL has not changed the commitments in response to the airlines' concerns regarding airline incentives and publication of PRM and pre-notification figures.

CAA's response to the stakeholders' views

2.105 The CAA notes that GAL has not amended the commitments regarding the total rebates payable, the absence of rebates if failures continue for more than six months in a financial year and the offsetting impact of airline service quality failures.

2.106 The CAA considers that, as it does not regulate the airline service standards, it should be up to the parties involved to resolve this issue themselves, using the dispute mechanism if necessary. However, the CAA will monitor the impact of these provisions as part of its monitoring regime, in particular whether they are reducing GAL's liability for repeated service quality failures. Should the CAA's concerns be realised, it could take further action either through its enforcement powers or through a section 22 licence modification.

2.107 The CAA has accepted GAL's December 2013 commitments on service quality. Many of the parameters of the core service quality are either based on Q5 or have been agreed with airlines. As stated in the final proposals, the CAA will monitor performance of the service quality regime as part of its review to ensure that the commitments are working in passengers' interests. The CAA will not hesitate to take action if it considers that there is detriment to passengers that is not being addressed through contractual mechanisms. As rebates can fall to zero if there are six or more failures of a service quality metric in a financial year, the CAA will investigate any repeated service quality failures of this duration and take enforcement action if required.

2.108 The CAA considers that it is important for GAL and the airlines to agree the pier service levels as quickly as possible, otherwise there is a risk that performance in this service will suffer. If this cannot be agreed by the time the licence comes into force, the CAA will consider imposing a pier service level using its powers under section 22 of the Act.

2.109 With regard to the monitoring and publication of the PRM service, the CAA notes that the PRM service is primarily an airport operator's responsibility. It notes that GAL, as with many other airport operators, might choose to adopt two standards: one for the performance of its PRM service where passengers pre-notify; and one for where passengers do not pre-notify.

Dispute resolution

The proposed condition as set out in the December 2013 commitments

2.110 Airlines will be able to obtain remedies as part of the contractual arrangements in the COU, including recourse to the courts. Airlines will also have rights of redress under the ACRs where GAL has failed to set airport charges in accordance with those regulations. The CAA can also investigate and give compliance orders under those regulations.

2.111 GAL has also included a provision allowing faster resolution of disputes though non-binding adjudication by independent experts. The process proposed for this adjudication follows that set out in section 108 of the Housing Grants Construction and Regeneration Act 1996 (the 1996 Act). The findings of the dispute resolution process are binding until determined by legal proceedings or are agreed by the parties and do not prevent either party from seeking urgent relief from the court.

Reasons for the proposed condition

CAA's final proposals

2.112 In the final proposals, the CAA considered that the dispute resolution provision offered in the commitments addressed the CAA’s previous concerns around the airlines’ rights of redress and offered a suitable alternative to seeking redress through the courts for the adjudication of disputes.

Stakeholders' views

2.113 The airlines considered the drafting of the dispute process was not clear as it appeared to require either party to take disputes through the adjudication process before launching court proceedings (other than when seeking injunctive relief). They considered this was unreasonable and was not consistent with the 1996 Act. They noted that there may be occasions when there was no benefit in seeking non-binding adjudication.

2.114 The airlines also considered that the time limit of 90 days for bringing disputes to court after expert determination was unreasonable, given that, in normal contractual relationships, the limit would be 6 years. They stated that it would be very difficult to coordinate the airlines’ position and bring a dispute in such a short time period.

2.115 GAL responded to these concerns following its consultation on the COU and has amended the provisions to clarify that the dispute mechanism is optional.

CAA's response to the stakeholders' views

2.116 The CAA welcomes GAL’s amendment to make it clear that the dispute mechanism is optional.

2.117 The CAA considers that the limit on parties bringing disputes to court after expert determination is not unreasonable to ensure that once disputes have started they can be resolved in a timely manner. In such cases, the CAA considers that the facts of the case will have been gathered and the airlines would have already coordinated their position with regards to the dispute. A 90-day period is similar to the period in which parties must seek a Judicial Review so the CAA does not consider this is an unreasonable time limit. The CAA also notes that this provision does not limit the period in which the dispute can be referred to either the expert or the court in the first place, but only limits the ability to continue a dispute once it has started.

Operational resilience

The proposed condition as set out in the December 2013 commitments

2.118 GAL has committed, in consultation with relevant parties, to developing, publishing and maintaining an operational resilience plan setting out how it will operate an efficient and reliable airport to the levels required by the Core Service Standards or otherwise agreed with service providers and, in particular, how it will secure the availability and continuity of airport operation services, particularly in times of disruption. In developing this plan and associated documents, GAL will have regard to any relevant guidance issued by the CAA.

2.119 GAL will, so far as reasonably practical, coordinate and cooperate with all relevant parties to deliver this operational resilience commitment, including at least two meetings a year to discuss any issues pertinent to this commitment.

2.120 GAL also requires all airlines and groundhandlers to use all reasonable endeavours to cooperate in implementing the plans during periods of disruption. The CAA notes that, under the provisions of the commitments condition in the licence, these obligations on third parties are not considered to be licence conditions and as such are not enforceable by the CAA.

Reasons for the proposed condition

CAA's final proposals

2.121 Detailed reasons for requiring the inclusion of operational resilience provisions in the regulatory regime were set out in the initial proposals. In summary, examples of poorly managed events at airports generally over the last few years have shown that operational resilience is necessary as part of the wider industry framework for dealing with disruption. There needs to be a much more coordinated approach with the airport operator having a central role in planning and coordinating the industry's response. To achieve this, GAL should be required to plan for, and coordinate the wider industry response to, disruption. The CAA considers that, with good collaboration, clear expectations and plans setting out relevant roles and responsibilities, coupled with effective application of the denied boarding regulations, this will be a significant step forward towards a more efficient whole industry response. This is likely to be an on-going process that will need time to develop fully.

2.122 GAL included provisions in the September 2013 commitments along the lines the CAA had proposed as a licence condition in the initial proposals. In the final proposals, the CAA was concerned that the commitments included a requirement to have regard to, rather than comply with, any guidance issued by the CAA when developing operational resilience plans. The CAA considered that this could allow GAL to develop operational resilience plans that are not in passengers' interests.

2.123 The CAA also commented that the operational resilience provisions require airlines to comply with GAL's rules of conduct. The CAA considered that this could allow GAL to exert its SMP over airlines where this may not be in passengers' interests, for example by imposing inappropriate costs.

Stakeholders' views

2.124 The airlines were strongly opposed to the provision in the commitments that the airlines and groundhandlers must "take the actions allocated to them in [GAL's] plan(s) during periods of disruption" and noted the CAA's concern in the final proposals. They considered that the caveat that airlines must use "reasonable endeavours to cooperate with [GAL]" in the first part of the operational resilience commitment would not be enough to prevent GAL being able to dictate what the airlines must do.

2.125 The airlines also questioned whether GAL should be required to include details of how it will consult on its plans and to commit to more than one meeting a year.

2.126 GAL noted the airlines' request for more frequent meetings on operational resilience and said that operational resilience was as key to GAL as to the airlines so consultation on plans would take place as and when the parties considered it necessary. However, GAL has subsequently committed to consult twice a year. It said it was well aware of the requirements of proper consultation and did not see a need to include specific provisions in this area.

2.127 GAL was surprised at the CAA's concern about GAL requiring the airlines to comply with rules of conduct as this appeared to contradict the proposals in the draft licence in the initial proposals. However, it has removed the requirement from the commitments for airlines to take the actions allocated to them in its plans and replaced "all reasonable endeavours" with "best endeavours" to cooperate.

CAA's response to the stakeholders' views

2.128 The CAA is generally content with GAL's December 2013 commitments on operational resilience which, in setting out how GAL intends to run an efficient and reliable airport to the levels required by the Core Service Standards or otherwise agreed with service providers and how it will secure the availability and continuity of airport operation services, particularly during disruption, is consistent with the operational resilience condition proposed in the CAA's initial proposals. The CAA notes that GAL is still only committing to have regard to any guidance issued by the CAA rather than to comply with guidance. As neither the licence nor the commitments place any formal caveats with regards to consultation by the CAA before any guidance is issued[37], the CAA has accepted the commitments as proposed, but notes that, in the event of any enforcement action, the CAA will take into consideration the extent to which GAL has had regard to any guidance.

2.129 In both the initial proposals and the final proposals the CAA stated that operational resilience at airports needs strong, centralised leadership to coordinate planning for and response to disruption and it is clear that this role is best suited to the airport operator with its direct links to all the service providers at the airport. In requiring GAL to take on this responsibility and associated accountability, the CAA recognises that GAL needs to be able to set out reasonable

37 Although as good practice the CAA would normally consult before issuing such guidance.

expectations of what it requires from its partners in this area to ensure an effective whole industry response. As far as possible, these expectations should be developed jointly and agreed, on a voluntary basis but ultimately it should be up to GAL to understand the requirements of the airport and, as far as possible, its stakeholders during disruption and to take strong leadership decisions.

2.130 In the initial proposals, the CAA noted that resilience planning work has so far concentrated on closure of the runway due to bad weather or volcanic ash. However, disruption can also be caused by a number of other factors. The CAA would therefore expect GAL to have contingency plans for loss, for whatever reason, of:

- access to key infrastructure at the airport (such as the terminals, runway or airfield);
- IT systems;
- key suppliers; or
- key staff (including UK Border Force (UKBF)).

2.131 To clarify the expectations set out in the final proposals, the CAA notes that disruption can be caused by many different factors, including severe weather[38], industrial action, security incidents, cyber attack, accidents at the airport or even incidents at facilities remote from the airport upon which the airport relies[39]. CAA would expect to see that GAL has risk assessments for the infrastructure under its control and for all the services it offers at the airport, with clear management processes and clear communication plans in place for remedying and dealing with the impacts of loss of that infrastructure or service. These should also include dissemination of information to passengers and a provision of a 'backstop' level of passenger welfare where the airlines are slow or unable to do so. If these are in place, in the event of any investigation, the CAA would normally expect to concentrate on how well the company had reacted to, and managed the event. However, if the plans are not adequate, the CAA will take proportionate regulatory action, from requiring changes to the plans to taking enforcement action under the Act.

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38 For example, the flooding which caused disruption on Christmas Eve 2013.

39 For example, an accident at a major oil storage depot or disruption to the fuel pipeline could have a significant effect on fuel supply to the airport.

2.132 Where services are provided by a third party and GAL only acts as a landlord for the facilities (such as fuel supply or groundhandling services), the CAA would not expect GAL to have contingency plans for ensuring continuity of supply of those services but would only expect GAL to have plans for the effect that disruption to those services would have on its own operations.

2.133 In the initial proposals, the CAA also made it clear that, in order for resilience plans to work effectively, within the high-pressure environment caused by disruption, they must be underpinned by solid day-today- working relations, possibly through the development of formal business continuity models. It noted that the government's guidance on resilience[40] states that "business continuity management must be regarded as an integral part of an organisation's normal on-going management processes." Therefore, the requirement goes wider than times of disruption and the CAA would expect GAL to maintain clear working arrangements with relevant parties. The CAA notes that this will be addressed by GAL's commitments to have a plan setting out how it intends to run an efficient and reliable airport to the levels required by the Core Service Standards or otherwise agreed with other service providers.

2.134 With respect to the requirements on third parties to take the actions allocated to them in the plans, the CAA had concerns in the final proposals that the commitments as drafted could allow GAL to exert its SMP over airlines, particularly in a way that is not in the interests of passengers. This was because the airlines were required to take the actions allocated to them in the plans but these did not have the same safeguards that were included in the proposed licence condition For example, the proposed licence condition made clear that any ‘rules of conduct’ must be proportionate and relate specifically to the purpose of the licence condition to secure the availability and continuity of airport operation services to further the interests of passengers and that GAL must consult on any rules.

2.135 GAL’s December 2013 commitments largely follow the principles in the proposed licence condition. GAL will set out within the resilience plans the principles, policies and processes for securing the availability and continuity of airport operation services which it will

40 https://www.gov.uk/resilience-in-society-infrastructure-communities-and-businesses

develop in consultation with all relevant parties. The December 2013 commitments also require the airlines to use best endeavours to cooperate with GAL in implementing the plans, rather than requiring the airlines to comply (as was the case in earlier versions of the commitments). The CAA therefore no longer has concerns that GAL could use these provisions to exert its SMP over the airlines. However the CAA expects GAL to ensure that the actions are applied in a proportionate manner to the various airlines and groundhandlers.[41] In addition, the actions should not require airlines to do more than is required of them under other legislation, such as their welfare obligations under EU261.[42]

2.136 GAL has committed to having regard to any guidance issued by the CAA. The CAA considers that the preceding paragraphs constitute guidance on what expects GAL to include in its resilience plans. The CAA does not propose to issue further guidance at this stage, beyond what is included in this notice, but may do so if the need arises, for example following any recommendations from GAL's review of the disruption on Christmas Eve 2013. In addition to issuing guidance, the CAA considers that it should retain a right to be able to require GAL to review and revise the plan if it considered that the plan is likely to fall short of meeting the high level outcome or has been found wanting following practical experience. The CAA would seek to get GAL to make these changes voluntarily in the first instance but, if necessary, may use its powers under the Act to either modify the licence or to take formal enforcement action.

2.137 The licence requires GAL to comply in a manner designed to further the interests of passengers so the CAA could intervene if GAL exerted its SMP to the detriment of passengers. Furthermore, the CAA has concurrent powers under the Competition Act 1998 to address abuse, particularly where this results in a distortion of competition.

2.138 The requirements on third parties in the commitments to cooperate with GAL and to take the actions set out in the rules will not be a

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41 By proportionate, the CAA means proportionate to the requirements of an event as well as proportionate to the services offered by each stakeholder.

42 Regulation (EC) No 261/2004 of the European Parliament and of the Council of 11 February 2004 establishing common rules on compensation and assistance to passengers in the event of denied boarding and of cancellation or long delay of flights, and repealing Regulation (EEC) N0 295/91.

condition of the licence as the licence cannot put obligations on third parties. It will be up to GAL to decide how to conduct its relations with airlines so as to comply with its commitments and its licence requirements.

Financial conditions: regulatory accounts and continuity of service plan

The proposed condition as set out in the December 2013 commitments

2.139 The December 2013 commitments include a provision to publish detailed statutory accounts consistent with GAL's status as a UK registered company that will provide information for airlines, the CAA and other users of those accounts to undertake an analytical review of GAL's on-going business performance, capital investment and financial returns and to assess whether GAL's charges are reasonable. GAL will not publish separate regulatory accounts but to ensure a consistent approach, GAL will publish the same information in its accounts as was included in the 2011/12 statutory accounts with regards to the operating costs, revenues, fixed asset base, depreciation and capex.

2.140 GAL will publish the value of its asset base and the underlying assumptions. The CAA will ask GAL to undertake a shadow RAB calculation to use as part of its ongoing monitoring regime.

2.141 GAL will also provide to users of Specified Activities, PRM Services, Check-in & Baggage Storage Facilities,[43] and to the CAA, an annual statement of actual costs and revenues in respect of each of these activities for the previous financial year.

2.142 GAL has also committed to preparing and maintaining a continuity of service plan (CSP) describing the legal, regulatory, operational and financial information that an administrator, receiver or new management might reasonably be expected to require, including the aerodrome manual and any other statutory or regulatory documents that GAL is required to maintain. GAL will make such amendments to the form, scope and content of the plan as the CAA may reasonably require.

[43] As defined in the COU.

Reasons for the proposed condition

CAA's final proposals

2.143 The commitments offered in September 2013 included a requirement to publish the value of the asset base and the underlying assumptions and calculations. The CAA considered that this was not sufficient for the calculation of the RAB, which could be different to the statutory asset base for a variety of reasons. The CAA considered that the continued calculation of the RAB was important should any subsequent RAB-based regulation be required.

2.144 The CAA also noted that it would be possible for airlines to monitor prices, as the overall revenue from airport and other traffic charges will be available in GAL's statutory accounts. GAL is also committing to publish the cumulative revenue difference (including underlying actuals data) for both the blended and published charge basis. The CAA considered that this, together with reporting requirements under the ACRs, will provide airlines with sufficient information to challenge GAL's calculations should they wish to do so.

2.145 The CAA noted that a CSP is included in the commitments and this sufficiently addressed the CAA's concerns regarding continuity of service should GAL find itself in financial distress. The CAA considered that the benefits of including a licence condition in addition to the commitment are unlikely to outweigh the costs. The CAA therefore proposed that the licence does not include a condition in respect of a CSP.

Stakeholders' views

2.146 The airlines noted that GAL only proposed to publish a shadow RAB up to the 2016 review. The airlines did not consider this was adequate, stating that the CAA could intervene at any stage of the commitment period if necessary and therefore GAL should continue to publish the shadow RAB for the whole period. There were no comments from stakeholders on the CSP in response to the final proposals.

CAA's response to the stakeholders' views

2.147 The CAA has accepted GAL’s commitment to prepare a CSP and has not included a separate licence condition.

2.148 While GAL stated in its response that it would prepare a shadow RAB calculation for the CAA up to 2016, this is not included in the heads of terms of the commitments or the proposed COU. The CAA considers that it is important that GAL continues to undertake a shadow RAB calculation until it is considered that GAL no longer meets the MPT. This calculation will be useful in case tighter price control regulation needs to be reintroduced. The CAA will therefore continue to ask GAL to undertake a shadow RAB calculation throughout the commitments period, if necessary using its information powers under section 50 of the Act.

Part D: Financial Conditions

Financial resilience conditions

The proposed licence conditions

2.149 The following elements of the standard regulatory financial ring fence are included in GAL's licence:

- a requirement to provide an annual certificate of adequate resources;[44]
- a restriction on business activity;[45]
- an ultimate holding company undertaking;[46] and
- an obligation to report changes in the banking ring fence.

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44 GAL's company directors must annually certify to the CAA whether they expect to have (or not to have) adequate resources (including financial, staff and other resources) to continue to operate for the following 24 months. Where circumstances change, the CAA must be informed as soon as possible. The CAA proposed that this requirement can be designed to reduce any administrative burdens.

45 The proposed condition sets the restriction quite widely to cover 'the business activities of Gatwick airport'. The proposed condition also includes a de minimis qualification and/or provision for the CAA to grant exemptions, where this would be in passengers' interests.

46 The proposed condition places an obligation on GAL to obtain a legally binding undertaking from its ultimate holding company not to do anything that would place the Licensee in breach of the licence.

Reasons for the proposed licence condition

CAA final proposals

2.150 GAL included in early versions of the commitments:

- provisions which would require it to provide an annual confirmation of adequate resources to operate the airport and to give prior written notice to the CAA if it intends to amend, vary or supplement any of its finance documents in respect of credit rating requirements;
- a requirement to notify the CAA of any variations in the banking ring fence that relate to the credit rating requirement. However if the protection in the banking ring fence changes, in the absence of a licence, there would be nothing the CAA could do to replace that protection. This commitment therefore would only be effective if the commitments were underpinned by a licence; and
- a requirement for the directors to provide an annual certificate of adequate financial resources. There was no indication of the time period to be covered. Unless the certificate covers a period of at least two years then there is a risk that there would be insufficient time for remedial action to be taken if issues arose.

2.151 The early versions of the commitments did not include;

- a requirement to obtain a holding company undertaking. GAL questioned the benefit of a holding company undertaking given the ownership structure of GAL. The CAA considered that a holding company undertaking is required to prevent the airport operator from being open to pressure by a holding company to do something which is not consistent with passengers' interests. The CAA did not consider that GAL's current ownership, which could change during Q6, negates the need for this requirement;
- a restriction on business activities as GAL stated that the finance documents include a similar restriction. The CAA was concerned that the finance documents could change, and in the absence of licence protection, remove the protection to passengers.

2.152 Therefore, in the final proposals, the CAA included a separate condition in the licence relating to financial resilience. The CAA considered that the financial resilience conditions as set out in the final proposals continued to be appropriate in the absence of commitments that can address the CAA’s objectives robustly. The CAA considered that these set the right balance between the benefits and costs of facilitating resilience. However, the CAA acknowledged that some of these overlap with the commitments offered by GAL and to the extent that the commitments address the CAA's concerns then the benefits are unlikely to outweigh the costs of duplicating the commitments in the licence.

2.153 The CAA considered that the commitment given by GAL that it would notify the CAA of any changes in the banking ring fence relating to the credit rating was sufficient to meet the CAA's objective in this respect and does not need to be included in the licence.

2.154 However, the CAA did not consider that GAL's commitments were sufficient for other aspects of financial resilience.

2.155 While the commitments included an adequacy of resources certificate it did not state the future period to which this relates. The CAA considered that 24 months was appropriate as it gave the CAA adequate time in which to work with stakeholders and take any action that might be appropriate. The CAA therefore proposed that the licence includes a condition requiring a certificate of adequate resources that GAL will have sufficient resources to provide airport operation services at the airport for 24 months. The CAA included a requirement that alongside the certificate the licensee shall also submit a statement of the factors the directors have taken into account in providing that certificate. This will enable the CAA to assess better the certificate provided.

2.156 The commitments did not include an obligation for GAL to obtain legally binding undertakings from holding companies not to do anything that would cause GAL to breach its licence. The CAA considered that this was an important condition which went wider than just financial resilience. The CAA noted GAL's concerns about the appropriateness because of its corporate structure, but also noted that such an obligation is widespread in other regulated sectors where there is a range of corporate structures. The CAA stated that it would work with GAL to identify those companies in its corporate structure which would be required to give such an undertaking. The CAA proposed that the licence includes an obligation for GAL to obtain legally binding undertakings from holding companies not to do anything that would cause GAL to breach its licence.

2.157 The commitments did not include a restriction on the business activities of GAL. Although it is difficult to tightly define the business activities of an airport operator, the CAA saw merit in restricting GAL to operating Gatwick and prohibiting it from clearly unrelated activities. Other group companies would remain free to undertake whatever activities they wished. The CAA proposed to set the restriction quite widely to cover 'the business activities of Gatwick airport'. The CAA also proposes the inclusion of a de minimis qualification and/or provision for the CAA to grant exemptions, where this would be in passengers' interests.

Stakeholders' views

2.158 GAL questioned the CAA’s proposals to replicate the business restrictions in the licence when there are already debt covenants with similar restrictions. It suggested that all the necessary financial resilience conditions can be included in the COU. GAL remained of the view that it was not necessary to include a requirement to have an undertaking from an ultimate holding company, and this was not a useful or proportionate method of addressing the risk of excessive pricing or failure in service standards. It also considered that requiring a certificate of adequate resources for the next 24 months was not proportionate and suggested this should be 18 months instead.

2.159 The airlines suggested that the licence should require GAL to certify that it has adequate resources to deliver its core services rather than providing airport operation services as the CAA proposed in the final proposals. The airlines also suggested that GAL should remove the financial resilience conditions from its commitments to prevent conflict or confusion with the requirements of the licence.

CAA's response to the stakeholders' views

2.160 The CAA notes GAL's concerns with the adequacy of resources certificate requirement to be issued annually and covering 24 months. The CAA understands that GAL's banking and bond covenants require it to maintain 12 months' liquidity. However, the CAA's licence condition for adequate resources covers something slightly different - it is not a liquidity requirement but rather that management has the reasonable expectation that it has adequate resources, including financial and operational, for the next 24 months. This does not mean that it has to have cash in place today, for example, to redeem a bond in 23 months' time, but rather that it has the reasonable expectation that it will have resources in place in time. In effect, management would be confirming that they expect over the next 24 months that the business has sufficient resources to operate.

2.161 The licence condition also requires the licensee to bring to the attention of the CAA as soon as possible if it has reasons to believe that the latest certificate no longer holds true. Combined with the annual certificate this means that the CAA has early sight of any issues and can work with stakeholders to minimise any disruption or deterioration in service and thus act in passengers' interests.

2.162 The annual certificate covering 24 months means that the minimum oversight is approximately 12 months (i.e. the day before the next certificate is produced). If an annual certificate was provided covering only 12 months then towards the end of those 12 months the CAA would have very little forward visibility.

2.163 The CAA has considered whether an alternative formulation could meet its needs. Alternatives included:

- a certificate covering 12 months but produced quarterly;
- a 12 month certificate, but a requirement to assess whether the latest certificate still holds true if issued today;
- a requirement for a tougher requirement covering the first 12 months and a looser requirement covering the subsequent 12 months.

2.164 The CAA considers that none of these provide any material benefit to passengers compared to the CAA's proposals but all were more complex and/or burdensome than the final proposals.

2.165 The CAA also considers that the financial resilience licence conditions should be considered as a whole. Other regulated sectors, such as water, energy and NATS (En Route) plc, have more extensive financial resilience licence conditions and special administration regimes. For airports there is no special administration regime and the proposed resilience conditions do not go as far as other sectors (for the reasons explained in the initial and final proposals). As a consequence, the CAA needs to place greater reliance on this licence condition and therefore it is appropriate that it covers a longer period than found in some other sectors

2.166 The CAA considers that the definition in the Act of airport operation services in the airport area is wider than that of Core Services in the commitments and, as a new certificate is required annually, this would cover all the Core Services required in the coming year. The CAA has therefore not changed this obligation.

Other issues raised

"Insurer of last resort"

Stakeholders' views

2.167 In their response to the initial proposals, the airlines urged the CAA to remove GAL's unilaterally imposed condition in the COU relating to liability and replace it with a condition which would be present in any normal commercial relationship between a customer and supplier.

2.168 The airlines noted in their responses to the final proposals that the commitments still place the burden of "insurer of last resort" on the airlines. They contended this is inconsistent with normal commercial relationships where the supplier would have liability for direct costs incurred by its customers through the supplier's negligence or under performance. They also considered that the clause on waivers was too one-sided now that the commitments also placed obligations on GAL, and should be extended to all parties.

2.169 The CAA notes that GAL has now removed from the COU the condition requiring airlines to indemnify GAL against all costs etc arising from a breach of the COU or the requirements of any Managing Director's Instructions (MDI) or Gatwick Airport Directives. However, the clause regarding waivers remains pertinent to GAL only, rather than to all parties and the condition absolving GAL from all liability remains unchanged.

CAA's response to the stakeholders' views

2.170 The CAA notes the airlines' concerns about the clauses on waivers and liability, but notes that these are conditions of the existing COU and not part of the commitments that will also be licence conditions.

Summary of the proposed licence conditions

Part A: Scope and Interpretation

2.171 The CAA is proposing to include the core area of the airport (as defined in section 5(4) of the Act), but exclude the cargo and aircraft maintenance areas, in the airport area covered by the licence.

Part B: General Conditions

2.172 The CAA has not made any changes to the payment of fees condition or to the revocation condition, compared to those set out in the final proposals.

Part C: Price Commitment Conditions

2.173 The CAA is including a licence condition that incorporates the commitments and requires them to be included in the Gatwick Airport COU. GAL must comply with the commitments in a manner designed to further the interests of passengers, so far as reasonably practicable. GAL is restricted with regards to the changes that can be made to the commitments, and is restricted in the level of costs of a future second runway that it can pass through automatically to the airlines.

Part D: Financial Conditions

2.174 The CAA has included a financial resilience condition as set out in the initial proposals, and included a requirement to inform the CAA if GAL was to seek advice on insolvency.

Licence for GAL

2.175 The proposed licence is set out in Chapter 3.

CHAPTER 3

Proposed licence and conditions

Part A: Scope and interpretation of the Licence

A1 Scope

A1.1 The CAA has made a market power determination under section 7 of the Act on 10 January 2014 that means, for the purposes of section 3 of the Act, Gatwick Airport Limited (the Licensee) is the operator of a dominant airport area at a dominant airport.

A1.2 The Airport (as defined in sections 66 and 67 of the Act) is London Gatwick Airport.

A1.3 The Airport Area is those areas of the Airport, that comprise:

a) the land, buildings and other structures used for the purposes of the landing, taking off, manoeuvring, parking and servicing of aircraft excluding the aircraft maintenance facilities at hangar 6 maintenance area 1 and hangar 7 maintenance area 2; and

b) the passenger terminals.

A1.4 The CAA, in exercise of the powers conferred by section 15 of the Act, hereby grants to the Licensee this Licence authorising the Licensee and those persons listed in section 3(3) of the Act, to require a person to pay a relevant charge in respect of airport operation services that it provides at the Airport, subject to the conditions of this Licence.

A1.5 This Licence shall come into force on 1 April 2014 and shall continue in force until revoked in accordance with Condition B2 of this Licence.

A2 Interpretation

A2.1 Unless specifically defined within this Licence or in the Act or the context otherwise requires, words and expressions used in the Conditions shall be construed as if they were an Act of Parliament and the Interpretation Act 1978 applied to them. References to an enactment shall include any statutory modification or re-enactment thereof after the date of the coming into effect of this Licence.

A2.2 Any word or expression defined for the purposes of any provision of

Part I of the Act shall, unless the contrary intention appears, have the same meaning when used in the Conditions.

A2.3 Any reference to a numbered Condition or Schedule is a reference to the Condition or Schedule bearing that number in this Licence, and any reference to a paragraph is a reference to the paragraph bearing that number in the Condition or Schedule in which the reference occurs.

A2.4 In construing the provisions of this Licence, the heading or title of any Condition, Schedule or paragraph shall be disregarded.

A2.5 Where the Licensee is required to perform any obligation by a specified date or within a specified period and has failed to perform, such obligation shall continue to be binding and enforceable after the specified date or after expiry of the specified period, but without prejudice to any rights or remedies available against the Licensee under the Act or this Licence by reason of the Licensee's failure to perform by that date or within the period.

A2.6 The provisions of sections 74 and 75 of the Act shall apply for the purposes of the publication or sending of any document pursuant to this Licence.

A3 Definitions

A3.1 In this Licence:

a) the Act means the Civil Aviation Act 2012;

b) the CAA means the Civil Aviation Authority.

Part B: General Conditions

B1 Payment of fees

B1.1 The Licensee shall pay to the CAA such charges and at such times as are determined under a scheme made under section 11 of the Civil Aviation Act 1982 in respect of the carrying out of the CAA's functions under Chapter I of the Act.

B2 Licence revocation

B2 The CAA may revoke this Licence in any of the following circumstances and only in accordance with sections 48 and 49 of the Act;

(a) if the Licensee requests or otherwise agrees in writing with the CAA that the Licence should be revoked;

(b) if:

(i) the Licensee ceases to be the operator of all of the Airport Area; or

(ii) the Airport Area ceases to be a dominant area; or

(iii) the Airport ceases to be a dominant airport;

(c) if the Licensee fails:

(i) to comply with:

1. an enforcement order (given under section 33 of the Act); or

2. an urgent enforcement order (given under section 35 which has been confirmed under section 36); or

(ii) to pay any penalty (imposed under sections 39, 40, 51 or 52 of the Act) by the due date for any such payment,

where any such a failure is not rectified to the satisfaction of the CAA within three months after the CAA has given notice in writing of such failure to the Licensee, provided that no such notice shall be given by the CAA before:

(iii) the proceedings relating to any appeal under section 47 of the Act brought in relation to the validity or terms of an order or the CAA's finding or determination upon which it is based are finally determined; or (as the case may be);

(iv) the proceedings relating to any appeal under sections 47 or 55 of the Act brought in relation to the imposition of a penalty, the timing of the payment of the penalty or the amount of the penalty are finally determined.

Part C: The price commitment conditions

C1 Price commitments

C1.1 The Commitments are conditions of this Licence and shall be set out in the Conditions of Use.

C1.2 Obligations placed on third parties in the Commitments shall not be treated as conditions of this Licence.

C1.3 In complying with this Condition C1 and the Commitments the Licensee shall, so far as reasonably practicable, do so in a manner designed to further the interests of passengers regarding the range, availability, continuity, cost and quality of airport operation services.

Modification of the Commitments

C1.4 The Licensee shall not modify the Commitments otherwise than in the circumstances set out in the modification provisions of the Commitments.

C1.5 The modifications that can be made under Condition C1.4 are modifications set out in the modification provisions of the Commitments at:

(a) paragraph 6.1 of Schedule 2 to the Conditions of Use (price commitments);

(b) paragraph 6.2 of Schedule 2 to the Conditions of Use (pass through of second runway costs in the price commitments) up to a total limit of £10 million per annum;

(c) paragraph 5 of Schedule 3 to the Conditions of Use (service commitments); and

(d) the final paragraph in Schedule 3 Appendix I to the Conditions of Use (core service standards).

C1.6 Modifications can be made to the Commitments under Condition C1.4 at any time.

C1.7 Where the CAA makes any changes to the conditions of this licence under section 22 of the Act, the Licensee shall, as soon as reasonably practicable, make any necessary consequential changes to the Conditions of Use.

Pass through of second runway costs

C1.8 Where a provision in the Commitments at paragraph 6.2 of Schedule 2 to the Conditions of Use allows any amendments to the Indicative Gross Yield Profile to allow for the pass through of second runway costs, any such amendments over and above the £10 million allowed under Condition 1.5(b) shall be subject to the modification provisions under sections 22 to 30 of the Act.

C1.9 The CAA may, following consultation, issue guidance to the Licensee with regard to the pass through of second runway costs.

C1.10 Where the Licensee requires a modification to the Indicative Gross Yield Profile in accordance with Condition C1.8, it must inform the CAA in writing, setting out its reasons and justification for the modification in accordance with any guidance issued by the CAA under Condition C1.9.

Definitions

C1.11 In this Condition C1:

(a) the Commitments means the contractual obligations given by the Licensee to providers of air transport services at Gatwick Airport and in the case of certain obligations also to other service providers of Gatwick Airport as contained in the following provisions of the Conditions of Use as agreed by the CAA and to be effective from the date this Licence comes into force and as amended from time to time under Conditions C1.3 to C1.5 namely:

(i) Condition 2.1.2 of the Conditions of Use (Applicability and Enforceability of Conditions of Use);

(ii) Condition 2.1.3 of the Conditions of Use (Variation);

(iii) Conditions 2.1.12-2.1.21 of the Conditions of Use (Dispute Resolution);

(iv) Condition 5 of the Conditions of Use (Price Commitment);

(v) Condition 6 of the Conditions of Use (Service Standard Commitment);

(vi) Condition 7 of the Conditions of Use (Continuity of Service and Financial Resilience Commitment);

(vii) Condition 8 of the Conditions of Use (Investment and Consultation Commitment);

(viii) Condition 9 of the Conditions of Use (Financial Information Commitment);

(ix) Schedules 2, 3 and 4 to the Conditions of Use and associated appendices;

(x) Annex to the Conditions of Use (the Gatwick Airport Manual of Measurement of satisfaction, security queues and availability); and

(b) the Conditions of Use means the Gatwick Airport Conditions of Use, published by the Licensee;

(c) the Indicative Gross Yield Profile has the meaning set out in Paragraph 1.11 of Schedule 2 to the Conditions of Use; and

(d) the pass through of second runway costs means the recovery of reasonable costs (capital, operating and financing) of applying for planning permission for a second runway and the subsequent development of the second runway and associated airport infrastructure.

Part D: Financial Conditions

D1 Financial Resilience

Certificate of adequacy of resources

D1.1 The Licensee shall at all times act in a manner calculated to secure that it has available to it sufficient resources including (without limitation) financial, management and staff resources, to enable it to provide airport operation services at the Airport.

D1.2 The Licensee shall submit a certificate addressed to the CAA, approved by a resolution of the board of directors of the Licensee and signed by a director of the Licensee pursuant to that resolution. Such certificate shall be submitted within four months of the end of the Licensee’s financial year and shall include a statement of the factors which the directors of the Licensee have taken into account in preparing that certificate. Each certificate shall be in one of the following forms:

(a) “After making enquiries based on systems and processes established by the Licensee appropriate to the purpose, the directors of the Licensee have a reasonable expectation that the Licensee will have available to it, after taking into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid, any amounts of principal and interest due under any loan facilities and any actual or contingent risks which could reasonably be material to their consideration, sufficient financial and other resources and financial and operational facilities to enable the Licensee to provide airport operation services at London Gatwick Airport of which the Licensee is aware or could reasonably be expected to make itself aware it is or will be subject for a period of two years from the date of this certificate.”

(b) “After making enquiries based on systems and processes established by the Licensee appropriate to the purpose, the directors of the Licensee have a reasonable expectation, subject to what is said below, that the Licensee will have available to it, after taking into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid, any amounts of principal and interest due under any loan facilities, and any actual or contingent risks which could reasonably be material to their consideration, sufficient financial and other resources and financial and operational facilities to enable the Licensee to provide airport operation services at London Gatwick Airport of which the Licensee is aware or could reasonably be expected to make itself aware it is or will be subject for a period of two years from the date of this certificate. However, they would like to draw attention to the following factors which may cast doubt on the ability of the Licensee to provide airport operation services at London Gatwick Airport for that period……..”

(c) “In the opinion of the directors of the Licensee, the Licensee will not have available to it sufficient financial or other resources and financial and operational facilities to provide airport operation services at London Gatwick Airport of which the Licensee is aware or of which it could reasonably be expected to make itself aware or to which it will be subject for a period of two years from the date of this certificate.”

D1.3 The Licensee shall inform the CAA in writing as soon as practicable if the directors of the Licensee become aware of any circumstance which causes them no longer to have the reasonable expectation expressed in the then most recent certificate given under Condition D1.2(a) or (b).

D1.4 The Licensee shall obtain and submit to the CAA with each certificate provided under Condition D1.2 a report prepared by its Auditors stating whether or not the Auditors are aware of any inconsistencies between, on the one hand, that certificate and the statement submitted with it and, on the other hand, any information which they obtained during their audit of the relevant year end accounts of the Licensee.

D1.5 If the Licensee or any of its linked companies (or, where applicable the directors and officers of any of those undertakings) seeks, or is advised to seek, advice from an insolvency practitioner or any other person relating to:

(a) the Licensee's financial position or ability to continue to trade; or

(b) that linked company's financial position or ability to continue to trade, only to the extent that it would affect the Licensee's financial position or ability to continue to trade, the Licensee must inform the CAA within 3 working days.

Restriction on activities

D1.6 The Licensee shall not, and shall procure that its subsidiary undertakings shall not, conduct any business or carry on any activity other than:

(a) the Permitted Business; and/or

(b) any other business or activity for which the CAA has given its written consent for the purposes of this Condition, such consent not to be unreasonably withheld or delayed.

Ultimate holding company undertakings

D1.7 The Licensee shall procure from each Covenantor a legally enforceable undertaking in favour of the Licensee in the form specified by the CAA that that Covenantor will:

(a) refrain from any action, and procure that every subsidiary of the Covenantor (other than the Licensee and its subsidiaries) will refrain from any action, which would then be likely to cause the Licensee to breach any of its obligations under this Licence;

(b) promptly upon request by the CAA (specifying the information required) provide to the CAA (with a copy to the Licensee) information of which they are aware and which the CAA reasonably considers necessary in order to enable the Licensee to comply with this Licence.

D1.8 Such undertaking shall be obtained within seven days of the company or other person in question becoming a Covenantor and shall remain in force for so long as the Licensee remains the holder of this Licence and the Covenantor remains a Covenantor.

D1.9 The Licensee shall:

(a) deliver to the CAA, within seven days of obtaining the undertaking required by Condition D1.8, a copy of such undertaking;

(b) inform the CAA as soon as practicable in writing if the directors of the Licensee become aware that the undertaking has ceased to be legally enforceable or that its terms have been breached; and

(c) comply with any direction from the CAA to enforce any such undertaking.

Definitions

D1.10 In this Condition D1:

(a) the Covenantor means a company or other person which is at any time an ultimate holding company of the Licensee;

(b) a linked company means any company within the Licensee's Group where the financial position of that company or its inability to continue to trade would have an adverse effect on the Licensee's financial position or ability to continue to trade;

(c) Permitted Business means:

(i) any and all business undertaken by the Licensee and its subsidiary undertakings as at 1 April 2014;

(ii) to the extent that it falls outside Condition D1.10(c)(i), the business of owning, operating and developing the Airport and associated facilities by the Licensee and its subsidiary undertakings (including, without limitation, any and all airport operation services, provision of facilities for and connected with aeronautical activities including retail, car parks, advertising and surface access and property development letting and management development thereof); and

(iii) any other business, provided always that the average over the term of the Commitments of any expenses incurred in connection with such businesses during any one financial year is not more than 2% of the value of the shadow RAB at the start of the financial year.

CHAPTER 4

A monitoring framework for GAL's commitments

4.1 This chapter sets out the monitoring framework that the CAA proposes to introduce alongside the licence to monitor the impact of the commitments.

CAA's final proposals

4.2 While recognising that GAL had gone a long way to addressing the CAA's concerns with the commitments, the CAA stated that a number of concerns remained, which it considered would be best addressed through a monitoring framework in addition to the proposed licence conditions. The proposed monitoring framework involved:

- a short focused assessment of the performance of the commitments in the second half of 2016, after seeking stakeholders' views;
- a requirement for GAL to continue to publish a shadow RAB calculation;
- an expectation for GAL to publish service quality performance on its website and in the terminal and an expectation that the measurement of the service quality regime was undertaken in passengers' interests;
- a commitment to investigate any service quality failures that persist for more than six months;
- a commitment to consider the treatment of the costs of a second runway early in Q6 and if GAL did not follow CAA policy then the CAA would actively consider a licence amendment;
- a commitment to monitor charges for non passenger aircraft,

- an expectation that the monitoring and licensing framework would evolve over time, with the monitoring regime scaled back if the commitments are operating in passengers' interests and GAL develops good relationships with airlines, but if they are not then the CAA stated it would consider imposing additional licence requirements.

4.3 The CAA subsequently proposed to introduce licence conditions to address airline concerns around second runway costs and premium charges.

Stakeholders' views

4.4 In its response to the final proposals, GAL has further sought to address the CAA's concerns with the commitments, in particular around second runway costs and premium service charges. These issues are discussed in more detail in the licensing chapter.

4.5 GAL asked for clarification in two areas of the monitoring framework.

- The scope of the review of the performance of the commitments in the second half of 2016, where GAL raised concerns that the review could undermine the long-term nature of the commitments framework and requested the review focused on the areas of concern identified by the CAA (to the extent that they had not been addressed in the revised commitments). GAL also stated that following the review it may also be an appropriate time to consider removing the licence. GAL committed to calculating a shadow RAB up to this date only.
- The way in which the CAA intends to allow the recovery (or otherwise) of second runway costs, where GAL stated that it is prepared to commit to follow CAA policy in this area on the understanding that the policy statement will be issued in early 2014 and GAL recognised that:
  - it is unlikely that the CAA would end up with a policy that deterred promoters from taking forward any efficiently developed scheme recommended by the Airports Commission, given that provision of any additional capacity which the Commission recommends is likely to be in the in the interests of passengers;

- If the CAA made it impossible for GAL to develop a viable business case for a second runway at Gatwick, GAL would not proceed with the development of such a scheme.

4.6 The ACC stated that the 2016 review should consider whether the commitments are operating in passengers' interests. The ACC also considered that the CAA needed to be sure that the commitments were operating in passengers interests throughout the period and so the CAA should continue to retain the ability to impose a RAB-based price control if necessary. Consequently GAL should maintain the shadow RAB calculation throughout the period.

CAA's final view

4.7 The CAA maintains its view that passenger benefits can flow from the flexibility of the commitments, and the scope they offer to develop bilateral contracts that tailor the airport operator's offering to the needs of individual airlines, combined with the licence. CAA recognises that GAL has addressed many of its and airlines' concerns around the commitments. The CAA has also gone some way to addressing airlines' concerns around a second runway through the introduction of a new licence condition.

4.8 Part and parcel of this optimistic view is a recognition that significant uncertainty remains about how the framework will evolve - this is inevitable in a framework that can respond to commercial developments. The CAA is resolute that it will step in to protect passengers' interests should this become necessary. The CAA therefore intends to implement a monitoring framework.

4.9 Particular areas that the CAA intends to keep under review (and which the CAA has so far not addressed through licence conditions, although it could if it was in passengers' interests) include:

- the price in the commitments which is currently above the CAA's fair price benchmark;
- the SQR particularly looking at repeated service quality failures;

- the capital plan which includes no commitments to deliver specific outputs beyond a minimum average spend of £100 million per year, so GAL could fail to deliver outputs that are in passengers' interests;
- the commitments do not include a requirement to publish the value of the RAB; and
- the operational resilience commitment only 'has regard to' guidance issued by the CAA.

4.10 The CAA has considered whether it would be appropriate to introduce licence conditions on these issues. However, in some cases this would cut across the flexibilities that are the principal benefit of the commitments, for example in terms of capex. In other areas this could add significantly to complexity, for example if SQR levels were set in the licence but the other price control conditions were in the commitments. Consequently the CAA sees merit in monitoring performance of the commitments to ensure that they are promoting passengers' interests and addressing the particular issues highlighted above.

4.11 The CAA does not agree with GAL that the review of the commitments should focus solely on the issues identified by the CAA. Given the flexibilities in the commitments there may be a number of issues that might arise during their operation that it is not possible to predict in advance. Consequently the CAA considers that monitoring reviews should consider whether the commitments and licensing and monitoring framework are operating as a whole in passengers' interests.

4.12 The CAA continues to consider that it will be important for the regime and airport operator/airline relationships to bed down and would therefore not expect to undertake monitoring in the first year of the new regime, apart from the issues identified below. Consequently, the CAA does not intend to initiate a review until the second half of 2016, when the CAA intends to ask stakeholders for views and undertake a short and focused assessment of the performance of the commitments, and publish its findings. However should concerns emerge beforehand that are of sufficient seriousness, the CAA may undertake a monitoring review before the second half of 2016.

4.13 One area where the CAA considers that annual monitoring is appropriate is around pricing. As set out in Appendices H and I, there is a 1.6% per year difference between the CAA's 5-year fair price benchmark of RPI-1.6% per year (over five years) and GAL's blended price (the most appropriate comparison) of RPI+0% per year. However, the CAA recognises that the prices actually paid by airlines will be determined by a number of factors. Given the importance of price to passenger welfare, the CAA will monitor GAL's prices annually. When monitoring prices the CAA will take into account any material reasons for differences between prices and the fair price benchmark, for example the level of capex. If prices are above the fair price benchmark then the CAA will consider action under the licence, which could include introducing additional licence conditions to restrain prices, or to place conditions on GAL's ability to alter the structure of charges (for instance, this could restrict GAL's ability to minimise the overall level of discounts, which are typically on winter charges).

4.14 The other area where the CAA will undertake annual monitoring is on service quality. In its latest version of the commitments GAL has committed to the publication of a report on the achievement of airport wide standards on its website and in the terminals. The CAA would expect such publication to include performance against standards and any rebates paid. While in general the CAA would expect service quality monitoring to be carried out by airlines, the CAA considers that it should undertake sufficient monitoring to identify whether GAL fails an individual metric for more than six months. If GAL fails an individual metric for more than six months then service quality rebates can reduce to zero and CAA would expect to undertake an investigation into the failure to identify whether any enforcement action is required.

4.15 One area where GAL had yet to finalise the commitments in advance of the CAA's decision on the commitments is on the service quality measurement regime and the level of the targets on pier service. The CAA would expect that GAL will reach agreement with airlines (through the ACC) on these matters. If agreement cannot be reached, the CAA will make a decision on any outstanding issues and may implement that decision using its powers under section 22 of the Act.

4.16 Although GAL does not believe it is necessary, in its response GAL states that it will prepare a shadow RAB calculation for the CAA as part of its ongoing monitoring regime, up to the review scheduled for 2016. The CAA considers that it is important that GAL continues to undertake a shadow RAB calculation throughout the commitments period unless it is considered that GAL no longer meets the MPT. This calculation will be useful in case tighter price control regulation needs to be reintroduced. Although as stated in the final proposals there should be no presumption that the CAA would use the shadow RAB number as the basis for any future RAB-based price control. To this end the CAA has included the framework for the shadow RAB calculation in Appendix J. If the CAA were setting a price control in the future, and were considering whether to include capex in the RAB calculation the CAA would continue to use the twin test of: efficient project management and consultation in line with the requirements in the commitments.

4.17 The CAA has decided not to include explicit separate monitoring on the prices charged to cargo operators. There were only 8 dedicated cargo flights at Gatwick in 2012 and the CAA has not found that GAL has SMP in this market. The CAA therefore considers monitoring in this area would be unnecessary and disproportionate.

4.18 The CAA would expect the monitoring regime and to some extent the licensing regime to evolve over time. If GAL can develop good relationships with airlines and the flexibilities within the regime are operating in passengers' interests then the CAA considers that this could lead to a scaling back in the CAA's monitoring of the commitments. Contrary to GAL's request the CAA does not consider that it would be appropriate to commit to undertaking a new market power assessment at this stage. Given the recent completion of the assessments and the scale of resources and time involved, the CAA considers that a new market power assessment should only be undertaken if there is a material change in circumstances.

4.19 If the commitments are not operating in passengers' interests and relationships with airlines are poor then the CAA can, as appropriate, use its enforcement powers and/or impose additional licence requirements through the modification process as set out in the Act. This should address the risks that the flexibilities within the proposed regime are not working in passengers' interests.

APPENDIX A

The calculation of the fair price

Final proposals

A1 The final proposals calculated a fair price based on the maximum average level of GAL’s airport charges, using a single till RAB calculation. The CAA intended that this would act as a counterfactual for the assessment of alternative forms of regulation including GAL’s commitments to airlines. In the absence of acceptable commitments, the CAA intended that this calculation could be used as the basis for setting a price cap for Q6.

A2 In the final proposals the CAA made the following statements in response to criticisms from GAL that the CAA's fair price calculation was flawed.

- The concept of a fair price was consistent with the CAA’s general duty to further the interests of passengers by ensuring that, in aggregate, the charges paid by passengers are consistent with the average net costs of those services, while maintaining a suitable level of service quality and an appropriate range of airport operation services.
- In regulating airport charges the CAA would expect that, to some extent, the difference between the regulated price and the market clearing price would be passed on from airlines to passengers through competition in the airline market. If charges were not regulated then airport operators would retain the difference between costs and charges without any discernible benefit to passengers. The CAA noted that its approach was consistent with the CC's final report on the market review into BAA, which for example stated that
- "Even under separate ownership, moreover, as a result of capacity constraints, competition in the short term may focus on particular types of traffic, for example in off-peak periods, and therefore be unlikely to be sufficiently effective to substitute for regulation." (paragraph 6.87)

- The use of a single till RAB-based approach for calculating the fair price provided a cost-based price which mimicked what would happen in a fully functioning competitive market and was consistent with the approach commonly used across many regulated sectors. It was also consistent with the approach used by the CC in calculating price caps for Q4 and Q5.
- The concept of a fair price would not be detrimental to future passengers, as the interests of future passengers are likely to emerge as similar to those of current passengers. This was also because most future passengers will be people that already fly. While over time the needs of passengers may change, in a competitive market airlines would need to respond to these changes to maximise their profits.

Responses to the final proposals

A3 In response to the final proposals, GAL raised the following concerns with the CAA's concept of the fair price:

- The CAA has not addressed the concerns raised by GAL in its response to the initial proposals, in particular;
  - the CAA has not demonstrated the transmission mechanism where lower airport charges would feed through into lower air fares to passengers; and
  - the CAA has not demonstrated that the current practice of artificially constraining prices below what GAL considers as competitive levels could lead to passenger detriment, as such an approach allows potentially sub-optimal slot allocations to endure;
- the concept of the fair price does not focus on the benefits to passengers and other levels of price could benefit passengers to an equal or greater extent and so the fair price is an inappropriate benchmark against which to assess alternative forms of regulation; and

- the CAA has presented no real evidence that any price above the fair price should be considered excessive and that a reduction in airline profitability at Gatwick would lead to a reduction in travel opportunities, higher ticket prices or reduced service quality, and GAL provided a report from Compass Lexicon (CL) which set out concerns with the SLG Economics (SLG) report for the CAA and in particular whether reductions in airport charges would be passed on to users:
  - airlines at Heathrow and Gatwick are capacity constrained (which GAL stated was based on the CAA's market power assessment) and so would not have an incentive to pass on reductions in airport charges;
  - even if airlines are not capacity constrained a reduction in airport charges would not impact on the optimal fare;
  - empirical evidence does not show that airlines have been passing on reductions in cost;
  - rising passenger numbers mean that falling air fares reflect a relaxation of capacity constraints at Gatwick;
  - increases in airport charges will lead to airlines switching airports;
  - sunk costs will not stop airlines from switching airports; and
  - the secondary slot market may not be efficient and so airport slots will not be held by airlines that value them most.

A4 GAL also raised concerns with the evidence used by the CAA in its calculation of the fair price which are set out later in this chapter.

A5 BA provided a report by RBB Economics (RBB) which raised concerns with the CL report for GAL. RBB considered that the CL report was fundamentally incorrect as it had misunderstood standard economics and the reality of the airline industry. In particular RBB stated that:

- airport charges were likely to be passed onto passengers as airlines do not face a vertical supply curve and fares will respond to changes in marginal costs;

- airline switching would be insufficient to prevent GAL from exercising SMP, as airline profitability will be much less significantly affected if changes in airport charges are passed through to passengers;
- allowing airport operators freedom of pricing will not deliver efficient outcomes as this would lead to increased fares. Secondary trading of slots has been successful in improving capacity utilisation, increasing the mobility of slots between airlines and allowing new entry on some routes.

A6 GAL provided a further response from CL, which raised the following concerns with the RBB report:

- RBB did not address other reports published by CL in particular reports on airline switching and the distribution of rents between airport operators and airlines, which it assumes that RBB has not seen;
- RBB focuses on the experience and position of BA, where easyJet may be more representative of GAL's customer base;
- RBB argues that capacity can be increased by an increase in aircraft size and if this is the case then neither Heathrow nor Gatwick would be capacity constrained;
- CL stated that it agreed that if prices raised above market clearing levels then it would expect airlines to reduce demand but this is not relevant to the SLG report, which considers whether an increase in charges above current levels would be passed onto passengers;
- while accepting that changing the size of an aircraft is a complex commercial decision, it was not clear to CL that reducing aircraft size in response to an increase in airport charges would be a rational response;
- it was not clear why an airport operator would increase variable rather than fixed charges if this would feed through into higher fares, causing passengers to switch away;

- CL state that GAL would not increase prices to monopoly levels, not least as it has put forward a set of voluntary commitments to address any concerns over prices and faces competition from at least all other airports in London and most likely from airports across Europe;
- CL state that other airlines face different options to BA, and for example easyJet could switch aircraft to Stansted where spare capacity exists, or even BA could switch aircraft to Madrid which has spare capacity and is a base for the International Airlines Group (IAG) operations;
- CL state that an increase in airport charges (if it occurred) would not lead to an airport being built in the short run, but this was not its argument which was that prices are currently below market clearing levels and if prices were deregulated then prices would be set at a level which reflects the demand for their services and would be constrained from competition from airports both within London and throughout Europe that have spare capacity; and
- CL agreed that slot trading has undoubtedly led to an improvement in the allocation of slots but it cannot be assumed that this will lead to an optimally efficient allocation, for example as airlines will act strategically.

Key issues

The CAA's response to GAL's previous concerns

A7 The CAA set out its response to GAL's previous concerns in the final proposals. Subsequent to its response the CAA asked GAL to clarify where the CAA had not addressed its previous concerns. GAL has not provided any further details in addition to its response. The CAA considers that it has adequately addressed GAL's earlier concerns (as set out briefly above and in paragraphs 2.4 to 2.29 of the final proposals).[47]

[47] CAA, October 2013, Economic regulation at Gatwick from April 2014: final proposals, http://www.caa.co.uk/docs/33/CAP1102.pdf

The concept of the fair price and the impact on passengers

A8 As set out in the final proposals the CAA considers that the concept of the fair price benefits passengers and is consistent with its statutory duties. The CAA considers that the fair price based on a single till RAB approach sets airport charges in relation to costs and mimics what would happen in a fully functioning competitive market. GAL does not set out how other levels of, presumably higher, prices could serve passengers interests to an equal or greater extent. This is particularly so when the fair price is for a minimum level of service quality with airlines able to purchase higher service quality if their passengers demanded it. The CAA notes that, as set out in the final proposals, prices above the fair price (for a minimum level of service quality) are likely to benefit the airport operator rather than passengers. In particular as new runway capacity is effectively exogenous, any increase in charges above the competitive level is unlikely to lead to additional airport capacity but to increased profits to the airport operator, with no discernible benefits to users. This is likely to be the case for the duration of this price control, with no new runway capacity likely to be available in that time.[48]

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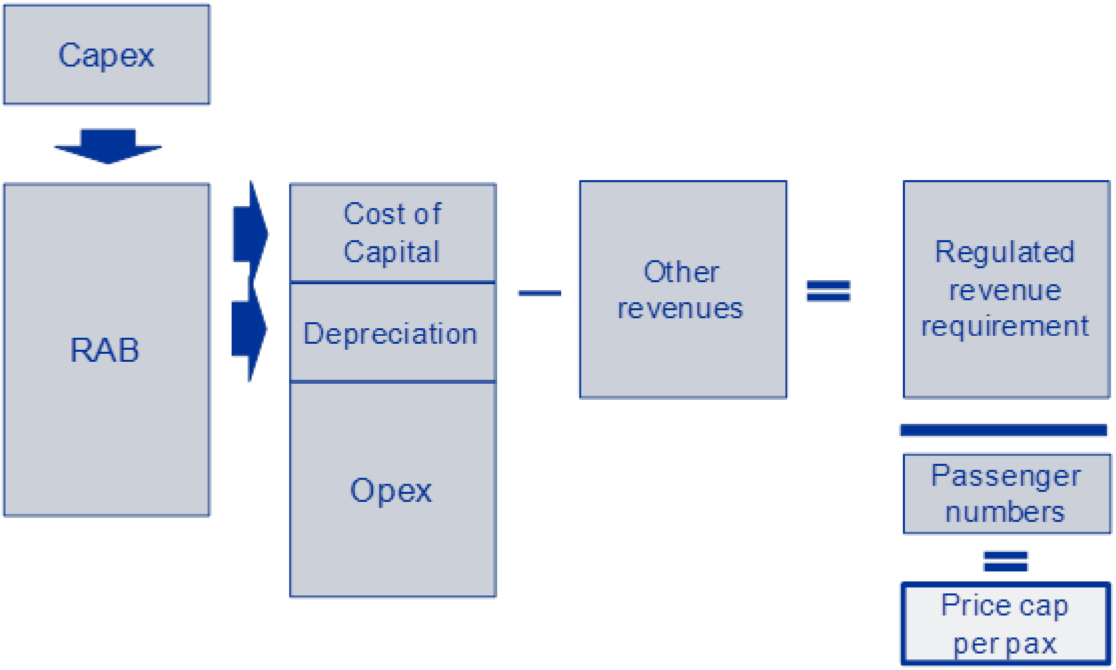
48 See Gatwick proposals for a second runway, which state that this could be open by 2025. http://www.mediacentre.gatwickairport.com/News/A-second-runway-at-London-Gatwick-is-theaffordable-sustainable-and-deliverable-solution-80b.aspx

Heathrow's proposals for a third runway are forecast to deliver extra capacity between 2025 and 2029, with a statement that a new hub at Stansted or in the Thames estuary would not be delivered until at least 2032. http://mediacentre.heathrowairport.com/Press-releases/Heathrow unveils-a-new-approach-to-third-runway-5e2.aspx

Figure A.1: RAB-based building blocks



Source: CAA

A9 The CAA has asked SLG to review the concerns raised by CL on whether reductions in airport charges would be passed on by airlines to passengers in terms of lower air fares. The responses of SLG and RBB to the issues raised by CL on the SLG report are set out below.

- CL's view that airlines are capacity constrained. SLG stated that average load factors at both Heathrow and Gatwick had scope for further improvement, with increases in load factors seen at both airports over the last five years, and so airlines were not capacity constrained.

- CL's view on the impact of a reduction in charges on the optimal fare. SLG stated that 73% of airport charges at Heathrow and 65% of airport charges at Gatwick were per passenger and so affected the marginal cost and the optimal fare. Other elements of airport charges also affected fares as they impacted on per aircraft costs which put upward pressure on the per passenger margins in airline yield management systems. RBB stated that the majority of airport charges at Gatwick were on a per passenger basis accounting for between 55% in the peak and 96% in the winter off peak of total airport charges, and, as CL had stated, standard economic theory would mean that fares will respond to changes in marginal cost. RBB noted that this was the case even if there was no competition on a route.
- CL's view that if variable airport charges impacted on fares then an airport operator would focus increases in airport charges on the fixed element of charges. SLG stated that airlines will want to ensure that the revenue from passengers on an aircraft will cover the costs of that aircraft and so per aircraft charges will put an upward pressure on the minimum per passenger margins. SLG also stated that it was unlikely that just by restructuring charges from a per passenger to a per aircraft basis airport operators would be able to increase charges indefinitely with no impact on fares as CL seemed to suggest. The CAA notes that between 2005/06 and 2012/13 GAL's real per passenger charges increased by around 30% and HAL's by over 100%.
- CL's statement that airline aircraft size decisions were a complex commercial decision and it was not clear that reducing aircraft size would be a rational response to an increase in airport charges as it may have higher variable costs. SLG stated that the decision to alter an aircraft is taken at an aircraft rather than passenger level and is therefore based on the average rather than purely variable costs of the aircraft.

- CLs' view that the empirical evidence does not show airlines have been passing on falls in costs. SLG stated that real per passenger revenues and costs have fallen at both BA and easyJet and for Virgin real fares have risen slower than costs. SLG state that evidence points to passenger demand growing faster than air fares and costs and competitive pressures in the airline market have led to cost reductions being passed through to passengers as lower fares.
- CL's statement that easyJet may be more representative of GAL's customer base than BA and easyJet will have less opportunity to increase aircraft size as it operates a less diverse aircraft fleet. SLG agreed that there may be less opportunity to increase both capacity and load factors at Gatwick than Heathrow due to the lower proportion of full service carriers, however this has not stopped seat and passenger load factors from increasing at both airports. In addition SLG cited the recent purchase of the Flybe slots by easyJet which will increase average aircraft size.
- CL's statement that rising passenger numbers mean that falling air fares reflect a relaxation of capacity constraints. SLG pointed to evidence at Heathrow and Gatwick which showed that passenger numbers have increased faster than the number of flights, which suggested that it is airline behaviour rather than airport investment that has increased capacity. Furthermore SLG stated that the use of price controls is to constrain the SMP of Heathrow Airport Limited (HAL) and GAL in the relevant market in which they operate.
- CL's statement that it was unclear whether RBB had considered CL's previous report on how capacity constraints affect the distribution of economic rents between airport operators and airlines. SLG reviewed this report and stated that the empirical position of the airlines at Gatwick is in between the extreme positions of no capacity constraints and total capacity constraints. SLG stated that where there are firm capacity constraints there are still opportunities to increase aircraft size and load factors. As a result depending on the degree of competition between airlines, some of the change in airport charges is likely to feed through to passengers.

- CL's concerns over the efficiency of the secondary slot market. CL claimed that strategic considerations prevented the secondary slot market from operating efficiently. SLG did not agree that there was a sub-optimal use of capacity at Heathrow and Gatwick, citing the relatively rare use of slots by smaller aircraft and the fact that slot coordinators take account of the potential use of slots when allocating capacity. Both SLG and RBB cited the European Commission Impact Assessment on secondary trading of slots which found that secondary trading at London airports had been successful in improving capacity utilisation. RBB further stated that the same study found that in 2010 39% of the slots at Gatwick were operated by a different airline to that which operated the slots in 2007, indicating a liquid and active secondary trading market. In response CL stated that the secondary slot market was not fully efficient as airlines may act strategically. SLG agreed that there may be imperfections in the operation of the secondary slot market but optimal efficiency was not required for competition to have an effect.

A10 SLG did not consider in detail CL's and RBB's comments on the potential for airlines to switch. The CAA has considered the potential for airlines to switch in detail in the CAA's MPT in relation to Gatwick (and Heathrow). The CAA found that airline switching is unlikely to constrain a 5 to 10% rise in current airport charges at either Gatwick or Heathrow.

A11 In response to the revised SLG report GAL raised a number of further concerns. These concerns are set out below together with the CAA's response.

- GAL expressed surprise that the SLG report compares the economic regulation of airports with the regulation of railways. The CAA does not consider that its approach to regulating airports, for example the use of a RAB-based approach to setting price controls, is markedly different to the approach used by other economic regulators, including rail. In addition the CAA does not consider that GAL's example of spectrum market regulation is a good comparator to airports not least due to the impact of government policy on privately held runway capacity in the south east.

- GAL stated that the SLG report does not acknowledge that the CL reports were provided on the basis that the CAA's view of binding capacity constraints is correct. The SLG report explicitly recognises that runway capacity at both Heathrow and Gatwick is severely constrained.[49] The CAA does not consider that runway capacity constraints are the same as the capacity constraints on airlines which can, to some extent, increase aircraft size and load factor even though there are runway constraints. However increases in airline capacity would not exercise the same constraint on GAL's market power as the relaxation of runway capacity constraints as it would not allow airlines to threaten to move their services to Heathrow (or vice versa).
- GAL did not consider that the revised SLG report substantiates the conclusions reached in the previous SLG report. The CAA rejects this. The revised SLG report reaches the same conclusion as the earlier report, that, to some extent, passengers are likely to see the increase (or reduction) in airport charges feed through into higher (or lower) fares. The revised SLG report provides additional empirical evidence to support this statement.
- GAL stated that the SLG report does not explain why airlines operating in a capacity constrained environment would increase fares in the event of an increase in airport charges particularly if such an increase impacted on airlines fixed costs. The SLG report sets out how it considers changes in both fixed and variable airport charges will impact on fares. The CAA notes that competition in the airline market under runway capacity constraints is imperfect and it would expect airlines to consider changes to fixed as well as variable costs in setting fares otherwise airlines would not generate sufficient income to remain in business.

49 SLG, September 2013, Q6 review of the distribution of economic rent between airport, airlines and passengers and cargo users at Heathrow and Gatwick, Page 6. http://www.caa.co.uk/docs/78/Review%20of%20distribution%20of%20economic%20rent%20-%20final%20report.pdf

- GAL stated that an increase in charges towards the competitive level would make the most marginal routes no longer profitable, but in a market with excess demand, this would make capacity available for new routes with a higher willingness to pay and hence deliver more optimal use of scarce capacity. The CAA considers that the SLG report has considered this point and in particular the efficiency of the secondary slot market.
- GAL stated that the SLG report claimed that low cost carriers would not switch due to sunk costs. This is incorrect. The SLG report states that "unless the airport price rise was very significant, it is unlikely that it would prompt the airline to switch to other airports given the sunk costs involved in their existing investments and the one-off costs involved in switching."
- GAL stated that the empirical evidence presented by SLG did not substantiate that fares at Gatwick have fallen, and certainly not in recent years. In addition GAL stated that the data used by SLG was mostly for Heathrow, did not cover all airlines and did not control for changes in journey length. The airlines analysed by SLG are BA, Virgin and easyJet. Together these airlines cover over 50% of passengers at both Heathrow and Gatwick.[50] The SLG analysis took account of journey length by normalising revenues and costs per kilometre. The SLG analysis shows that prices have not fallen as swiftly as costs (for BA and easyJet) although this was not the point being challenged in the original CL report which was whether prices and costs have fallen over the last ten years. The SLG analysis confirmed that both prices and costs have fallen for both easyJet and BA (whose largest bases are Gatwick and Heathrow respectively) and the reductions in both have been similar. For Virgin prices have risen slower than costs.

[50] CAA statistics 2012, includes British Midland for Heathrow and flybe for Gatwick given the recent acquisitions.

- GAL stated that the SLG report appeared to imply that 17% of flights using small aircraft was a small proportion. GAL considered that this was a significant proportion of flights using smaller aircraft and this demonstrated that there was additional capacity in the south east. The CAA notes that the figures quoted by SLG were the number of passengers rather than the number of flights using smaller aircraft and were for 2012 and included Flybe. In 2012 Flybe made up around 20% of passengers using smaller aircraft and an even greater proportion of the passengers using the smallest type of aircraft for example those under 50 tonnes maximum take-off weight. Consequently given easyJet's acquisition of the Flybe slots the number of passengers on smaller aircraft is likely to reduce going forwards.

A12 The CAA has considered the evidence provided by CL, SLG and RBB. The CAA notes that CL provides little empirical evidence for its arguments and where CL does provide theoretical arguments these are either inconsistent with the empirical evidence provided by SLG and RBB, or are not consistent with standard economic theory. The CAA considers that the empirical evidence cited by both SLG and RBB shows that airlines have increased capacity, for example by increasing average aircraft size, and so, will to some extent compete and pass on changes in costs. The CAA notes that GAL itself accepts that the main increase in capacity going forwards will be an increase in aircraft size.[51] The CAA considers that evidence set out in the MPT in relation to Heathrow and Gatwick demonstrates that airlines are unlikely to switch from an increase in airport charges and so airlines will need to pass these costs onto passengers or suffer a reduction in profitability. In addition the operation of the secondary slot market does not appear to have prevented significant changes in the airlines operating from Gatwick over the last ten years as shown in figure 2.2 in the final proposals. The CAA further notes that if CL arguments are correct in that there has been a relaxation of capacity constraints at Gatwick then this is likely to mean that changes in airport charges are more rather than less likely to be passed on. For these reasons the

51 GAL, July 2013, Airports Commission: Proposals for providing Additional Runway Capacity in the Longer Term, paragraph 2.24. http://www.gatwickairport.com/PublicationFiles/business_and_community/all_public_publications/transforming_gatwick/Gatwick_Airport_Proposals_for_additional_longterm_runway_capacity19Jul2013.pdf

CAA considers that changes in airport charges, will, to some extent, be passed onto users through changes in air fares.

A13 GAL raised concerns over the CAA's view that an increase in airport charges above the fair price would reduce travel opportunities, lead to higher ticket prices or reduced service quality. Based on the analysis undertaken by SLG and RBB, the CAA continues to consider that an increase in airport charges will, to some extent, lead to higher ticket prices. If an increase in airport charges is not passed on through higher ticket prices, airline profitability in the UK is such that airlines are likely to reduce other costs which could impact on airline service quality[52], or in extremis reduce routes (although for the reasons set out in the market power assessment the CAA does not consider that this would be sufficient to impact on the profitability of GAL and HAL to increase airport charges).

A14 The CAA considers that the transmission mechanism for such a pass through is clear where changes in airport charges feed through into changes in the marginal and average costs of an operation and consequently the fares charges. Furthermore the evidence from UK carriers, set out in the SLG report, shows that airlines have tended to pass changes in costs through to air fares.

A15 The CAA does not consider that the current controls hold airport charges below competitive levels, as charges related to costs would be expected in a fully functioning competitive market.

The use of consultancy studies

A16 GAL raised four overlapping concerns with the evidence used by the CAA in its calculation of the fair price. The CAA has considered each of the high level points raised by GAL.

[52] See for example BA's removal of meals on some short-haul flights in response to a decline in profitability, http://www.theguardian.com/business/2009/jul/29/british-airways-scraps-meals-short-haul-flights

- GAL considered the consultants' reports appeared to lack balance. The CAA rejects this criticism. The CAA has consulted on the terms of reference of the consultancy studies with GAL and other stakeholders. The consultants have been working to these terms of reference, which are published on the CAA's website. They were produced in a context where an appeal against the final licence notice (by GAL or materially affected airlines) is in contemplation and the evidence would be relied on in any appeal. The CAA does not consider that the terms of reference were unbalanced and wholeheartedly rejects any suggestion that the consultants were told to produce unbalanced reports.
- GAL considered the consultants' reports were based on inadequate evidence or assertion, with GAL in particular querying the evidence provided in the Helios report. The terms of reference required the consultants to provide evidence of efficiency savings or potential to outperform forecasts. To overcome the potential information asymmetry with GAL, the consultants used a variety of sources of information to reach their findings including benchmarking, national and industry statistics, specific examples from other airports or sectors and local market information or knowledge. The CAA considers that the consultants' reports have adequately addressed the terms of reference and it has taken account of the robustness of the analysis when deciding on the appropriate projections for its fair price calculations.
- GAL considered the consultants' reports have not sufficiently addressed the feedback provided by GAL. GAL has had numerous opportunities to comment on the consultants' reports and GAL's concerns have been put to the consultants and asked for a response. The CAA would not expect the consultants to agree with each of the points raised by GAL, nor would it expect GAL to agree with all of the points raised by the consultants.

- GAL complains that the CAA has provided an insufficiently rigorous review of the consultants' reports. The CAA rejects this criticism. The CAA has reviewed each of the consultants' reports before they were published and in a number of cases challenged their findings and evidence to ensure that they were robust. The CAA has considered the consultants' reports together with the comments made by GAL and other stakeholders when making judgements on the appropriate projections for its fair price calculations.

A17 The CAA has considered the more detailed points on the specific studies in the building block components.

Fair price calculations

A18 Estimates of a fair price, using a single till RAB-based approach, have been provided over:

- five years, consistent with a typical duration of a regulatory price control used in previous airport reviews, the proposed duration of a RAB-based price control in the initial proposals (given the uncertainties in forecasting for a longer duration[53] and is commonly used in other regulated sectors); and
- seven years, for comparison with GAL's 7-year commitment proposals.

A19 The following appendices (B to H) do not include proposals for a price control, but provide a basis for assessment of alternative forms of regulation (Appendix I) and also for the CAA's proposed licence conditions.

[53] The CAA did not receive responses to the initial proposals that asked the CAA to consider a RAB-based price control of longer than five years.

APPENDIX B

Traffic forecasts

B1 This chapter sets out the CAA's final views for the traffic forecasts that will be used to derive the price cap for GAL during Q6. Traffic forecasts are important to a RAB-based price control in a number of ways. They define the denominator in the price cap for Q6, which sets a maximum average revenue yield. They also influence other building blocks dependent on passenger numbers, such as operating expenditure (opex), commercial revenues and service quality. This chapter consists of the following sections:

- approach to forecasting;
- issues between GAL and the airlines;
- responses to CAA's final proposals; and
- the CAA's final views.

Approach to forecasting

B2 In the short term, GAL's forecasting methodology is based on a ‘bottom-up’ short-term capacity forecast for the first two years (up to 2015/16) and a ‘top-down’ econometric forecast over the medium and longer terms.[54]

B3 In the longer term, the capacity model explains passenger numbers as a function of supply decisions such as airlines' capacity plans, average aircraft size and passenger load factor, network plans and flight frequency based on historical performance and market trends. The model considers long-haul and short-haul services separately,

54 This combined approach, with the first two years based on capacity plans provided by the airlines and econometric modelling for the following years, was thoroughly discussed during the CE process. There was no general disagreement amongst the parties regarding this forecasting approach.

and therefore requires an assumption about the future proportion of such services at the airport.

B4 The top-down econometric model for forecasting the total unconstrained London traffic (segmented by long haul, short haul and domestic) is based on a regression analysis of London passenger traffic for the period between 1990 and 2011, against economic, oil price and average airline fare variables. The constrained forecast for Gatwick, which takes into account capacity constraints in the London airport system, is then derived based on additional assumptions regarding market maturity rates, the ability of Gatwick to gain market share of London traffic and the allocation of any spill traffic in the London system.[55]

Issues between GAL and the airlines

B5 The four key issues raised by stakeholders in response to the CAA's final proposals were:

- traffic growth in the base year;
- the more favourable economic outlook and whether expectations of continuous traffic growth over the next seven years are realistic;
- easyJet's use of Flybe's slots and the stability of airline traffic declarations; and
- GAL's announcement of 21 new slots from summer 2014.

B6 This section considers each in turn.

Base year traffic growth

B7 An accurate forecast of traffic based on reasonable assumptions is important in a building block price control or in a fair price proposal. The base year traffic has a significant impact on the overall passenger volume over Q6 and the CAA received responses from the airline community regarding the impact of the year to date traffic performance at the airport.

[55] Spill traffic is traffic which moves from its preferred airport to an alternative due to capacity constraints.

Stakeholders' views

B8 The ACC, easyJet, BA and Virgin considered that the CAA's final proposals forecast did not take proper account of the impact of higher base year traffic on Q6 passenger volume given that current traffic outturn has significantly outperformed the growth previously assumed. Figure B.1 shows that, since the initial proposals, traffic at Gatwick has continued to show stronger growth than previously assumed and the rolling 12-month average passenger volume to October 2013 was already running at 35.2 million, that is 0.5 million (or 1.4%) higher than assumed in the final proposals.

Figure B.1: Forecast of passengers (in million) for 2013/14 and the rolling year actual

	CAA FP (Sep 13)	GAL (May 13)	ACC (Jun 13)	ACC (Nov 13)	GAL (Dec 13)	Actual (Nov 12-Oct 13)
Passengers	34.7	34.4	34.8	35.2	35.2	35.2

Source: CAA, GAL and ACC

B9 GAL considered that traffic growth in the year to date reflected increases in routes, based aircraft and load factors and this needed to be tempered by the traffic reductions from airlines ceasing to operate[56] or delaying commencement of operations at Gatwick.

B10 The higher short-term traffic of 35.2 million in 2013/14 and 37.3 million in 2014/15 in GAL's latest projection reflects the advancement of the recovery in traffic earlier than previously forecast (by two years against the final proposals forecast) due to the current optimism in the economy and is not expected to lead to permanently higher traffic.

CAA's final view

B11 The CAA agrees with the airline community that the stronger than expected growth of traffic so far this year should be reflected in the forecast passenger volume for the base and the following years, although the upward adjustment may need to be moderated to allow for the possibility of some 'one-off' factors due to the summer Olympics in 2012 and one of the coldest and wettest winters on record in 2012/13.

[56] GAL cited US Airways, Air Berlin, Air One and Hong Kong Airlines as examples.

B12 Given that the summer 2013 outturn traffic at Gatwick was running at a growth rate of 4.3% against summer 2012[57], passenger volume for 2013/14 is likely to reach at least 35.4 million, an increase of 3.5% or 1.2 million over 2012/13 when passenger numbers totalled 34.2 million. Consequently, the CAA has decided to uplift its forecasts in the final views by 0.7 million in 2014/15 to reflect the impact of this unexpected strong growth on the overall volume of Q6 traffic. This annual increase is then reduced across the period, down to 0.5 million by the end of Q6.

Gross Domestic Product (GDP) outlook

B13 UK economic growth accelerated to its fastest pace in more than three years in the third quarter of 2013 as the recovery continued across all main sectors. According to the Office for National Statistics (ONS) GDP rose by 0.8% between July and September, up from 0.7% growth between April and June and the highest quarterly growth recorded since the second quarter of 2010.

B14 According to the Bank of England (BoE), the recent recovery is likely to be sustained as reduced uncertainty and a continued easing in credit conditions should help to unlock pent-up demand from households and companies.[58]

B15 Figure B.2 compares the GDP assumptions used by GAL (Jun 13) and the ACC (Dec 12) with the average of a range of latest independent and consensus forecasts. These latest GDP forecasts represent a significant uplift from GAL's assumptions over most of the Q6 period.

Figure B.2: Forecast of GDP growth

	GAL	ACC	Consensus Forecast	HM Treasury	Bank of England
Year	**Jun 13**	**Dec 12**	**Oct 13**	**Nov 13**	**Nov 13**
2013	0.8%	n/a	1.4%	1.4%	1.6%
2014	1.6%	n/a	2.2%	2.3%	2.8%
2015	1.9%	2.0%	2.3%	2.4%	2.3%

57 Note that the summer 2013 growth rate is partly distorted by the summer Olympics in 2012.

58 'Inflation Report', Bank of England, November 2013.

	GAL	ACC	Consensus Forecast	HM Treasury	Bank of England
2016	2.1%	2.1%	2.2%	2.4%	2.5%
2017	1.8%	2.1%	2.1%	2.3%	
2018	1.7%	2.2%	2.0%		
2019	1.9%	2.3%	2.1%		
2020	2.2%	2.2%	2.1%		
2021	2.3%	2.3%	2.1%		

Source: GAL, ACC, Consensus Forecast, HM Treasury and BoE

B16 Given the more favourable economic outlook, the recent announcements on long-haul growth by BA and Norwegian from the airport, and the strong traffic growth in the base year, the airlines considered that GAL has the opportunity to significantly outperform the traffic estimates in the CAA's final proposals.

B17 GAL considered that economic growth in the current year has been volatile and a return to sustained growth is by no means firmly established. In light of the general economic uncertainty, including in Europe or the US, GAL considered that the short-term turbulence that GAL and some of its airline customers are experiencing may extend into the medium term which would cause traffic growth to revert to GAL's longer term projections based on their econometric modelling.

B18 GAL noted that even during periods of unbroken economic growth, year-on-year traffic growth has not been guaranteed, particularly for a period as long as seven years.

CAA's final view

B19 In light of recent evidence which suggests a more sustained economic recovery, a marked improvement in business and consumer sentiment and the forecast economic outlook, particularly for the immediate term, the CAA considers that there is a need to uplift its short-term traffic forecasts for the first three years to 2016/17. The CAA has therefore increased its traffic forecast by around 0.2 million in 2014/15, with the increase falling to 0.1 million in 2016/17. However, no additional growth is assumed beyond this.

B20 The CAA has considered GAL's argument that even during periods of unbroken economic growth traffic growth has not been guaranteed.

The CAA accepts that traffic growth is not guaranteed however the GDP elasticities used by GAL are based on relationships derived from data over a period of 21 years and so take this into account.

Use of the acquired Flybe slots by easyJet

Final proposals

B21 The CAA estimated that easyJet's purchase of 25 Flybe slot pairs in May 2013 and the resulting increase in average passenger loads would lead to an additional 1 million passengers per year.

Stakeholders' views

B22 The ACC stated that they continued to consider that the Flybe slots would lead to around 1.6 million additional passengers per year, based on typical easyJet load factors. easyJet however stated that it only expected an additional 600,000 passengers per year, as it did not consider that the slots would be fully utilised, particularly in winter. This was a reduction from easyJet's original estimate of 1.6 million additional passengers per year.

B23 GAL did not provide an updated forecast of the impact of the sale of the Flybe slots. In response to the initial proposals, GAL estimated that there would only be a 350,000 – 550,000 per year increase in passengers as a result of switching Flybe's slots to easyJet. GAL took the view that the Flybe slot times were not a perfect fit for the traditional easyJet three wave based business model and that the application of the average passenger load of 149 passengers per flight by the ACC did not take into account seasonality ratios or route specific intelligence. In response to the final proposals GAL continued to consider that the ACC and CAA had overstated the impact on traffic growth due to the slot transfer. GAL also made reference to the easyJet press release on 19 November 2013 which stated that it only expected an additional 300,000 passengers per year from the slots.[59]

CAA's final view

B24 Having considered all the responses, the CAA has revised its previous estimate of the slots impact (around 1 million additional passengers

59 http://corporate.easyjet.com/media/latest-news/news-year-2013/19-11-2013b-en.aspx?sc_lang=en. EasyJet considered that this was simply a cautious statement on their expected passenger numbers.

per annum on average) by a reduction of 0.55 million passengers in 2014/15 so that the initial increase in passengers due to the slot transfer is more in line with the estimates by easyJet and GAL, at 0.45 million. However, based on the CAA analysis of easyJet's slot portfolio and route network plan for the airport, the CAA considers that the potential long-term additional traffic as a result of the slots purchase could be above easyJet's estimate. The CAA has therefore assumed that the incremental traffic from easyJet's use of the Flybe slots would grow to 0.6 million per year by 2016/17 and thereafter (a reduction of 0.4 million per annum on the final proposals forecasts)[60].

Availability of 21 new slots from summer 2014

Issue

B25 On 3 October 2013, GAL announced a significant increase to its scheduled capacity limits for Summer 2014/15.[61] This announcement of the 21 new daily slots[62] - which included 8 morning peak departing slots - constitute around 2.4% of the total runway movements allocated on a peak summer week during summer 2014.[63]

B26 The impact of this new peak capacity had not been previously factored into the forecasts by easyJet, the ACC and the CAA.

Stakeholders' views

B27 BA stated that the scale of the new peak slots released for summer 2014 appears to be much larger than previous peak capacity increases in summer seasons when normally only 1-2 new peak departure slots were created in the 0500-0800 hours.[64]

60 The forecasts for the first two years in the CAA's final proposals were based on airlines' latest short-term capacity plans and traffic forecasts submitted to the CAA on a confidential basis. However, given the likely presence of individual and collective optimism bias embedded in these capacity plans, the CAA had therefore taken a conservative approach in deriving its short-term forecasts.

61 'Gatwick Airport Scheduling Declaration for Summer 2014', 3 October 2013.

62 These were made available through operational improvements on the ground and improved separation control.

63 Total runway movements allocated in a peak week during summer 2014 is 6,021 movements according to the Airport Coordination Limited (ACL) London Gatwick Summer 2014 initial Coordination Report.

64 Over the last 7 summer seasons, summer 2010 was the only exception when 5 new slots

B28 BA and the ACC considered that the composition and timing of these slots are such that each peak slot could lend itself to a 3 rotations per day short-haul flight by a based airline. This meant that the 8 new early morning departures slots could facilitate the growth of 24 daily return flights or 48 sectors per day.

B29 By assuming that half of these slots would be flown year round and the other half would be limited to a 6-month season only, and by applying a similar passenger load per flight as assumed previously in the easyJet's Flybe slot usage, the ACC estimated that the newly created 21 slots would result in an increment of 1.9 million passengers per annum.

B30 easyJet gave a more conservative estimate of an increase of 900,000 passengers a year which was simply based on the utilisation of the 9 peak departing slots (which includes 1 slot in the evening peak).

B31 GAL recognised the short-term advancement of traffic demand (by about 2 years) and stated that it had created the extra slots to fulfil the demand that earlier than anticipated economic recovery had generated. Consequently, GAL considered that the availability of new slots did not add to forecast traffic as suggested by the ACC.[65]

CAA's final view

B32 The CAA considered that Gatwick, being the busiest single runway airport in the world, has already been under runway capacity constraint especially during the peak periods. It is therefore CAA's view that availability of the new peak slots will help alleviate some of the excess demand and lead to increased overall traffic.

B33 According to the ACC; easyJet, Thomson and Monarch have each acquired one of the 8 peak slots while Norwegian and BA acquired the remaining 2 and 3 slots respectively from the International Air Transport Association (IATA) initial coordination conference in November 2013. However, it is difficult to gauge the extent of additional passengers that these newly created peak slots will generate at the airport without knowing how the airlines will be utilising them (both in the summer season and throughout the year) in

were made available according to the ACL data.

65 Nevertheless, GAL now expected traffic to increase to 35.2 million and 37.3 million in 2013/14 and 2014/15 respectively.

conjunction with their existing slot portfolios.[66] Furthermore, it is plausible that increased services by these airlines could lead to offsetting declines in services and passengers from other operators using the airport. The CAA has taken this into account in deriving its forecasts.

B34 According to the ACL data[67], total air transport movements (ATMs) and seats initially allocated in summer 2014 are 15.5% and 20.1% higher respectively than in summer 2013, with a corresponding increase of 4.0% in seats per passenger ATM.[68]

B35 Of the 6,310 weekly slots allocated at the IATA initial coordination conference, 625 of them are acquired by either new entrants (52 slots) or incumbents (573 slots) for new services, including the 147 (=21x7 days) newly created slots per week.[69]

B36 However, the CAA notes that only 2 of the 52 slots acquired by the new entrants are for year-round services, while only 63 of the 573 slots acquired by incumbents are being used to provide year-round services by aligning the summer slots with the schedule in the adjacent season. This seems to suggest that only a few, if any, of the acquired slots are being used to provide new year-round services. The majority of them are being used by incumbents to either serve a summer season only service or to complement an existing winter service.

B37 In light of the above information, the CAA considers that the ACC is likely to have overstated the potential traffic growth by assuming the 8 peak slots are capable of facilitating 3 aircraft rotations per day throughout much of the year. The CAA considers that it is more

66 It should be noted that not all of the slots or seats allocated at the conference will be claimed and/or fully utilised over the whole season as demand for slots at initial coordination for a future season is very likely to be overstated by airlines. It is also plausible that airlines that have acquired the new peak slots may decide to surrender some of their other sub-optimal existing slots as a result.

67 London Gatwick Summer 2014 Initial Coordination Report, Airport Coordination Ltd.

68 Analysis of ACL's 'Start of Summer Season Report' for Gatwick for the past four years suggests that ATMs at the end of a season were 2.5%-5.5% less than at the start of the season. This is in addition to a likely reduction in slot take up between the initial allocation and the start of the summer season.

69 These newly created 147 slots per week represent 2.3% of the total weekly slots allocated for a peak week in Summer 2014.

appropriate to use a more cautious assumption that each of the peak slots would only facilitate 2 aircraft rotations per day and that half of these slots would be used for a 6-month season only. This is equivalent to an assumption that each peak slot would be used to facilitate 1.5 aircraft rotations per day throughout the year.

B38 The CAA has assumed an average passenger load of 150 on these flights[70], which will lead to an increase of around 1.3 million passengers per year. When deriving these forecasts the CAA has taken into account the potential optimism in, and stability of, airlines' declarations, for example the CAA's forecast growth is lower than the increase in summer slot allocation and the ACC forecast.

CAA final forecasts

B39 Figure B.3 compares the CAA's final forecasts with the forecasts from ACC, GAL[71] and the CAA's final proposals. The CAA's final forecasts are derived by taking into account the combined impact on traffic growth from a number of changing factors: a better than expected growth in the base year traffic, a more upbeat economic outlook particularly in the initial years of the Q6 period, an injection of 21 new peak slots from summer 2014 and a reduced utilisation of Flybe's slots by easyJet.

B40 The revised forecast figures indicate a total of 193.8 million passengers over Q6, compared to 186.0 million in the CAA's final proposals, an increase of 4.2%. The ACC's latest estimate of 198.1 million is 2.2% higher than the CAA's final forecast.

[70] This is a concervative estimate as the average passenger load on easyJet's A320s at Gatwick in 2012 was around 160 and for other airlines (excluding Flybe) the average load was around 155 according to CAA Airport Statistics. The ACL Summer 2014 Initial Coordination Report suggests an increase of 4% in seats per ATM for summer 2014.

[71] GAL did not submit a revised Q6 forecast to its May 2013 forecast which did not take into account Flybe's slot deal with easyJet. However, GAL did provide a revised projection of traffic of 35.2 million and 37.3 million for 2013/14 and 2014/15 which included its estimate of the impact from the Flybe slots transfer and the newly created 21 slots.

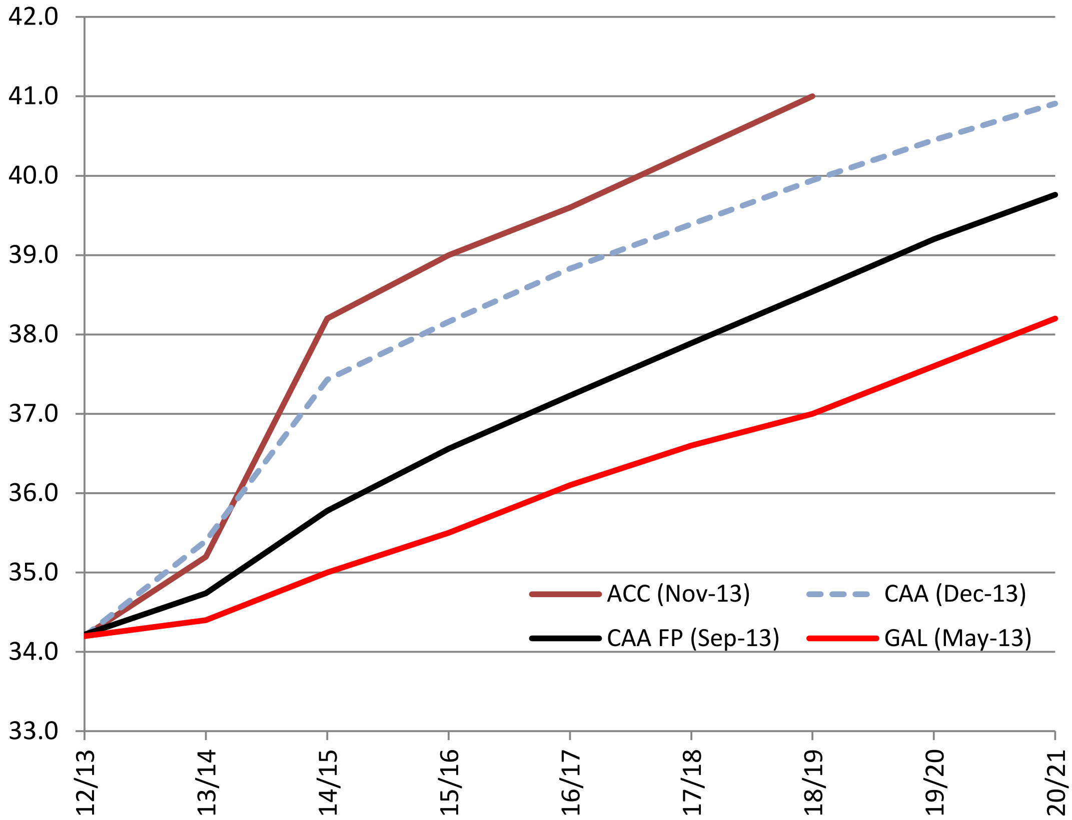
Figure B.3: Forecast of passengers (in million) and annual growth rates

	CAA (Dec 13)	% chg	ACC (Nov 13)	% chg	GAL (Dec 13)	% chg	CAA FP (Sep 13)	% chg	GAL (May 13)	% chg
2012/13	34.2		34.2		34.2		34.2		34.2	
2013/14	35.4	3.4%	35.2	2.9%	35.2	2.9%	34.7	1.5%	34.4	0.6%
2014/15	37.4	5.7%	38.2	8.5%	37.3	6.0%	35.8	3.0%	35.0	1.7%
2015/16	38.2	2.0%	39.0	2.1%			36.6	2.2%	35.5	1.4%
2016/17	38.8	1.8%	39.6	1.5%			37.2	1.8%	36.1	1.7%
2017/18	39.4	1.4%	40.3	1.8%			37.9	1.8%	36.6	1.4%
2018/19	39.9	1.4%	41.0	1.7%			38.5	1.7%	37.0	1.1%
2019/20	40.5	1.3%	--	--			39.2	1.7%	37.6	1.6%
2020/21	40.9	1.1%	--	--			39.8	1.4%	38.2	1.6%
Q6	193.8	1.6%	198.1	1.8%			186.0	1.9%	180.2	1.4%
Q6+2	275.1	1.5%	--	--			265.0	1.8%	256.0	1.5%

Source: CAA, ACC and GAL

B41 Figure B.4 shows the CAA forecasts alongside those of GAL and the ACC in graphical form.

Figure B.4: Comparison of Gatwick passenger forecasts (in million)



Source: CAA, ACC and GAL

APPENDIX C

Capital expenditure

C1 This appendix considers the appropriate level of capex to be taken into account in the fair price calculation. It consists of the following:

- capital expenditure process to date;
- the CAA's final proposals;
- the responses to the final proposals;
- the CAA's final view; and
- the CAA's final view projections.

C2 It should be noted that the capex will not be fully paid for during the price control period. Consistent with the RAB methodology, new capex is added to the RAB. Each year, a contribution to prices is made from a capital charge (i.e. the WACC multiplied by the RAB) and a depreciation charge. Therefore, although Q6 capex will have only a limited effect on Q6 prices, it will need to be fully charged to prices over time.

Capital expenditure process to date

C3 The capital programme has been subject to extensive discussions between GAL and the airlines as part of the formal CE and subsequently. This has led to a number of projects being dropped or refined.

C4 Following formal CE, GAL's January 2013 RBP set out a capital programme of £0.9 billion for Q6 split between asset stewardship, Q5 carry over and development projects. The ACC supported £0.4 billion of this expenditure but did not support commercial projects which increased prices in Q6 and projects which airlines considered did not provide value for money enhancements to the passenger experience.

C5 The CAA's initial proposals reviewed GAL's RBP in terms of the inclusion of individual schemes and the efficient cost of those schemes. The review included independent consultancy work commissioned by the CAA from Davis Langdon (DL) and Steer Davies Gleave (SDG). Based on this review the CAA's initial proposals included a capex allowance of £0.8 billion for Q6.

C6 In response to the initial proposals GAL has updated its capex forecast for the Q6 period from £0.9 billion to £1.1 billion. This difference derived mainly from the inclusion of hold baggage screening (HBS) costs to comply with DfT requirements.

C7 The expenditure on asset stewardship supported by the airlines was reduced by around £6 million due to greater efficiency assumptions. Following GAL's revision of business cases for some projects the ACC expressed support for a number of additional schemes (upgrade check-in (part only), North Terminal (NT) coaching bays, South Terminal (ST) IDL reconfiguration (phase 1), ST public access and Disability Discrimination Act (DDA) compliance, and stand reconfiguration). The ACC did not have a common view on the delivery of 95% pier service in NT (Pier 6 South), NT IDL capacity extension, early bag store and check-in ceilings and floors.

CAA's final proposals

C8 The final proposals reviewed GAL's updated capex programme of £1.1 billion in terms of:

- the inclusion of individual schemes, in particular whether schemes were in passengers' interests; and
- the efficient costs of those schemes.

C9 The CAA's review of the inclusion of individual schemes for the final proposals drew on the outputs from CE; the agreements reached between the airport operator and airlines; further independent consultancy work commissioned by the CAA from DL[72] which

[72] Davis Langdon, September 2013, Gatwick Airport: Q6 Capex review for the CAA: Phase three report - final, http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

examined the technical justification of schemes; and research into whether schemes were in passengers' interests. The CAA's final proposals used DL's proposals on scheme costs for enhancement schemes, adjusted, where appropriate, for the proposed reduction in scope.

C10 In developing its final proposals the CAA has also commissioned independent consultants SDG to update their previous April 2013 report on renewals (asset stewardship) following the responses to the CAA's initial proposals.[73] The CAA's final proposals on asset stewardship were based on SDG's core stretch targets.

C11 The CAA found that the majority of schemes proposed by GAL were in passengers' interests. The CAA found that the scope of some schemes was not fully justified and should be reduced, in particular NT border zone, NT arrivals, NT early bag store schemes and NT/ST check-in and bag drop. The CAA also removed the costs of three schemes: runway two costs, where the inclusion of the scheme did not appear to be consistent with previous regulatory treatment of these costs; business systems transformation and hangar facilities, where there was not sufficient evidence to include the costs of the scheme. Having received updated business cases from GAL for the revised schemes, in its final proposals, the CAA included the costs of the following projects that were not included in the CAA's initial proposals: NT coaching bays and NT baggage reclaim.

C12 The CAA's review of the efficient scheme costs drew on the two above mentioned independent consultancy studies commissioned by the CAA: SDG study that reviewed GAL's capex on asset stewardship and the DL study that reviewed GAL's enhancement/development capex projects. SDG identified efficiencies to asset stewardship costs from the removal of double-counting in project risk allowances and a reduction of on-costs to be in line with benchmarks. DL identified efficiencies to project costs from a reduction in unit costs, a reduction in on-costs in line with benchmarks and the removal of double-counting in risk allowances.

73 Steer Davies Gleave, September 2013, Review of Maintenance, Renewals and Other Operating Expenditure at Gatwick Airport: Phase 3 Final Report, http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

C13 Based on the inclusion of schemes and the assessment of efficient costs the CAA included a capex allowance of £0.8 billion for Q6.

Responses to the final proposals

GAL's response

C14 In its response to the CAA's final proposals GAL stated that it welcomed the CAA's inclusion of most projects put forward in the RBP and later updated but was concerned about the reductions in budget and scope of some projects. GAL considered the CAA's calculation of the cost of projects unrealistic.

C15 GAL stated it maintained its comments on capex from previous consultations, particularly the following.

- SDG's Benchmarking data: GAL repeated its disagreement with the CAA accepting SDG's benchmarking and questioned the reliability of such benchmarking. GAL particularly considered that PAS55 was enough of a tool for identifying the optimum point of asset renewal. GAL considered SDG incorrectly implied that unscoped work and risk were the same hence incorrectly assumed stretch targets. GAL also continued to disagree with the CAA and SDG on the level of on-costs.
- HBS costs: GAL repeated its disagreement with SDG's cost savings as they were presented at a high level and did not include all of the scope required.
- DL review: GAL referred the CAA to comments previously made by GAL in relation to the work by DL.
- Capital costs for the last 2 years of commitments: GAL considered it incorrect for the CAA to state a breakdown of these costs was not provided as these were included in the RBP. GAL stated that the only change to the RBP numbers was the ST IDL project to which a business case was provided in June 2013.

- ST IDL Capacity: GAL stated that ST IDL Capacity was not forecast to be completed by 2018/19 and therefore asked the CAA to update the forecasts for the last 2 years of commitments with the budgeted £18.18 million for 2019/20 and £15.82 million for 2020/21 (in 2013/14 prices).

Other stakeholders' views

C16 The ACC, BA, easyJet and Virgin responses were aligned and focused on the inclusion of Pier 6 South project. The responses also raised issues around construction price inflation and Q7 capex.

Pier 6 South

C17 The airlines disagreed with the inclusion of Pier 6 South in the capital plan. The airlines considered that the CAA included the proposed extension within the capital plan despite:

- the CAA's earlier conclusion that the project provided costs in excess of the passenger benefit;
- evidence from the airlines that 95% Pier Service Level (PSL) would be achieved throughout Q6 through the use of efficient stand planning and using towing levels similar to those undertaken currently: airlines pointed out that modelling showed that 93% PSL would be reached in 2018, 96% PSL would be reached in 2018 with the airfield towing levels that are currently in place, and 97% PSL would be achieved in 2018 if efficiency improvements were made on the airfield;
- no evidence over a claimed £44 million delay cost: the airlines considered that GAL's estimated delay costs were not reliable as no expert evidence was presented to the airlines to support this assertion nor was this figure consulted on. The airlines urged the CAA to require further evidence on this from GAL and corroborate it against the other stand rehabilitation work at Gatwick;
- GAL providing information to the CAA on 2018 Pier Service that was inconsistent with that previously provided to airlines: it was noted that GAL later corrected the evidence and confirmed that the estimate given to the airlines was the valid figure. The airlines considered this cast a shadow over other information provided by GAL.

C18 The airlines considered that the business case for this project was poor and provided little value. It was suggested that this project was treated the same way as the HBS project and included as a development and not a core capex project which would allow it to be included if traffic development required it, following consultation with airlines.

Construction price inflation

C19 The airlines also considered that the construction price inflation had been applied inconsistently and incorrectly. In Q5 the airlines stated that there was a levy of 2% added to capex to reflect the rise in construction costs (attributed to the Olympics). The airlines considered that now with the CAA's consultants DL indicating the future Construction Output Price Index (COPI) will be below (RPI) inflation it was incorrect for the CAA not to acknowledge that. The airlines also considered that the CAA's approach was inconsistent with its Regulatory Policy Statement[74] that forecast COPI would be taken into account at each review. The airlines considered that just because there was uncertainty it was not a reason to ignore this issue, as there was uncertainty in any forecast.

Q7 capex

C20 The airlines considered it was inconsistent for the CAA to allow GAL a capital plan of £151.4 million and £201.6 million for the first two years of Q7 given the CAA's support for GAL's commitments which included a minimum of £100 million spend per year.

CAA's final view

C21 As part of its final proposals, the CAA reviewed the cost and inclusion of individual schemes. On making a decision on which schemes to include in its final view the CAA has considered how best to further its statutory duties in particular to further the interests of existing and future passengers, and to do so, where appropriate, by promoting competition.

74 Paragraph E81 Annex E - CAA Q5 decision.

C22 The CAA considers that airlines have an important but not an exclusive role in helping it define how it furthers passengers’ interests for the purpose of development proposals for Q6. While airlines do not represent passengers, their interests are often broadly aligned. However, this may not always be the case, for example in situations of airline market power, or where passengers' ability to act in the market is hampered (e.g. information issues). For example, future passengers may have interests which are not well articulated by airlines currently operating at the airport..

C23 The CAA undertook independent validation and assurance to ensure that a settlement is in passengers' interests, drawing on various sources including passenger research, complaints data and the views of the CAA Consumer Panel as set out in the final proposals.

C24 The CAA's response to stakeholder comments is presented under the following headings:

- Pier 6 South;
- Construction price inflation;
- Q7 capex;
- ST IDL Capacity; and
- other.

Pier 6 South

C25 NT Pier Service (Pier 6 South extension) would provide an additional 6 Code E stands (4 could be Code F) and additional 8 Code C stands to ensure delivery of 95% pier service in the NT. The project would increase airport charges by £0.23 per pax over the 40 year asset life.

C26 The Pier 6 South scheme has been controversial between GAL and the airlines. Only one airline, Emirates, supported the project as it was attracted to the additional A380 stands and the facility to board premium passengers from a lounge directly onto the aircraft. The other airlines considered that 95% pier service could be achieved in 2018 through stand reconfigurations and increased towing.

C27 DL in their assessment identified that Pier 6 South was the only viable long-term solution to maintaining 95% pier service in the NT but stated that it was debateable whether GAL had put forward a strong business case for the scheme.

C28 The CAA has reviewed the evidence on the justification for the Pier 6 South scheme. The CAA has placed weight on DL's statement that the Pier 6 South extension appears to be the only long-term option. The CAA also notes that GAL's high case traffic forecast, on which the modelling of pier service is based is similar to the CAA's base case traffic forecast for 2018/19 (39.2 million passengers per year compared to 39.9 million passengers per year).

C29 GAL estimated that the costs of delaying Pier 6 South extension would be around £44 million in Q6 (£30 million) and Q7 (£14 million). These costs related to asset replacement works required if the Pier 6 South extension was not built. In November 2013 GAL provided the CAA with a breakdown of these costs. These costs were based on an independent assessment of pavement (stand, pier and taxiway) conditions, undertaken in 2012. The CAA notes that at that time a significant proportion of stands and pavements were already life expired. On this basis the CAA considers that it is likely that significant costs are likely to be incurred from asset replacement or life extension in the absence of Pier 6 South. The CAA considers that any costs in this respect would not appear to be in passengers' interests.

C30 If the CAA was considering only Q6 then, given the relatively small increase in pier service forecast by GAL (from 93.4% to 96.6% in 2018 based on the average busy day), it appears that increased towing could provide a means of maintaining 95% annual average pier service, in particular as GAL forecast similar levels of towing in 2013. However, by the end of Q7 then reduction in pier service without Pier 6 South could be substantial at around 5% and GAL has stated that increased coaching at this level would not be operationally feasible. Consequently, the CAA considers that Pier 6 South is required to meet airport operational requirements in Q7. If the Pier 6 South extension was delayed until Q7 then this could increase the total costs of the project as the Q5 design work could need to be repeated and there would be additional costs of renewals during Q6. The CAA considers that this would not be in passengers' interests. Consequently, the CAA maintains its view that the costs of the Pier 6 South scheme should be included in the capital plan for Q6.

Construction price inflation

C31 The CAA previously noted that GAL had not uplifted its capex plan for real growth in construction price inflation after 2013. In August 2013 DL forecast that the COPI would be below inflation at least for the first few years of Q6. However, given the uncertainty over the forecast the CAA previously did not adjust GAL's assumptions on COPI.

C32 The airlines criticised the CAA for not incorporating the COPI projections in its capex forecast. The CAA notes, however, that COPI was only below inflation in the first few years of Q6 and was forecast to return above inflation in the second half of the Q6 period.

C33 In November 2013 the CAA reviewed more up to date forecasts based on COPI in the second quarter of 2013 which pointed towards expected increases in COPI. These are presented in figure C.1 below.

Figure C.1: Forecast for COPI and RPI

Year	COPI*	RPI**	Real COPI
2014/15	1.20%	3.10%	-1.90%
2015/16	1.40%	2.90%	-1.50%
2016/17	2.60%	3.00%	-0.40%
2017/18	3.30%	3.70%	-0.40%
2018/19	3.70%	3.60%	0.10%

Source: *Davis Langdon, **CAA analysis[75]

C34 The CAA notes that COPI is forecast to fall below inflation in the first few years of Q6 but the difference between COPI and RPI forecasts is more marginal than at the time of the final proposals.

C35 The CAA notes that the forecast COPI is based on All New Construction. The CAA notes that All New Construction includes the following categories: Public Housing, Private Housing, Public Non-

75 The CAA has adopted the following in its RPI series:

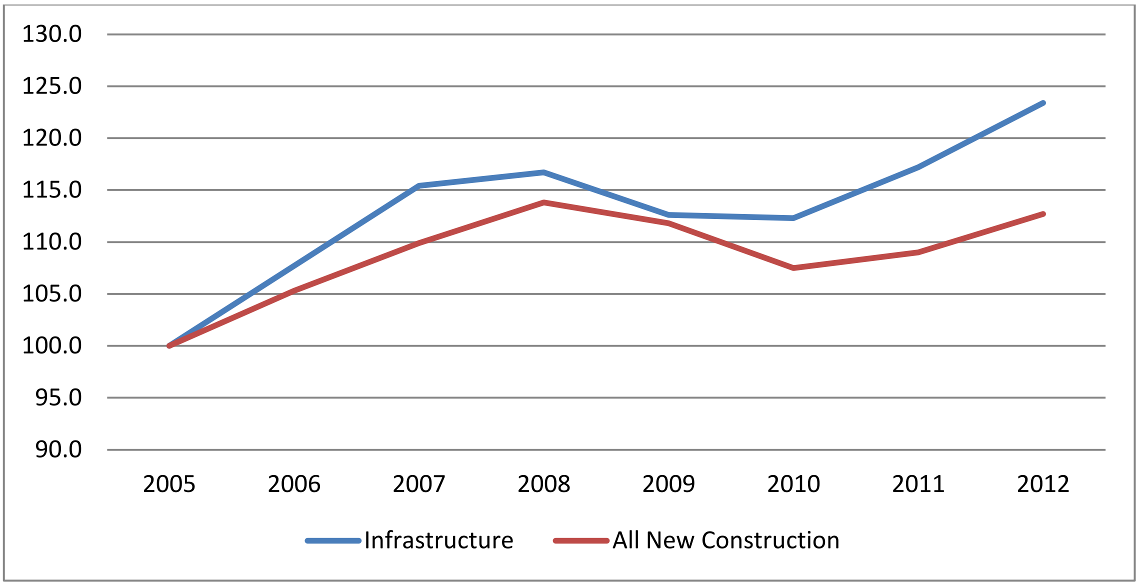
- the actual RPI indices (CHAW series) up to October 2013 published by Office of National Statistics;

- monthly RPI indices obtained by interpolating the quarterly RPI forecasts from Oxford Economics Forecasting for the Period November 2013 - December 2017;

- annual RPI forecasts from Consensus Forecasts for 2018 and 2019.

Housing, Private Industrial, Private Commercial and Infrastructure. The CAA considers the Infrastructure component is likely to be the most relevant for forecasting capex inflation at GAL. The CAA notes that the Infrastructure component has been increasing at a higher rate than the overall All New Construction index in the past few years (see figure C.2) and considers that this trend could continue into Q6.

Figure C.2: Comparison of Infrastructure and All New Construction output price indices (2005 = 100)



Source: BIS[76] and CAA analysis

C36 The CAA notes that the use of the infrastructure COPI appears to be consistent with the view of the CC in its Q5 price control review for Gatwick and Heathrow.[77] In this review the CC stated that construction price inflation has been more pronounced for housing projects than infrastructure projects and therefore considered that inflationary pressures would be more appropriately measured by analysing trends in the infrastructure COPI and the commercial building COPI.

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[76] BIS quarterly construction price and cost indices: quarter 2 2013, output price indices, available from: https://www.gov.uk/government/publications/bis-quarterly-construction-price-and-cost-indices-quarter-2-2013

[77] CC, Heathrow Airport Ltd and Gatwick Airport Ltd Q5 price control review, 2007, Appendix D: Capital investment and construction inflation, available from: http://www.competition-commission.org.uk/our-work/directory-of-all-inquiries/heathrow-and-gatwick-quinquennial-review/final-report-and-appendices-glossary

C37 Infrastructure COPI may be a more accurate measure of future construction price inflation for airport capex. However forecasts for Infrastructure COPI are not available. The CAA continues to consider it inappropriate to make a separate additional allowance for real COPI given:

- recent trends: with Infrastructure COPI above All New Construction COPI, and All New Construction COPI marginally below RPI forecasts; and
- the uncertainty involved in the COPI forecasts and its volatile nature, which were also noted by the CC in its Q5 review.

Q7 capex

C38 The airlines considered it inappropriate to allow a capex of £151.4 million and £201.6 million for the first two years of Q7 while GAL's commitments required it to invest only £100 million per year over each year of commitments. The CAA notes, however, that GAL's £100 million per year spend is the minimum requirement for investment and it does not mean that the capex in the first two years of Q7 will be £200 million. The CAA maintains that for the purpose of calculating a 7-year comparison fair price it is appropriate to use GAL's forecast capex plan included in the RBP after removing HBS costs (which were brought forward to Q6).

C39 The CAA notes that the RBP included a breakdown of costs by project and by year in Q7 but it did not provide a detailed breakdown of costs within each project. Given the early stage of the development of some of the projects it has not been possible for the CAA to undertake a detailed bottom-up review of the expenditure on each of the individual projects.

ST IDL Capacity

C40 As discussed in its final proposals, the CAA considers the ST IDL Capacity project provides net financial benefits to passengers during Q7 and therefore considers the project to be in passengers' interests. Following GAL's explanation that there was an error in the project sheet previously sent to the CAA and that the project would not finish in Q6, the CAA considers it appropriate to amend its previous forecasts for the first two years of Q7 to include the additional costs of the project. This has increased the core capex in the first two years of

Q7 by £17.2 million and £14.9 million in 2019/20 and 2020/21 respectively.

Other

C41 The CAA notes that points raised by GAL in reference to HBS costs and reports by SDG and DL have already been addressed in the CAA's final proposals[78] or the consultants' reports. GAL has not provided the CAA with new information to support the points already raised and addressed by the CAA and its consultants.

C42 On 2 December 2013 GAL requested that if the CAA was to re-calculate the RAB, then it should include the following additional capex:

- runway 2 additional cost of £20 million for the purpose of the Airports Commission (above the costs previously forecast);
- re-development of the Gatwick train station cost at a cost to GAL of up to ✂; and
- noise insulation scheme costs.

C43 For reasons stated in its initial and final proposals, the CAA maintains its view not to allow runway 2 costs to be added to the RAB.[79]

C44 GAL stated that the DfT asked GAL to consider contributing to the re-development of the Gatwick train station, with a scenario that the "government would be contributing £180 million and GAL would be asked to contribute ✂"[80]. The CAA points out that GAL noted itself that the discussions with DfT were at an early stage. The CAA does not consider it appropriate to add this project to the Q6 capex because:

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78 Chapter 4 of CAA's final proposals, in particular paragraphs 4.25, 4.27, 4.31, and 4.63.

79 Chapter 5 of CAA's initial proposals, in particular paragraph 5.50 and Chapter 4 of CAA's final proposals, in particular paragraph 4.43.

80 GAL, Gatwick's counter-response to the ACC's response to the CAA's final proposals, 2 December 2013.

- on 4 December 2013 the government published the National Infrastructure Plan 2013[81] which announced that the government was taking forward measures proposed by the Airports Commission[82] by introducing a package of improvements to airport-surface access. Although these measures mention a full re-development of the railway station at Gatwick, it is mentioned that a sum of £50 million (not £180 million as initially implied by GAL) would be made available subject to satisfactory commercial negotiations with the airport operator;
- discussions with DfT relating to this project are at an early stage, as pointed out by GAL and as confirmed by the government's statement of 4 December 2013;
- GAL has not provided the CAA with any details or breakdown of this costs other than an overall estimate of around ✂ over the commitments period;
- the project has not been consulted with airlines;
- a £53 million scheme (with GAL's contribution of around £8 million) for the station's upgrade was agreed in 2010 and planned to complete in 2013; and lastly
- the Office of Rail Regulation (ORR) has published its final determination setting out funding, required outputs and the regulatory framework for Control Period 5 (CP5: April 2014 - March 2019) in October 2013[83] and this project was not considered.

C45 In relation to noise insulation scheme the CAA points out that GAL has not provided an estimate of the overall cost of the scheme apart

81 Available from: http://www.parliament.uk/documents/commons-vote-office/December%202013/3%20December/4th-December-2013/1.CHANCELLOR-National-Infrastructure-Plan.pdf

82 Letter from the Airports Commission with recommendations on short-term surface transport measures, paragraph 26 November 2013, available from: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263208/surface-access-letter.pdf

83 ORR, Periodic Review 2013: Final determination of Network Rail's outputs and funding for 2014-19, October 2013, available from: http://www.rail-reg.gov.uk/pr13/PDF/pr13-final-determination.pdf

from stating ✂. The CAA therefore considers it does not have sufficient evidence to include this scheme.

Efficient costs of individual schemes

C46 The CAA has drawn on the SDG and DL consultancy studies to develop its final projections and final view on the efficient costs to be included in the fair price. To be consistent with the price in the commitments and a RAB-based comparator the CAA has only included the costs of the core capex plan. It is notable that under both the commitments and a RAB-based alternative, GAL has proposed that the costs of HBS are held outside the proposed price cap/path. The CAA has not included the costs of hangar facilities and business systems transformation in the core capex plan as the business cases for these projects do not currently appear to be strong.[84] The CAA also excluded the costs related to the development of the second runway from the capital plan.

C47 It should be noted that both SDG and DL undertook their analysis based on the 2013/14 price base used by GAL. The CAA has converted these costs to 2011/12 prices.

C48 As stated above, the CAA does not consider it appropriate to make a separate allowance for real COPI given the uncertainty involved in the forecasts.

C49 After considering all stakeholder comments, the CAA maintains its stretch targets for renewals and proposals on scheme costs adjusted where appropriate for proposed reductions in scope as set out in its final proposals. Figure C.3 sets out the CAA's final view on the Q6 capex programme. The total core capex programme is £790.8 million which is a 13% reduction in GAL's core plan in its response to the initial proposals.

Figure C.3: CAA final view on the core and development capex plan for Q6

84 The CAA notes that GAL does not itself to be the operator of the maintenance facilities as part of the operator determination.

(£ million)

	2014/15	2015/16	2016/17	2017/18	2018/19	Total
Total asset stewardship	**55.1**	**74.3**	**63.5**	**64.3**	**63.1**	**320.3**
ST Baggage & Pier 1	61.9	21.7	0.0	0.0	0.0	83.6
Pier 5	2.7	0.0	0.0	0.0	0.0	2.7
Other carry over projects	1.6	0.0	0.0	0.0	0.0	1.6
Total carry over	**66.3**	**21.7**	**0.0**	**0.0**	**0.0**	**88.0**
Delivery of 95% Pier Service in NT	4.5	43.6	70.5	32.8	0.6	152.0
NT Security Reconfiguration	4.4	6.0	5.3	2.3	0.0	17.9
Early Bag Store	0.5	0.6	5.2	5.0	0.5	11.8
Upgrade Check-in & Bag Drop	0.9	2.7	4.4	4.0	22.6	34.6
NT Border Zone	0.0	0.4	0.8	4.2	1.7	7.1
NT IDL Capacity Expansion	18.2	25.0	22.2	8.2	0.0	73.6
Stand Reconfigurations	0.7	7.1	1.4	0.2	0.0	9.4
Long Stay Car Products	0.0	0.0	0.0	0.6	4.1	4.7
Digital Media	0.1	2.4	0.8	0.1	1.6	5.0
Commercially Important Persons Departures	0.1	1.8	0.0	0.0	0.0	1.9
NT Baggage Reclaim	0.0	0.0	0.2	1.3	1.2	2.6
NT Arrivals Transformation	0.4	1.3	4.0	0.0	0.0	5.7
ST IDL Capacity	0.0	0.4	1.0	9.2	13.9	24.5
CIP Arrivals	0.1	1.8	0.0	0.0	0.0	1.9
Additional NT Coaching Bay	0.1	0.2	0.6	0.9	0.0	1.9
ST Public Transport and DDA Access	0.4	0.3	2.7	4.1	0.0	7.6
Consolidated Car rental and Motor Transport facility	0.3	0.9	3.5	0.0	0.0	4.7
Stands 551 and 552	0.8	5.3	0.0	0.0	0.0	6.1
Minor Projects	1.9	1.9	1.9	1.9	1.9	9.4
Total core enhancement capex	33.3	101.8	124.5	74.9	48.0	382.5
Total core capex plan	154.7	197.8	188.0	139.2	111.0	790.8

	2014/15	2015/16	2016/17	2017/18	2018/19	Total
Business Systems Transformation	3.1	3.1	3.1	2.8	2.8	14.9
Hangar Facilities	3.7	0.0	0.0	0.0	0.0	3.7
HBS replacement	5.9	4.3	49.8	42.7	6.6	109.4
Liquid Explosives Detection	0.0	0.4	1.2	0.0	0.0	1.6
Total development projects	**12.7**	**7.8**	**54.1**	**45.5**	**9.4**	**129.6**
Total capex plan	167.5	205.6	242.1	184.8	120.5	920.4

Source: CAA calculations

C50 For the first two years of Q7, 2019/20 and 2020/21, the CAA's forecast capex was £353.1 million based on GAL's RBP reduced by the costs of HBS replacement and ST IDL capacity project. Following GAL's point that ST IDL capacity project was not due to complete in Q6, the CAA allowed for the additional capex to be added to its final view projections. Given the early stage of development of many projects it has not been possible for the CAA to undertake a detailed bottom-up review of the expenditure on individual projects. The CAA is also conscious that given the early stage of development costs are likely to change before the projects are delivered. Figure C.4 sets out the CAA's forecast capex plan for the first two years of Q7.

Figure C.4: CAA's final projections for capex for the first two years of Q7 (£ million)

	2019/20	2020/21
Asset stewardship	78.4	99.2
Long stay capacity (Decking) post 2019	1.9	4.7
CIP Building replacement (NT)	9.4	9.4
NT Avenue reconfiguration	1.9	4.7
NT Baggage Reclaim reconfiguration	0.0	2.8
NT Short Stay Car Park	1.7	8.6
ST Baggage Reclaim	0.9	0.9
Additional staff car park capacity	2.4	2.7
NT IDL Phase 2 (Post 2019)	18.9	18.9
Baggage capacity expansion (Post 2019)	0.0	1.9
Railway contribution	9.4	9.4

	2019/20	2020/21
Bridge over railway	0.0	0.9
ST Short Stay Multi Storey Car Park	0.0	1.9
Product development - Car Parking, Post 2019	1.9	1.9
Terminals works Post 2019	4.7	8.0
Piers works (Post 2019)	11.3	16.0
Commercial products (£25m holding figure, scope to be determined)	4.7	4.7
Industrial bays (assume 3 warehouses and associated bays works)	3.8	3.8
Landside restaurant	0.0	0.9
ST IDL Capacity	17.2	14.9
Total	168.6	216.6

Source: CAA analysis of GAL's RBP

CAA final view

C51 Based on the above analysis, figure C.5 sets out the CAA's final view on GAL's efficiency capex over Q6 and the first two years of Q7.

Figure C.5: CAA's final projections for capex (£ million)

	2014/15	2015/16	2016/17	2017/18	2018/19	Total	2019/20	2020/21
Asset stewardship	55.1	74.3	63.5	64.3	63.1	320.3	78.4	99.2
Carry over	66.3	21.7	0.0	0.0	0.0	88.0	0.0	0.0
Core enhancement capex	33.3	101.8	124.5	74.9	48.0	382.5	90.1	117.4
Total core capex plan	**154.7**	**197.8**	**188.0**	**139.2**	**111.0**	**790.8**	**168.6**	**216.6**
Development enhancement capex	12.7	7.8	54.1	45.5	9.4	129.6	0.0	0.0
Total capex plan	**167.5**	**205.6**	**242.1**	**184.8**	**120.5**	**920.4**	**168.6**	**216.6**

Source: CAA calculations

APPENDIX D

Operating expenditure

D1 This chapter considers the appropriate opex allowance for the Q6 price control calculation and contains the following sections:

- a summary of the CAA's opex process to date;
- a description of the opex allowance contained in GAL's RBP for Q6;
- a summary of the CAA's final proposals for the Q6 opex allowance;
- a summary of stakeholders' views on key issues affecting the opex forecasts; and
- the CAA's final decision for the opex allowance over Q6.

Opex process to date

D2 To date, the Q6 opex process has consisted of the following stages.

- GAL published its IBP in April 2012 providing its initial opex estimate of £1,528 million over Q6.
- Between April and December 2012, GAL and the airlines engaged in a process of CE over the forecasts in the IBP, providing a report to the CAA highlighting areas of agreement and disagreement.
- Opex estimates were updated in GAL's RBP in January 2013. This estimate reduced total opex by 3% to £1,481 million over Q6. This estimate was summarised in Chapter 5 of the CAA's initial proposals.
- The CAA commissioned several consultancy studies to test the forecasts contained in the IBP and RBP based on benchmarking, analysis of historical trends and testing the assumptions underlying the business plan.

- The CAA used this evidence to develop the opex estimate described in the initial proposals published in April 2013. The forecast was for £1,385 million over Q6, equivalent to a 1.1% reduction per year. This estimate was based on GAL achieving an efficient cost base by the end of Q6.
- Stakeholders responded to the initial proposals and the CAA published its final proposals on the 3 October 2013. The final proposals included a lower opex forecast of £1,378 million, equivalent to a 1.3% reduction per year over Q6.
- Stakeholders responded to the final proposals by 4 November 2013. The key points contained in these responses and the CAA's final view are summarised throughout this chapter.

D3 Figure D.1 provides a summary of the opex forecasts in GAL's business plans and the CAA's initial and final proposals for comparison.

Figure D.1: GAL opex forecasts

£ million 2011/12	2014/15	2015/16	2016/17	2017/18	2018/19	Total
IBP	296	299	304	312	317	1,528
RBP	288	294	297	300	301	1,481
CAA - IP	283	280	277	274	271	1,385
CAA - FP	283	279	276	272	269	1,378

Issues

D4 GAL and the airlines hold different views over the appropriate opex allowance for Q6 based on differing assumptions about the scope for efficiency. There is also some uncertainty and informational asymmetry between GAL and the CAA over opex, which requires the CAA to apply judgement to several issues.

D5 The CAA considers that the main areas of contention between GAL and the airlines concerning GAL's opex projections and the CAA's initial proposals have been:

- the analysis and conclusions of the top-down benchmarking;

- the analysis and conclusions of the employee pay benchmarking studies and achievability of efficiency savings;
- the analysis and conclusions of the pensions benchmarking, studies and achievability of efficiency savings;
- the scope for greater security process efficiency including flow rates, roster efficiency and the potential for outsourcing;
- the scope for greater efficiency through savings in other areas including maintenance, utilities, rent, rates, police, air navigation services (ANS), cleaning and other costs;
- the scope for greater efficiency from frontier shift; and
- the CAA's judgement over these issues and the overall scope for efficiency at Gatwick.

D6 Each of these issues, stakeholders' views and the CAA's final views are described below.

Top-down benchmarking

Issue

D7 The CAA reviewed the available benchmarking evidence and undertook its own analysis as part of the initial proposals. The CAA concluded that this analysis tended to suggest that GAL had scope for efficiency catch-up based on direct comparisons of adjusted unit costs with other airport operators. The analysis also indicated that opex per passenger had grown rapidly in comparison with other airport operators and airlines.

CAA's final proposals

D8 The CAA stated that benchmarking evidence can be used to assess the relative level of opex at Gatwick, and can provide an indication of the potential scope for efficiency gains relative to peers. However, no benchmarking sample can be considered perfectly comparable to Gatwick and the results of top-down benchmarking analysis need to be interpreted carefully.

D9 The CAA considered the latest benchmarking evidence from the Air Transport Research Society (ATRS), Leigh Fisher, SDG and other evidence submitted by GAL and HAL. In summary, this evidence showed that:

- Adjusted opex per passenger at Gatwick is estimated to be between £9.10 and £9.60. This is around the average of the study samples, but above several comparators including Copenhagen (£7.90 to £8.00), Manchester (£8.00 to £8.20), Dublin (£6.20) and Edinburgh (£5.30).
- Analysis of residual productivity[85] in the ATRS study showed that Gatwick is ranked in 15th place behind Copenhagen, Zurich, Amsterdam and Manchester with an efficiency gap of around 55% relative to the efficiency frontier.[86]
- The Leigh Fisher study showed that between 2009/10 and 2010/11 total opex at Gatwick fell by 23%. This largely reflects the temporary increase in costs prior to the sale of the airport operator. Overall operating costs per passenger had fallen but remain above the average.
- The AT Kearney study commissioned by GAL showed that GAL's costs were slightly below the sample average. The CAA stated that this may be because Gatwick had the highest level of low cost passengers within the AT Kearney sample. Operators of airports with high levels of low cost passengers tend to have lower operating costs, which means that the sample could be less comparable to Gatwick than the other studies.

D10 The CAA's benchmarking analysis showed that in 2005 adjusted opex per passenger was £7.83 at Gatwick, by 2012 costs had fallen by 1% to £7.77. In comparison, at Copenhagen costs fell by 38%, from £8.14 in 2005, to £5.05 in 2012. This suggests that Copenhagen has outperformed Gatwick over this period. The CAA stated that Copenhagen had several similarities to Gatwick, including a similar number of passengers and ATMs, similar airline customers and infrastructure. The CAA stated that Copenhagen was comparable to Gatwick.

D11 Gatwick also had higher opex per passenger than Stansted, Dublin, Hong Kong, Edinburgh and Glasgow. These airports are less

85 Residual productivity is an econometric concept which seeks to measure the productivity of an airport operator by attempting to account for different inputs and outputs such as passengers, employees, runways and other factors.

86 ATRS, 2013, Airport Benchmarking Report - 2013, Part I, page 53.

comparable to Gatwick, but suggest that there may be scope for further efficiency.

D12 The CAA concluded that overall the available benchmarking evidence indicated that Gatwick is operating at around the average level of airports of its size and characteristics. However, there are several airports with similar characteristics, which outperform Gatwick. This suggests that there may be scope for further catch-up efficiency.

Stakeholders' views

D13 The CAA received one response on this issue.

D14 GAL welcomed the updated benchmarking analysis which showed that Gatwick is now slightly below the average of the sample but disagreed with the CAA's conclusions that the analysis indicated that there could be scope for efficiency. GAL made several criticisms of the analysis, including that adjustments based on national GDP per capita concealed regional wage differentials, which put GAL at a disadvantage. GAL stated that it drew labour from the south east of England, where GDP per capita is 26% higher than the EU average, compared with 12% higher for the UK as a whole.

D15 GAL undertook further analysis applying regional GDP data to the CAA's benchmark dataset and found that Copenhagen had reduced opex per passenger by 18% rather than 38%. GAL estimated that Copenhagen has reduced its opex per passenger from £10.23 in 2005 to £8.43 in 2010, meaning that its costs were actually higher than Gatwick. GAL estimated that Gatwick has lower costs than all of the airports in the sample except Luton, Glasgow and Stansted.

D16 GAL stated that it has recently ✂ and had achieved significant improvements in efficiency represented by a 32% reduction in opex per passenger since 2009/10, compared to a 4% increase at Heathrow. GAL stated that these findings meant that it was unlikely to have further scope for catch-up efficiency.

D17 GAL commented on the CAA's statement that operators of airports with a high proportion of low cost passengers tend to have lower operating costs, stating that the varied and evolving nature of its traffic, competition with other London airports and high rates of utilisation meant that it had to provide a wider service proposition, which increased its costs.

D18 GAL made several points regarding comparisons between Gatwick and Copenhagen airport, stating that there were several differences which meant that the airports are not perfectly comparable. These differences included that; terminal 1 at Copenhagen handles only domestic traffic, terminal 2 and 3 share a common security search area, IDL, baggage, border and arrival facilities; unlike Gatwick Copenhagen has no segregation between arriving and departing passengers and Copenhagen's three runways meant that it was less congested than Gatwick. GAL also stated that comparisons between airlines and airports are not relevant.

D19 GAL did not agree with the CAA’s comments on the AT Kearney analysis and stated that it should be given more significance than the other top-down studies. GAL stated that the study had applied a more detailed methodology and the comparisons were more appropriate. GAL stated that the study showed that GAL's opex per passenger was £8.22 in comparison with an average of £9.89.

CAA's final view

D20 GAL's adjustments to the top-down benchmarking analysis are based on amalgamating the GDP and population of several regions including inner London and others to represent labour costs at Gatwick. On this basis GAL estimate that GAL's regional wage costs are 26% higher than the EU average. Inner London has the highest GDP per capita in Europe, its inclusion in a sample to represent Gatwick is not appropriate and GAL's analysis is flawed. The Eurostat data for the South East (which better represents GAL's labour market) shows a difference of 16%.

D21 The CAA has updated its benchmarking analysis to account for differences in regional wage levels based on Eurostat Purchasing Power Parity (PPP) adjusted data[87] (taking the South East as a proxy for Gatwick). Relative to the previous analysis this shows that GAL's costs are closer to Stansted but higher than Aberdeen (reflecting very high wages in north eastern Scotland), adjusted opex per passenger at GAL remains higher than several comparators including Copenhagen, Dublin, Edinburgh and Glasgow. Overall this new analysis does not alter the CAA's previous conclusions.

87 http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/1-21032013-AP/EN/1-21032013-AP-EN.PDF

D22 The CAA notes GAL’s comments regarding the relevance of comparisons of operating costs between airlines and airport operators but considers that such comparisons can be useful. It is common practise for regulators to compare the performance of a company over time with comparable industry benchmarks; this includes companies in different industries.

D23 The airlines have made several comments about the savings that have been made in the airline industry and contrasted this with the rise in GAL's prices. Virgin has provided some evidence which indicates that it has been able to reduce costs in real terms in several areas including ✂, which suggests that GAL should have been, or be able to, make similar reductions in areas of its business.

D24 The AT Kearney study was focused on benchmarking central support costs, which only for around 13% of opex. This study is therefore less relevant to the assessment of total opex from a top-down perspective. The CAA notes that the AT Kearney study undertook a detailed bottom-up analysis of central support costs and has taken account of this. However, this method was not applied to other parts of GAL’s cost base. Gatwick has the highest level of low cost passengers of the sample, and that this is likely to mean that the sample airports would have higher costs. AT Kearney were not able to disclose the airports in the sample due to confidentiality and the CAA noted that it could not be sure of the comparability of the sample.

D25 The CAA considers that its benchmarking analysis is robust, and consistent with the available independent evidence and that it has drawn appropriate conclusions, confirmed by the findings of the various bottom up studies, described in the following sections.

Employee pay

Issue

D26 GAL's RBP assumes that staff wages would rise by RPI+0.75% per year in its RBP. The IDS employee reward benchmarking study examined GAL's staff costs against comparators finding that total staff reward was between 9% and 13% higher than benchmarks based on comparisons with general and aviation market rates. The analysis took account of variations in regional pay differentials, organisation size and other factors to compare staff costs. IDS also found that basic salaries at GAL had increased by 33% between 2006 and 2012, nearly twice the average rate of increase in the South East and that GAL had relatively high levels of absenteeism; 10 days per year compared with benchmarks of 6-8 days.

CAA's final proposals

D27 Based on GAL's regulatory accounts, in 2011/12 total staff costs were £141 million.[88] This implied that if GAL could reduce its staff costs in line with the IDS benchmarks it could achieve savings between £12.8 million and £18.5 million per year by the end of Q6 taking account of changes in headcount.

D28 The CAA stated that given the evidence that staff pay at Gatwick is high, further real terms increases included in GAL's business plan are unnecessary. The CAA estimated that reducing the planned increase from RPI+0.75% to RPI+0% would reduce staff costs by a further £6.6 million by 2018/19 relative to the RBP. This did not include any savings that could be achieved through changes to rosters, closer matching of labour supply and demand, staff grading or changes to pension provision.

D29 The CAA considered the achievability of the proposed reduction in staff costs to benchmarks. Assuming average RPI inflation of 3.5% per year over Q6, the CAA estimated that staff costs could be reduced by around 20% by the end of Q6 by applying a nominal wage freeze.[89] This is significantly above the proposed 10% to 13% reduction, suggesting that the savings are likely to be achievable.

D30 The CAA noted that, similar measures had been applied throughout the public sector, parts of which have experienced a 2-year nominal wage freeze from 2010[90] followed by a 1% nominal average pay growth from 2013.[91]

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88 Data on staff costs is available for 2012/13 however the IDS analysis is based on staff costs in 2011/12, therefore for consistency the CAA used 2011/12 data to estimate the potential for reductions in staff costs.

89 Figures based on forecasts from Office of Budgetary Responsibility (OBR), March 2013.

90 HM Treasury Budget 2010, page 17.

91 The 2011 Autumn Statement announced that public sector pay awards will average 1 per cent for the two years following the pay freeze. This guidance was restated in the HM Treasury Civil Service pay guidance 2013-14. The 1% guidance includes all elements of pay including staff progression increments.

D31 The CAA noted that current rates of staff turnover at Gatwick are around 6% compared with benchmarks of 13% in the wider economy.[92] This supports the conclusion that current rates of pay are better than benchmarks and that there could be scope for reductions over Q6.

D32 The CAA also stated that GAL had provided the CAA with its own internal benchmarking evidence undertaken by Hay Group, which estimated that total cash staff costs at Gatwick are between ✂% and ✂% above upper quartile and median benchmarks. The CAA stated that this evidence strongly supported the conclusions of the IDS study and suggests that the IDS benchmarks could provide a conservative estimate of the potential for efficiency.

D33 The CAA noted that GAL also has other methods of reducing wage costs, for example by bringing rates of absenteeism into line with benchmarks, which could save up to £1 million per year. GAL could also seek to increase the proportion of staff on new lower rates of pay.

D34 The CAA highlighted the recent improvement in economic outlook and stated that it is possible that forecast wage growth will begin to increase through Q6 so that benchmark earnings may drift upwards towards the end of Q6. The CAA noted that this could potentially reduce the scope for efficiency if wages in the general economy began to grow faster than RPI.

D35 Taking account of the points described above the CAA considered that GAL could reduce staff costs by between £19.4 million and £25.1 million per year by 2018/19.

Stakeholders' views

D36 The CAA received three responses on this point.

D37 GAL stated that the CAA had overestimated the potential for reductions to staff costs. It stated that staff costs were the only controllable element of opex and that the CAA's frontier shift savings would also largely fall in this area. GAL stated that in combination the CAA had effectively assumed that it could reduce staff costs by £26.8 million per year.

92 IDS, 2013, Benchmarking Employments Costs - Gatwick.

D38 GAL was concerned that the CAA had not taken account of their feedback on the IDS staff cost benchmarking study. GAL restated that the IDS study was not consistent with the methodology applied to the CAA's NATS (En Route) plc (NERL) review, in which IDS made a statement that the examination of individual job roles should allow for ±10% variation from the benchmark in individual staff roles to account for statistical noise in the variations in pay rates.

D39 GAL stated that the CAA had overstated the potential for staff cost efficiency because it had applied the benchmark efficiency to GAL's gross staff costs in 2011/12 of £141 million. This overstated the potential saving as the figure includes costs attributable to the capital programme.[93] These costs had been evaluated separately through the capex efficiency review and this created a risk of double-counting the scope for efficiency savings.

D40 GAL stated that the CAA had overestimated the feasibility of making changes to staff and pension policies, stating that it had inherited legacy wage arrangements from the previous owners, and had worked hard to bring wages into line with benchmarks. GAL stated that the CAA had not sufficiently considered the pace at which changes could be made to wages and pension arrangements and had not permitted any allowance for transitional or redundancy costs required by the implied changes.

D41 GAL did not accept that it could reduce staff costs by 20% with a nominal pay freeze. GAL stated that a proposed pay agreement at 2% nominal for 2013/14 and 2014/15 had not yet been agreed between GAL and its unions and this award was now going to dispute resolution through Advisory, Conciliation and Arbitration Service (ACAS). GAL highlighted that this provided an indication of the difficulties it would face in reducing wage costs and that reducing staff pay by 20% over 5 years would 'undoubtedly' lead to industrial action. GAL stated that a wage freeze would restrict its ability to recruit in key support areas and that the CAA had made overly optimistic assessments of economic growth in passenger and commercial revenue forecasts.

93 GAL's 2011/12 regulatory accounts state that £16.9 million worth of staff costs were capitalised.

D42 GAL provided analysis of two potential changes to staff costs; increasing the proportion of security officers on new starter rates, and sub inflation pay settlements, which it estimated could save a total of £9.8 million per year respectively.

D43 GAL stated that it did not agree with the CAA's estimate that it could achieve an efficiency of around £1 million per year through reducing rates of absenteeism. It stated that its rates of short-term absenteeism were around 5 days per annum, which is in line with benchmark rates of 4.4 to 5.6 days per annum. It stated that the reason for its higher rates of long-term absenteeism was the greater stress and physical strain involved in manual security jobs.

D44 Virgin stated that it was concerned that the CAA had been inconsistent in its analysis of macroeconomic factors. It stated that there was no data to support the modification of the original staff cost efficiency proposal, and that if wages are expected to increase more rapidly this would have a positive effect on commercial revenues that should also be taken into account. A stronger economy could also increase rates of turnover, which would allow GAL to employ staff on lower rates.

D45 BA stated that there is evidence to suggest that the UK labour market has behaved differently in the recent recession. The fall in employment has been much lower than expected based on historical experience with firms 'hoarding' labour. This is likely to mean that wage growth is likely to be suppressed in any recovery over the next few years.

CAA's final view

D46 The CAA considers that GAL's comments on the interpretation of the IDS study of NERL wage costs are not relevant to the airport study. IDS's advice on the NERL study was provided in reference to the assessment of individual job roles and not overall staff costs at a company level. Disregarding individual job roles with low variation to benchmarks would skew the analysis towards only relatively high and low paid jobs and distort the assessment of overall staff cost efficiency. The IDS analysis is also based on two separate benchmarks; general and aviation markets, which have been used to estimate an upper and lower bound for the differences in total staff costs. Each benchmark has different levels of divergence across job roles and modifying or excluding roles within 10% of the benchmark would adversely affect this analysis.

D47 GAL's own benchmarking evidence indicates that total staff costs are 22% to 46% higher than benchmarks, which suggests that the IDS study could provide a conservative estimate of the potential for efficiency.

D48 The CAA does not accept GAL's assumption that staff costs are the only controllable element of opex or that frontier shift savings would need to be made wholly in staff costs. The frontier shift saving is based on the observed performance of companies across a range of sectors, which have been able to increase their total factor productivity (TFP) by around 1% per year on average. GAL is likely to have scope to make similar savings through a range of measures such as technological progress, greater energy efficiency, new security equipment, reducing outsourced costs or restructuring for example.

D49 The IDS study was based on 2011/12 data and has taken account of the changes to GAL's staff costs since the sale, this is reflected in the relative benchmarks between Heathrow, Gatwick and Stansted, which indicate that GAL's staff costs are closer to benchmarks.

D50 The CAA's proposals are based on GAL reducing staff costs by 9% to 13% gradually by 2018/19 in line with the IDS benchmarks. This is an appropriate length of time for GAL to make required changes to its cost base and is consistent with the "glide path" approach applied to HAL.

D51 The CAA accepts GAL's comments on the capitalisation of staff costs and the potential for double-counting efficiency through the capex efficiency studies. GAL's total staff costs in 2011/12 were £141 million. This includes £20.9 million capitalisation meaning that net staff costs (included in opex as opposed to capex) were around £120 million. Staff costs increased to £144 million in 2012/13 including £22.1 million capitalisation, meaning net staff costs are now £122 million. This suggests that the wage cost efficiency could be lower than assumed in the final proposals - between £16.5 million and £21.4 million by 2018/19 in total.

D52 In the final proposals the CAA stated that the recent improvement in the economic outlook could mean that wages in the general economy could rise faster than inflation, reducing the scope for wage efficiency savings. New forecasts from the OBR[94] indicate that this is unlikely to be the case and show that average earnings will actually remain below inflation over Q6 on a cumulative basis. Figure D.2 shows that average wages are expected to be around 2% lower in real terms by the end of Q6 compared with a 2012 base. This means that GAL is likely to have greater scope for efficiency.

Figure D.2: OBR real average earnings growth assumptions

Year	March forecast		December forecast	
	Average Earnings	2012=100	Average Earnings	2012=100
2012	-1.1%	100	-1.2%	100
2013	-1.8%	98.2	-1.6%	98.4
2014	-0.1%	98.1	-0.3%	98.1
2015	0.4%	98.5	0.0%	98.1
2016	0.4%	98.9	-0.1%	98.0
2017	0.1%	99.0	0.0%	98.0
2018	0.1	99.1	-0.2%	97.8

Source: OBR March and December Economic Forecasts

Real average earnings calculated by subtracting RPI from nominal average earnings.

D53 Lower average wage growth over Q6, means that GAL is likely to be able to reduce costs by more than assumed in the IDS study, which was based on wage levels in 2012. Accounting for the reduction in average earnings over Q6 means that GAL could reduce wages by between 11% and 15%. This would result in a saving of between £13.4 million and £18.2 million per year by the end of Q6 (based on lower staff costs).

D54 The CAA notes GAL's comments about the difficulties of achieving the proposed wage cost efficiencies and GAL's sensitivity analysis. The CAA considers that the proposed savings could be exceeded through a nominal wage freeze, and that similar measures are being applied throughout the public sector. This indicates that the savings are

94 OBR, Economic Outlook December 2013.

achievable. The CAA notes that GAL has other methods of reducing staff costs, which could include reducing rates of absenteeism, increasing the proportion of staff on lower rates of pay and, if necessary, restructuring functions to reduce headcount.

D55 GAL's analysis of the impact of below inflation pay rises is based on an assumption that pay growth should be 2% less than inflation in 2014/15, followed 1% below inflation for the rest of the period. This is overly generous given the existing level of staff cost inefficiency.

D56 GAL's levels of absenteeism are higher than benchmarks (including at Heathrow) and could be reduced. The CAA does not accept that GAL's employees are under higher levels of stress or physical strain than the average UK company employee.

D57 The CAA has estimated that the cost efficiency could be exceeded with a nominal wage freeze over Q6 which would reduce costs by around 21%, assuming average inflation of 3.5%. This is significantly above the proposed reduction of 10% to 13% and indicates that the savings are achievable. The CAA has based the wage costs efficiency on GAL's own staff costs and headcount proposals and has not assumed that any changes in headcount are required.

Pensions - future service costs

Issue

D58 In the CAA's Q5 November 2007 proposals for Heathrow and Gatwick, the CAA stated that BAA's pension costs should be capped "on the basis of cash contributions to the pension fund each year" but that these should be capped at an appropriate level, to ensure airport users are not disadvantaged by the relative generosity of the scheme. Previous analysis by the CC indicated that an allowance of 20% of pensionable pay was appropriate. The CAA decided that it would allow a cap of 25%, partially to enable BAA to make changes efficiently.

D59 A study conducted by IDS estimated that pension costs would be equivalent to 24% of pensionable pay in 2013 on average (31% for the defined benefit (DB) and 10% for the defined contribution (DC) scheme).

D60 Whilst below the Q5 cap, this was estimated to be higher than comparative benchmarks of 20% for DB schemes and 7% for DC schemes. Based on this evidence, the CAA considered that GAL could reduce pension costs by up to £5 million by 2018/19.

CAA's final proposals

D61 The CAA commissioned Government Actuary's Department (GAD) to review the pension benchmarking analysis and stakeholders' comments on the initial proposals. The study reviewed the initial proposals, and benchmarking undertaken by IDS. GAD concluded that DB costs are based on a number of factors including the type of benefits provided, funding assumptions and other factors affecting investment returns. GAD considered that this created some uncertainty over the comparability of individual DB pension scheme contribution rates and that there is a range of possible contribution rates associated with an efficient level of pension benefit provision due to different funding assumptions.

D62 GAD considered that it was appropriate for the CAA to assume further efficiencies in GAL's pension scheme, as savings were being proposed by HAL, and analysed two changes based on comparisons with other typical DB schemes; increasing the normal retirement age from 60 to 65, and reducing the scheme's accrual rates from 1/54th to 1/60th. These were the same changes considered by the CC in the Q5 review.

D63 Based on these changes and GAL's own valuation assumptions GAD estimated that an appropriate allowance for DB pension costs would be 20% to 22% of pay. The CAA took account of GAD's advice and assumed a contribution rate of 21% through Q6. This resulted in an efficiency of £3 million per year by 2018/19.

D64 GAL also has relatively high average DC contribution rates of 11% in comparison to average rates of 7%.[95] Reducing the contribution rate to 7% would result in an efficiency of £2 million per year by the end of Q6. However the benchmark comparisons may be affected by the organisation of pension payments, in particular GAL has implemented a salary sacrifice scheme which would tend to increase its pension costs relative to benchmarks. Overall the CAA considered that GAL

95 Occupational Pension Schemes Annual Report 2010 (ONS), page 31.

had scope to reduce total pension costs by between £3.4 million to £5.0 million by the end of Q6.

Stakeholders' views

D65 The CAA received two responses on this issue.

D66 GAL stated that it had significant concern with the CAA’s analysis of pension costs. It stated that the CAA had not taken account of the closure of the DB pension scheme, which would effectively ‘sunset’ over the longer term. GAL stated that this was critical to the analysis of the airport operator's overall long term cost base and demonstrated that GAL was actively managing pension costs to an appropriate level.

D67 GAL stated that the GAD benchmarking analysis was not appropriate because it relied on comparisons with pension schemes from other businesses and sectors which are not comparable to GAL. GAL stated that the benchmark data was out of date and that negative movements in funding cost reduced the reliability of the benchmarking evidence.

D68 GAL stated that the pace of change implied by the pension efficiency was unrealistic as the final proposals represent a 35.5% cut to the pension contribution rate from April 2014. GAL stated that the CAA had given no consideration to the commercial and HR realities in determining an appropriate contribution rate or suitable time period over which to implement any pension scheme changes.

D69 GAL highlighted that the CAA had granted a pension allowance of 20% of pay at Gatwick, compared to 23% to 24% of pay at Heathrow. GAL stated that it did not understand the reason for this difference and as the pension schemes both originate from the former BAA DB scheme, it would expect the allowance for HAL and GAL to be the same.

D70 GAL stated that GAD had based its estimate on the provision of typical pension benefits, but had not accounted for GAL's atypical funding assumptions. GAL provided four scenarios which suggested that if GAL used typical funding assumptions, its pension cost allowance should be between 22% and 25%.

D71 The ACC stated that the CAA should make further changes to its pension allowance including reducing the employer contribution rate for the DB scheme to 14% in line with benchmarks; contribution rates for the DC scheme should be set at around 7% reflecting benchmark rates.

D72 The ACC stated that the 2011 ONS Occupational Pension Schemes Annual Report estimated that the average employer contribution rate to a closed private sector DB scheme was 14.4% in 2011, excluding any deficit reduction payments. The ACC concluded that this was a more appropriate contribution rate for GAL.

D73 The ACC also stated that the average employer contribution rate for a DC scheme was 6.5%, and there was no reason why GAL could not bring its own DC scheme into line with market averages.

D74 The ACC highlighted that the GAD report had stated that there could be scope for further benefit reductions than assumed in the report based on more recent benefit changes made by other schemes, which it stated could result in contribution rates falling to around 12%. The ACC believed that the CAA had not considered this option seriously.

CAA's final view

D75 GAL's comments about the benchmarking of its pension costs are not relevant to GAD's assessment of efficiency. GAD's analysis is based on GAL achieving benchmark levels of benefit provision, including reducing the retirement age and accrual rate of the pension scheme and is based on GAL's own funding assumptions. The analysis is consistent with the analysis undertaken for the Q5 review and assumes the same changes.

D76 The impact of these changes has been calculated using GAL's own funding assumptions and is not affected by changes to benchmark levels of pension funding. GAD also state that there may be scope for further reductions based on the latest trends in DB pension provision, which may not be reflected in the latest data on typical scheme provision.

D77 The CAA assumed that GAL could achieve an efficient opex cost base gradually by the end of Q6 and has made no explicit assumptions about the implementation of changes in the first year of Q6. The efficiencies are based on GAL bringing its pension scheme into line with benchmarks by 2018/19, which should be achievable. The CAA has modelled its efficiency saving on GAL's pension membership data; this takes account of GAL's closure of the DB scheme and the resultant gradual reductions in DB scheme membership and cost.

D78 The CAA notes GAL's comments about the difference in the pension allowance between HAL and GAL and its scenario analysis suggesting that it should have a higher rate of allowance. This difference is caused by the different funding assumptions applied by each scheme. HAL has made more conservative assumptions about its pension liabilities, which all else equal means that the short-term cash contribution required for a given level of pension benefit will be higher. For this reason the CAA has provided a higher allowance based on GAD's advice. Different funding assumptions affect the timing of pension costs, but have a negligible impact on the overall long-term cost. This is because more conservative pension funding assumptions are more likely to result in a funding surplus, which would reduce the need for future contributions.

D79 GAD's high level review of GAL's pension funding assumptions indicates that GAL's assumptions are not out of line with standard practice and the CAA has no reason to make different assumptions. GAL, in agreement with its pension trustees, has chosen to apply less conservative assumptions than HAL and the CAA has evaluated its pension costs in line with those assumptions.

D80 In line with Q5 policy which stated that: "there is advantage in moving progressively towards a regulatory approach in which labour costs are evaluated holistically, and discretion afforded to the regulated companies... to decide how best to remunerate staff." the CAA has undertaken a combined analysis of staff costs through the IDS benchmarking analysis which provided an analysis of costs with and without pension payments. However in this case a separate analysis of staff costs identifying the differences between staff on DB and DC pension schemes has been necessary to account for the different pension funding assumptions applied by each airport operator.

D81 The CAA notes the ACC proposal that pension costs should be capped at a benchmark rate of 14% based on ONS data of average company contribution rates. Similar analysis was used in the IDS study. There are two issues with the benchmark analysis.

- Different schemes with the same level of benefit provision have different contribution rates based on different funding assumptions.

- The ONS dataset is based on data from 2011. Since then, pension asset returns have been negatively affected by changing macroeconomic factors including declining bond yields, which have increased average contribution rates.

D82 These two factors mean that the ONS benchmark data is not perfectly comparable with GAL's pension cost. The CAA considers that it is therefore more appropriate to analyse future service costs based on GAL's funding assumptions and the level of benefits provided as described in the GAD report.

D83 The analysis of DC pension costs is not affected by these issues and there is an argument that GAL could reduce its costs from 11% to 7% in line with the benchmark. However, GAL has implemented a salary sacrifice scheme, which would tend to increase its DC costs relative to benchmarks.

D84 Overall the CAA considers that GAL has scope to reduce pension costs by between £3.4 million to £5.0 million by the end of Q6.

Pensions - deficit

Issue

D85 A report by the GAL scheme actuary in November 2011 estimated that a deficit of £12 million was likely to arise at the next scheme valuation in September 2013. Based on a recovery period of 10 years, GAL has included deficit recovery costs amounting to £5.7 million over Q6.

CAA's final proposals

D86 The CAA commissioned GAD to consider the treatment of the pension deficit. GAD concluded that there are two possible regulatory approaches to the treatment of pension deficits.

- Users meet the expected costs of benefit accruals, but the management of the scheme's liabilities is a matter for the company.
- Or users meet total pension costs including deficit contributions (and therefore also benefit from any surplus) subject to those costs being efficiently incurred.

D87 Based on the treatment of BAA's pension deficit costs in Q5, and the lack of a signalled change in policy, GAD concluded that the latter approach was appropriate and that in principle, deficit costs should be included in the Q6 allowance.

D88 GAD also found that GAL's latest interim funding update in September 2012 shows a total deficit of £1 million, which would be immaterial to the opex allowance once spread over a typical deficit recovery period of 5-15 years.

D89 The CAA accepted GAD's conclusion that in principle deficit costs should be included in the opex allowance based on the latest available full or interim pension funding valuation. The CAA stated that GAL's RBP estimate was not based on a full or interim valuation and excluded these costs, equivalent to £1.4 million by the end of Q6.

Stakeholders' views

D90 The CAA received two substantial responses on this issue.

D91 GAL welcomed the CAA's decision to accept the principle that pension deficit costs should be included in the "fair price calculation" but did not agree with the decision to disregard GAL's pension deficit estimate based on the insignificance of the £1 million deficit estimate recorded in the September 2012 actuarial funding assessment. GAL stated that an estimate by the scheme actuary showed that based on existing scheme funding principles and allowing for changes to market conditions GAL's pension deficit would be between £15 million and £20 million in September 2013. GAL considered the estimate of £12 million included in its RBP was a reasonable assumption as it was based on more prudent assumptions than applied by HAL to estimate its deficit.

D92 GAL stated that its estimate did not allow for any potential changes in the valuation methodology that may be agreed as part of the 2013 valuation and a more prudent approach to the valuation methodology could have a material adverse impact on the scheme deficit. GAL pointed out that the assumptions used to calculate the deficit are less prudent than those applied in the analysis of HAL, and that adopting HAL's assumptions would increase its deficit estimate.

D93 GAL stated that the next full actuarial valuation of GAL's pension scheme will be conducted in September 2013 and that in principle the deficit estimated in this valuation should be included in the opex allowance. In practice the valuation would not be available in time for the CAA’s final decision, but the CAA must make a reasonable allowance for the likely deficit costs. GAL stated that this would be consistent with the CAA taking account of future events with reference to the treatment of expected commutation payments to HAL associated with the sale of Edinburgh and Stansted.

D94 The ACC disagreed with the decision to allow GAL's deficit costs and stated that as a matter of principle, GAL's shareholders should bear the risk of deficit payments, given that: any deficit is likely to reflect GAL’s inefficiency; and the Q5 regulatory policy statement states that pensions should not be considered a cost pass through, but should be considered as part of a reasonable allowance for staff remuneration.

D95 The ACC considered that risks should in principle rest with those best able to manage them, so that GAL has a proper incentive to manage its pension costs effectively.

D96 The ACC noted that GAD’s analysis is based on GAL’s own 2010 valuation report including the rate of future pay increases. The ACC stated that GAL’s annual report stated that it had assumed that wage growth would be RPI+0.5% and noted that this was not consistent with the CAA’s wage efficiency proposal. The ACC stated that GAD had not taken account of this in their estimate of deficit costs.

D97 The ACC stated that pension policy had long-term implications for the company and its users and highlighted the Q5 policy statement that the CAA would seek to move towards a comprehensive treatment of wage and pension costs. The ACC stated that this policy had not been adhered to in the CAA’s final proposals.

D98 The ACC stated that the CAA should set out its pension policy for the future, building on the Q5 policy statement and stating clearly that no deficit payments will be made in future, unless the scheme benefits are consistent with benchmarks.

CAA's final view

D99 As stated in the final proposals, the CAA accepts that in principle deficit costs should be included in the opex allowance. GAD's recommendation is that the allowance be based on the latest available full or interim actuarial valuation. This shows that GAL's deficit is expected to be around £1 million in total. Recovery payments are therefore immaterial to the opex allowance over Q6 once spread over a typical recovery period of 5-15 years.

D100 GAL estimates that the deficit will increase to £12 million based on recent declines in corporate bond yields. GAL's estimate is also based on an amendment to its funding assumptions; that salaries will grow by 0.5% per annum. This is not consistent with the CAA's wage proposals, or GAL's own valuation assumptions.

D101 The CAA considers that it is not appropriate to make adjustments to the deficit costs based on recent changes in market conditions, which could be reversed over Q6. The latest actuarial review provides the best estimate of GAL's deficit costs. There is considerable uncertainty about GAL's estimate and possible changes to the deficit during Q6. In contrast, there is high certainty over the commutation payments to be made in respect of the sale of Edinburgh and Stansted.

D102 The CAA notes GAL's concerns that the pension deficit may turn out to be higher than forecast in the latest valuation, and the ACC's comments that GAL is best placed to manage the pension deficit. This issue is discussed further in the future pension policy section below.

D103 The CAA notes the ACC's comments about adherence to the Q5 regulatory policy statement, which is quoted above.

D104 The CAA interprets the policy statement as applying only to future service pension costs which are an integral part of staff cost remuneration. The CAA does not consider that deficit costs were intended to be covered by this policy statement. Deficits are attributable to a shortfall on the bulk of pension assets accrued over generations of employees. Including deficit costs as part of total staff cost benchmarking analysis could force GAL to reduce staff costs to below market rates to account for an unrelated and largely uncontrollable shortfall on historic assets, conversely any future surplus would imply that GAL could raise staff wages well above benchmark rates.

Future pension policy

D105 GAD stated that the CAA should consider setting out its policy for the future treatment of pension costs highlighting two issues; potential changes in the estimate of the scheme deficit at the next valuation and future policy for deficit recovery. This policy would only apply to GAL in the event that RAB-based regulation was applied.

D106 GAD stated that funding positions fluctuate over time due to changes in market conditions and other factors. The scheme's funding position could change significantly during the Q6 period and it would be a reasonable aim for the CAA to ensure that the choice of baseline valuation date does not affect the balance of pension costs met by shareholders and airport users in the long term. GAD stated that this could be achieved by adjusting for any differences between reasonably incurred pension deficit contributions and the price control allowance at future price controls (through an adjustment to the RAB for example).

D107 GAD stated that there are advantages in using the latest full actuarial valuation for the purpose of setting the deficit allowance, as it is consistent with the actual setting of future contribution rates and represents a more robust assessment of the scheme following a process set out in legislation.

D108 GAD also suggested that the CAA could consider options to strengthen incentives for the airport operator to manage pension costs such as only taking into account a certain percentage of the pension scheme deficit at future price control reviews, or signalling that the funding risk in respect of benefit accruals after a certain cut off date is entirely a matter for the company and its shareholders.

D109 With regard to the treatment of any deficit recovery costs at the next price control, the CAA considers that there are three main policy options:

- a continuation of the current policy, whereby passengers pay for deficits, and benefit from surpluses;
- a policy whereby shareholders pay for deficits, and benefit from surpluses; or
- a hybrid approach whereby deficit and surplus payments are shared between passengers and shareholders.

D110 An example of the latter approach is the ‘incremental deficit’ method developed by Ofgem whereby the pension liabilities are split between those accrued before and after a cut off point. Any scheme deficit is then split between these portions with customers paying for the former, and the company for the latter.[96]

D111 The CAA intends to consult stakeholders on potential changes to the treatment of deficit costs at the next price control review based on the options described above. Stakeholders should not assume that this will result in any changes to the current policy.

Pensions - commutation payment

Issue

D112 In 2010 GAL made a commutation payment of £104.7 million to BAA related to the sale of the airport operator, which removed GAL's liabilities associated with former employees in the BAA pension scheme. GAL stated that this payment should be included in the RAB as it was an investment by GAL which reduced ongoing opex costs.

CAA's final proposals

D113 The CAA commissioned GAD to provide advice on the treatment of the commutation payment. GAD concluded that the commutation payment had reduced GAL's pension liabilities, and potential deficit contributions associated with its former employees in the BAA pension scheme. In principle the costs should be allowed into the RAB because:

- the payment relates to liabilities for employees at Gatwick;
- had the payment not been made, GAL (not Heathrow Airport Holdings Limited) would have been liable for additional pension contributions;
- information provided by HAL indicates that the funds to meet the commutation payment were provided by the purchaser of GAL; and
- HAL has not sought to recover the amount of the commutation payment through its pension allowance, whereas GAL is seeking to do so.

D114 GAD also stated that:

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96 Ofgem, 2013, Energy Network Operators' Price Control Pension Costs - Regulatory Instructions and Guidance: Triennial Pension Reporting Pack supplement including pension deficit allocation methodology.

- the payment was likely to be higher than the expected costs of the liabilities avoided overall; but
- the commutation payment was around 45% of the section 75 estimate of the liabilities avoided, meaning that the risk associated with those liabilities has been removed at a relatively low cost.[97]

D115 Based on the second point GAD stated that it would be reasonable to include the full amount within the Q6 opex allowance spreading the cost over a long time period. GAD also stated that excluding part of the commutation payment would create inconsistencies with HAL's pension cost allowance, where the full amount of the commutation payment has been taken into account in the scheme deficit.

D116 The CAA accepted GAD's recommendations that the commutation payment should be included in GAL's Q6 allowance in full. The CAA included the full payment of £104.7 million in GAL's opening RAB.

Stakeholders' views

D117 The CAA received two responses on this issue.

D118 GAL welcomed the CAA’s decision to accept GAD’s recommendation that the commutation payment should be included in GAL’s Q6 allowance in full. However GAL stated that the amount included in the RAB should be adjusted to account for inflation and estimated that the payment should increase from £104.7 million to £112.5 million to account for inflation.

D119 GAL also stated that it did not agree with the CAA’s decision to set the depreciation of the payment at 15 years, stating that the length of the depreciation period should be independent of the amount of the payment. GAL argued that it should be allowed to recover the payment over a 10-year period in line with the normal period over which a company would fund a pension deficit. GAL also stated that there should be an interest adjustment based on GAL's cost of capital to account for amounts unrecovered since the payment date.

D120 The ACC did not support the inclusion of the pension commutation payment within the GAL fair price RAB estimate. The ACC stated that it did not understand the reason for the CAA’s change of view on the

97 Section 75 is a method of valuing pension liabilities, which is usually considered to provide a benchmark of the cost of fully insuring against the risk of future pension deficits.

commutation payment since the initial proposals and could not see any justification in GAD's report. The ACC argued that airlines were not consulted on the payment by GAL, and had not had a chance to comment on its value for money. The ACC considered that as GAL was going to make a rate of return on the payment, this was vitally important.

CAA's final view

D121 The CAA considers that it is appropriate to uplift GAL's commutation payment to account for inflation. The RPI index was 226.5 in 2010/11 and 237.3 in 2011/12. This means that the payment should be increased by 4.7% to £109.7 million. The CAA has included this amount in GAL's RAB.

D122 The CAA continues to consider that it is appropriate to assume that the payment is recovered over a 15-year period. This is in line with typical deficit recovery plans and reflects the large size of the payment. GAL has effectively paid a lump sum to remove pension costs which otherwise would have occurred over many years. It is appropriate that this cost is spread over a long time period.

D123 The CAA does not consider that it is appropriate to include an interest adjustment based on GAL's cost of capital for amounts unrecovered since the payment date as GAL undertook this payment without consultation with users and at its own risk.

D124 The CAA notes the ACC's concerns about a lack of consultation on the payment and its concerns about value for money. The GAD study found that the payment has effectively reduced GAL's pension costs risk for 45% of the section 75 cost. Therefore the CAA considers the cost to be efficient and has sought to avoid overburdening current passengers by spreading the recovery of the cost over a 15-year period. The CAA has taken account of the airlines' views on the commutation payment through responses to the initial and final proposals and publication of the GAD study.

Other opex

Issues

D125 The CAA commissioned SDG to examine the 'other opex' costs in GAL's business plan, including costs related to; rent and rates, utilities, police, NATS, PRM, cleaning and other items. The study proposed 'core' and 'stretch' efficiencies in several areas based on a combination of benchmarking evidence and challenges to the assumptions underlying the business plan. The original report concluded that GAL could achieve savings of between £4.6 million and £6.0 million relative to its business plan.

CAA's final proposals

D126 The CAA commissioned SDG to update their report to take account of stakeholder feedback on the initial proposals. SDG reviewed the evidence provided by stakeholders and provided an update to their report.

D127 The CAA considered GAL’s points and did not agree with its criticisms of the SDG report. Many of the efficiency proposals were based on the application of less conservative assumptions in the business plan including the use of official forecasts or policy for utility and police costs for example. GAL had not provided an adequate explanation for different assumptions used in its business plan. The CAA included savings of between £4.6 million and £6.0 million per year in its efficiency proposals based on the SDG Other Opex report.

Stakeholders' views

D128 The CAA received one detailed response on this issue.

D129 GAL stated that it was disappointed that SDG had not altered their original conclusions on the study in response to GAL's evidence. GAL considered that it had provided evidence to support its cost projections for utility and police costs whilst the consultant’s proposals lacked evidence. GAL made specific comments criticising the NATS, police and cleaning cost efficiency proposals stating that the CAA’s approach was consistently unbalanced.

D130 GAL highlighted that the CAA had frequently acknowledged the risks of reliance on benchmarking evidence, but had not taken account of this risk in its interpretation of SDG's proposals.

D131 GAL stated that NATS' costs would experience upward pressure due to scope and capability risk including from GAL’s approach to improving runway utilisation, increasing air traffic control officer (ATCO) wages and that there is a lack of suitable substitutes. GAL stated that SDG's assumption that GAL could reduce costs through improvements to procurement strategy were overly optimistic.

D132 GAL stated that the Winsor review of police pay indicated re-distribution of pay calibrated on levels of specialism as opposed to length of service. As the police deployed at Gatwick have one of the highest degrees of specialist skills this will increase pay at Gatwick faster than the average.

D133 GAL stated that SDG’s benchmarking made no attempt to normalise for service cleaning standards. GAL had very high expectations of cleaning standards which meant that costs would increase more rapidly than the average trend for minimum wages.

D134 GAL stated that it was disappointed that the study had not offered substantive fact-based evidence to support its conclusions or how the proposed efficiencies could be achieved.

CAA final views

D135 Most of GAL's points were considered at earlier phases of the study and SDG have therefore not changed their conclusions in the final update of the report, which was referenced in the final proposals.

D136 GAL's RBP assumed 1.9% real terms growth in police costs over Q6. SDG's efficiency proposal is based on a lower rate of growth in line with official policy. Police wage growth has been capped at 1% nominal for the past two years in line with government policy and real terms growth in pay at an aggregate level is unlikely over Q6. This is confirmed in the assumptions in Sussex police's own accounts.

D137 The Winsor review contains a variety of measures reforming police pay. Whilst some specialist skills will be rewarded, the overall reforms are intended to reduce police costs. Measures include lower rates of pay for new officers, pension reform and ending automatic promotion based on time served, overall these reforms mean that GAL's police costs are unlikely to rise in real terms over Q6.

D138 No benchmarking dataset can be considered perfectly comparable to GAL, but several steps were taken to improve the comparability of the data with that provided by GAL, including adjusting terminal areas and costs and seeking a wide range of benchmarks. All the airports were UK based and SDG did not consider that there were significant differences in service quality between the airports considered. SDG had also sought to take account of changes to employers' compulsory contributions to staff pensions, which had been omitted by GAL's analysis.

D139 In relation to cleaning SDG took account of differences in front of house and back of house terminal areas and accounted for the growth of minimum wage costs. GAL's wage growth assumptions have been systematically higher than benchmarks.

D140 The CAA considers that it has taken account of GAL's comments on this study and that it has provided a clear rationale for the basis of its efficiency proposals. Many of the savings (police, utilities and cleaning) are based on a lower estimate of outturn costs based on official data or policy. This reflects the conservative assumptions in GAL's RBP, (high wage growth assumptions for example). The CAA has assumed that GAL could achieve savings of between £4.6 million and £6.0 million relative to its business plan.

Maintenance costs

Issue

D141 The CAA commissioned SDG to assess GAL's maintenance cost forecasts. SDG benchmarked costs against eight other airports and concluded that some efficiency was likely to be possible through either maintaining costs per square metre at 2012/13 levels over Q6 or a reduction in maintenance costs in line with more efficient external benchmarks. SDG concluded that GAL could reduce maintenance costs by between £0.8 million and £4.2 million per year by the end of Q6. The higher savings were based on GAL closing 50% of the gap with external benchmarks.

CAA's final proposals

D142 The CAA commissioned SDG to update their report to take account of stakeholder feedback on the initial proposals. SDG did not accept most of GAL's criticisms of the study, that the report contained factual inaccuracies or that the assessment of efficiency was unbalanced.

D143 In response to comments from the airlines that GAL should close 100% of the gap with external benchmarks, SDG stated that this would not be appropriate due to Gatwick's characteristics as a multi-terminal airport, which could increase its costs relative to other airports.

D144 Overall SDG concluded that the responses to the initial proposals did not raise any new evidence or arguments that had not been considered in the earlier phases of the study and maintained their efficiency estimates. The CAA adopted efficiency savings of between £0.8 million and £4.2 million per year by 2018/19 within its efficiency range.

Stakeholders' views

D145 GAL stated that it was disappointed that SDG had not altered their original conclusions on the study, despite the evidence provided by GAL.

CAA's final view

D146 The CAA considers that it has taken account of stakeholders' responses to this report. SDG's efficiency proposals are based on holding costs constant in real terms per metre square or reducing the gap with more efficient benchmarks by 50%.

D147 These proposals are supported by benchmarking comparisons with eight other airports which shows that GAL's maintenance costs are 49% higher than the average of other UK airports. GAL's RBP also assumes that total maintenance costs per square metre will rise by 10% over Q6 (including staff costs) reflecting GAL's conservative RBP assumptions. This indicates that there is likely to be scope for efficiency over Q6.

D148 The CAA has adopted efficiency savings of between £0.8 million and £4.2 million per year by 2018/19 within its efficiency range.

Central support costs

Issue

D149 The CAA commissioned Helios to examine GAL's central support cost forecasts. The study examined historic and forecast central support costs at Gatwick and collected a range of benchmarks based on costs at other airports, airlines and bespoke Hackett and Gartner data tailored to GAL. GAL's costs were compared against these benchmarks to estimate the potential for greater efficiency in the airport operator's business plan.

D150 The study concluded that GAL could potentially reduce central support costs in several areas including finance, HR, IT and airport management. Overall the study concluded that GAL could reduce central support costs by between £2.9 million and £5.4 million per year by the end of Q6.

D151 The lower target was based on GAL maintaining current levels of cost over Q6, matching conservative benchmarks and removing unjustified increases in the RBP including in insurance and consultancy costs. The higher 'stretch' target was based on closing the gap with the most efficient external benchmarks.

CAA's final proposals

D152 In considering how to interpret this evidence the CAA considered several factors including:

- the late delivery of the report and lower level of stakeholder engagement, which has limited the airlines' opportunity to comment on the evidence;
- the wide range of benchmarks used in the report which sometimes provide conflicting assessments of efficiency and indicate that there is a wide range of cost levels in central support activities;
- the lack of detailed understanding of the drivers of central support cost provided by the report, and a lack of detailed cost saving proposals to support the potential efficiency savings suggested by the benchmarking evidence;
- the AT Kearney report provided by GAL which indicates that GAL is at or below average levels of cost in most areas of central support (in comparison to an undefined sample of European airports);
- the impact of proposed staff cost efficiency on central support costs; and
- responses from the airlines and GAL to the CAA's initial interpretation of the evidence.

D153 Both the AT Kearney and Helios studies indicated that GAL's performance in central support activities is generally close to comparable benchmarks of average performance. This suggests that GAL is not particularly inefficient in this area. However the Helios study did indicate that; there was scope for improvement relative to more efficient benchmarks; that staff costs are relatively high (supporting the IDS study) and that in some areas GAL's business plan implies a deterioration in performance over Q6.

D154 On balance the CAA considered that it would be appropriate to incorporate the 'core' efficiency proposals, after taking account of the reduction in central support costs linked to the wage cost efficiency described above.

D155 Central support staff account for around 10% of total staff costs and this proportion of the staff cost efficiency can therefore be attributed to central support activities (£2.2 million by 2018/19). Accounting for this, the CAA incorporated savings of £0.7 million by 2018/19 into its efficiency range.

Stakeholders' views

D156 The CAA received two responses on this issue.

D157 GAL stated that Helios' back office benchmarking did not feature any benchmarks that were tailored to a company of GAL's size, location, and industry despite such benchmark's being available. GAL highlighted the LECG Corporation (LECG) study undertaken for NERL as an example and suggested that the Hackett and Gartner benchmark of IT costs was inappropriate.

D158 The ACC noted that the Helios study found that GAL could reduce central support costs in several areas including finance, insurance, legal and communications costs and proposed that savings could be made through reducing wages, outsourcing, restructuring and reducing the seniority of departments. The ACC was critical of the CAA's interpretation of the study results and questioned why the CAA had paid for the report if it did not find the results satisfactory.

D159 The ACC stated that the CAA should adopt the mid-point of the consultant's recommendations (equal to £4.2 million per year in 2018/19). Similar points were made by easyJet.

CAA final views

D160 The CAA does not agree with GAL's criticism of the study. Central support functions are generally comparable across industries and the Helios study has taken account of a wide range of benchmarks including finance and HR benchmarks developed with guidance from the Hackett Group and specifically tailored to Gatwick's characteristics. The study has also used airport operator and airline cost benchmarks and other public information to develop an estimate of an appropriate range of cost in each central support activity based on key drivers including passenger numbers, employees and revenue.

D161 The uncertainty associated with the benchmarking and comparability with GAL has been taken into account through the analysis, the range of benchmarks examined and the interpretation of the study conclusions.

D162 The CAA has adopted Helios' core efficiency proposals, which include savings for insurance, finance, HR and legal costs where GAL had assumed costs would increase without justification. The Helios study efficiency proposals were partially based on staff cost reductions, which interact with the CAA's overall wage cost efficiency proposal. The CAA has taken account of this interaction which has reduced the efficiency to a net £0.6 million per year (to account for the change in staff cost efficiency described above).

D163 The CAA notes the ACC's comments on the interpretation of the study. The CAA has considered the stretch efficiency proposed by Helios, but did not have sufficient confidence in the benchmarking analysis to apply this efficiency. The benchmarking analysis indicates a wide range of costs in central support activities, meaning that a conservative approach to efficiency should be taken. Furthermore the study did not indicate that GAL was particularly inefficient compared to benchmarks. This finding was further supported by the AT Kearney study submitted by GAL.

Efficiency frontier

Issue

D164 In calculating the level of efficient operating costs over Q6, the CAA has to make an assumption as to how the "efficiency frontier" (the level of costs that a hypothetically efficient operator might incur) might change over time. The CAA commissioned Cambridge Economics Policy Associates (CEPA) to examine this question.

D165 CEPA estimated that, based on an estimate of adjusted TFP growth across a range of industries, an efficient organisation with a cost structure similar to GAL should expect to see ongoing net frontier efficiency gains of between 0.9% and 1.0% per year.

CAA's final proposals

D166 The CAA commissioned CEPA to update their study in response to GAL's submission including a report commissioned from Oxera critiquing CEPA's analysis.

D167 CEPA considered that the points raised by Oxera on behalf of GAL had already been accounted for in its study. It did not agree with Oxera that it was inappropriate to compare Heathrow, Gatwick and Stansted to other regulated utilities and had adopted standard practice for the estimation of frontier shift, consistent with regulatory precedent.

D168 CEPA also stated that its report had undertaken the sensitivities suggested by Oxera and that some of Oxera’s comments appeared to be based on an earlier draft version of the report, which was no longer relevant. CEPA stated that the examples cited by Oxera were not relevant to Gatwick. The Water Industry Commission for Scotland (WICS) decision was based on the recognition that there would be significant upward pressure on opex resulting from the requirements for Scottish Water to improve its performance. The Postcomm decision was contingent on the level of investment undertaken by Royal Mail. CEPA concluded that their recommended frontier shift range of between 0.9% and 1% remained valid.

D169 The CAA adopted CEPA's recommendation for a frontier shift target of between 0.9 and 1%, and has used this to estimate an efficiency saving for GAL accounting for the stretch savings included in the RBP.

D170 Basing the frontier shift estimate on the latest year of actual data rather than the forecast of opex costs in 2013/14 in the business plan would not make a material difference to the total frontier shift saving as costs in both years are similar. The CAA included a saving of between £6.0 million and £7.4 million by 2018/19 in the range of potential opex savings.

Stakeholders' views

D171 The CAA received two responses on this issue.

D172 GAL stated that staff costs are the only part of its cost base that it can control and that therefore the frontier shift efficiency proposal would have to be achieved through further reductions in staff costs. GAL stated that the achievability of these reductions in staff costs was questionable.

D173 GAL reiterated its criticism of the CEPA analysis stating that CEPA had not taken account of the breakup of BAA and security costs arising from changes to the security regime. GAL did not consider the CEPA report to be useful evidence.

D174 GAL stated that the CAA had incorrectly dismissed comments submitted by Oxera, which appeared to be based on a draft version of the report. GAL stated that the comments were based on the latest and final version of the report referenced in the initial proposals.

D175 GAL noted that CEPA acknowledged that it should have made explicit adjustments for quality and changes to security costs and service quality. GAL noted that CEPA suggested that its estimates are likely to be biased upwards.

D176 GAL stated that it was concerned that the CAA had applied efficiencies based on overlaying both top-down and bottom-up benchmarking and that this risked double-counting the potential for efficiency. GAL stated that the CAA had not provided evidence to respond to this point.

D177 GAL stated that Oxera suggested that an adjustment for catch-up efficiency should be applied to the estimation of frontier shift. GAL stated that whilst the approach recommended by CEPA had been adopted by Ofgem, it was considered flawed by some energy companies. GAL stated that a recently completed academic study showed that productivity growth estimates based on EU KLEMS data include catch-up efficiency with an estimate of around 25%.[98] Therefore the frontier shift target effectively double-counts the catch-up efficiency analysis.

D178 The ACC considered that the frontier shift target should be applied to the latest available actual data, rather than GAL's forecast, as this would ensure that GAL's outperformance would be shared with users.

D179 Virgin stated that the frontier shift target should be applied from the baseline point "when the airport" is already efficient and estimated that the total frontier shift savings for Q6 was £43.5 million. Virgin questioned the CAA's interpretation of GAL's security cost efficiency stating that the total security staff costs in the RBP do not support

98 Timmer, M., O'Mahony, M. and Van Ark, B. (2007), 'EU KLEMS Growth and Productivity Accounts: Overview'.

GAL's claim of an annual £3.9 million stretch efficiency. Total staff costs are forecast to grow by 3.8% over Q6 despite the efficiency initiative.

CAA's final view

D180 The CAA notes GAL's comments on the potential for overlaps in catch-up and frontier shift efficiency and the research by Oxera and others suggesting that a 25% adjustment to the frontier shift target is appropriate to account for this issue. The Oxera study states that "after applying the 75%/25% frontier shift/catch-up split, the range for the potential frontier shift becomes 0.4% to 1% per year with a mid-point of 0.7%. The CAA notes that this range is broadly consistent with CEPA's analysis which indicated a range of 0.9% to 1%.

D181 The Oxera study was prepared for Northern Ireland Electricity Limited (NIE). The CC has recently published its provisional determination for NIE's price determination. In this determination, the CC found that recent regulatory decisions indicate a range of between 0.5% and 1% for opex frontier shift and state that "a productivity assumption of 1 per cent a year should be applied to NIE's costs (i.e. to each of opex and capex)." This was based on evidence from the business plans submitted by the GB Distribution Network Operators (DNOs), most of which have included an assumption that costs can be reduced by 1% per year.

D182 CEPA also addressed this issue in their response to Oxera's note and did not consider that an adjustment to remove catch-up efficiency was necessary. CEPA acknowledged that the EU KLEMS data could suffer from a degree of measurement error associated with structural inefficiencies within firms but that "there should not be any long term systematic structural inefficiencies among the firms operating within our comparator sectors". CEPA also stated that it had placed a lower weight on sectors which include regulated companies, where catch-up efficiency would be more likely to be an issue within the KLEMS database. CEPA also pointed out that Ofgem had questioned the estimation of the 75%/25% split which was based on a comparison of UK industry catch-up with the world frontier for the period 1979-1988.[99]

99 Ofgem(2012), RIIO-T1/GD1: Real price effects and ongoing efficiency appendix, Final

D183 The break-up of BAA and improvements in opex efficiency are an issue for the assessment of catch-up efficiency, not frontier shift. This has been taken account of separately in the bottom up analysis.

D184 For these reasons, the CAA considers that a frontier shift target of between 0.9 and 1% is appropriate and consistent with regulatory precedent.

D185 The ACC argued that the CAA should base the efficiency savings on actual costs from 2012/13, arguing that this would ensure that GAL's cost savings are passed through to passengers. Basing the frontier shift estimate on the latest year of actual data would slightly reduce the frontier shift efficiency applied to GAL (1% per year from a lower number). The ACC's argument is related to the appropriate level of catch-up efficiency, which has been assessed separately.

D186 The CAA has included a saving of between £6.0 million and £7.4 million by 2018/19 in the range of potential opex savings.

Security process efficiency

Issue

D187 The CAA has considered three issues regarding security process efficiency:

- the scope for improvements in GAL's security flow rates;
- the scope for improvements in GAL's security roster efficiency; and
- the scope for efficiency gains from outsourcing.

CAA's final proposals

D188 Peak hour security processing flow rates at Gatwick are around 250 passengers per hour per lane in the ST and 200 in the NT (fluctuating higher and lower between summer and winter). This is relatively high compared with other airports with a benchmark sample average of around 170, and significantly higher than at Heathrow, which has flow rates around150.[100]

decision, pages 18-19.

100 Confidential report supplied by GAL: Benchmark Analysis of 10 European Airports, Copenhagen Airports.

D189 The CAA noted GAL's comments on airline baggage policy that a one bag policy will tend to encourage passengers to take larger amounts of luggage through security reducing flow rates. It is difficult to determine whether Heathrow or Gatwick face greater demands on security processes, however BA's baggage policy allows for two separate cabin bags, which on balance seems likely to increase the number of images per passenger and overall pressure on security flow rates at Heathrow.

D190 Overall, the CAA considers that GAL's flow rates appear to be high in comparison to benchmarks and the business plan incorporates further improvements. Based on the RBP, passengers per security FTE are expected to rise by 10% overall by 2018/19 and security headcount is expected to fall by around ✂%. This suggests that GAL has limited scope to reduce security costs through improving flow rates. The CAA does not therefore propose further efficiencies related to improving security flow rates.

D191 The CAA stated that the IDS study indicates that GAL's roster system is relatively efficient and that rates of overtime are not high. GAL has made several improvements to this area of its operations since the sale of the airport operator. The CAA did not propose to include further savings related to roster efficiency.

D192 Security outsourcing has been introduced at several European airports, including Birmingham and Oslo and has been proposed as an option for GAL by the airlines. Outsourced security staff are also used by the AOC to operate baggage security at Heathrow. This is considered by the airlines to be an activity analogous to passenger security in terms of scale, complexity and staff skill. The ACC provided evidence of potential savings based on benchmarking GAL against bids from outsourced security companies. The CAA considered that GAL's security processes are relatively efficient and therefore, any differences in cost are likely to be caused primarily by GAL's relatively high staff wage and pension costs. This has been taken into account through the employment benchmarking analysis and proposed wage and pension cost efficiencies described above, which will bring GAL's staff costs into line with efficient benchmarks by the end of Q6. Lower costs from an outsourced provider would be likely to be achieved through the same savings. Therefore applying further savings based on this evidence is likely to double-count the potential for reductions in security costs.

D193 Overall, based on these points, the CAA considered that there was limited scope for further efficiency in GAL's security processing.

Stakeholders' views

D194 The CAA received three responses on this point.

D195 Noting the CAA's analysis of HAL, GAL stated that the CAA's analysis of security efficiency was flawed. GAL stated that HAL was not likely to have greater pressure on its security processes as there are airlines at Gatwick which also apply a two bag policy, including BA and Norwegian; easyJet has also recently introduced new hand baggage sizing.

D196 GAL stated that as business passengers tend to travel more frequently they are used to security arrangements and are quicker and easier to process, this would tend to benefit HAL's flow rates.

D197 The ACC stated that the CAA had failed to take account of many of the arguments and evidence provided by airlines, including security costs benchmarking and the proposal to increase the utilisation of Archway Metal Detectors (AMD).

D198 Virgin re-submitted its security cost benchmarking analysis, which showed that GAL's security costs per man year are 72% above benchmarks and estimated that GAL could reduce its costs by £69.1 million over Q6.

CAA's final view

D199 The CAA considers that in addition to the core efficiency of the security function, there are several largely uncontrollable factors which affect security flow rates including passenger profile and baggage quantity and content. These factors influence flow rates in several ways including:

- the time taken for passengers to divest their luggage onto and from security conveyors and to pass through security arches;
- the number of x-ray scans per passenger; and
- the time it takes for a security officer to scan an individual bag and make an assessment of any security threat.

D200 HAL's largest carrier BA operates a policy of allowing two items of hand baggage through security as standard. GAL's largest carrier easyJet allows only one item of luggage as standard. This means that the average number of bags per passenger will be higher at Heathrow. As a consequence it may be the case that the density of hand bags may be greater at GAL.

D201 The CAA considers that it is likely to take longer to process a passenger with two bags, than with one bag. This requires at least two x-ray images to be taken and increases the time required for the passenger to divest and collect their belongings. The density of the bag is likely to be a less significant factor to overall processing times.

D202 GAL states that HAL has a greater proportion of business passengers, who are likely to be more familiar with security procedures, which would tend to increase flow rates. This may be true, but such passengers are also likely to carry more electronic items, such as laptops and tablet computers, which need to be removed from hand luggage and scanned separately. Such passengers are likely to take longer to divest and may therefore reduce flow rates. HAL also has a higher proportion of travellers from outside the EU who are less likely to be familiar with security processes.

D203 Overall, noting the uncertainty associated with each of these factors, the CAA considers that on balance HAL is likely to face slightly greater pressures on security processes. This is also reflected in the airport benchmarking provided by GAL, which shows that larger hub airports such as Amsterdam have lower flow rates than smaller airports with higher proportions of low cost carriers. For example, Amsterdam has a flow rate of ✂ passengers per hour compared to around 150 at Heathrow and up to 250 at Gatwick.

D204 The CAA notes the airline benchmarking which shows that GAL's security staff costs are around 70% higher than benchmarks. To some extent this finding is supported by the IDS study, which found that security staff costs are between 22% and 39% higher than benchmarks.

D205 GAL's high staff costs have been taken into account by the CAA's wage and pension cost efficiency proposals described above. Applying further savings based on this evidence is likely to double-count the potential for reductions in security costs.

Passenger Forecasts

Issue

D206 The CAA considered the differences between GAL's passenger forecasts and the CAA's higher passenger forecast assumptions, and considers that it is appropriate to take account of this factor explicitly.

D207 The CAA assumed that traffic growth would be around 6% higher than GAL's RBP assumptions over Q6. This would increase opex in some areas of the business including security costs for example. To account for this the CAA increased the opex allowance by £6.6 million by the end of Q6 based on an elasticity of 0.3.

Stakeholders' views

D208 The CAA received no responses on this point.

CAA's final view

D209 The CAA's latest forecasts show that traffic numbers are expected to be higher than assumed in the final proposals and 10% higher than assumed in the RBP. Based on an elasticity of 0.3, this will increase the traffic allowance from £6.6 million to £10.2 million by the end of Q6.

Other Issues

CAA Security Charge

D210 The CAA will assume responsibility for aviation security regulation and compliance monitoring in 2014 and will levy a charge on larger airports to fund this activity. This charge is expected to be around 4.9p per departing passenger. On this basis GAL is likely to be charged around £1 million per year by 2018/19. The CAA has included an allowance to account for this.

Additional Evidence from Airlines

D211 The CAA considers that most of the evidence provided by airlines has been considered either directly by the CAA or through one of the consultancy studies. Many of the proposals made by the airlines are likely to be implemented by the airport operator in order to achieve the efficiencies proposed by the CAA, for example reductions in wage rates, pensions, absenteeism and security costs.

Other Changes

D212 GAL has updated the business case of several of their capital projects in Q6. This has changed the opex associated with those projects. Overall the business case updates suggest that GAL's opex will be £0.8 million higher than assumed in the RBP by 2018/19. The CAA has incorporated this into its opex allowance.

Overall Level of Opex

Issue

D213 The CAA has identified several areas where GAL is likely to be able to reduce its operating costs. The evidence indicates a range of potential savings and the CAA has to apply some judgement to the choice within the range.

CAA's final proposals

D214 The CAA identified total savings of between £29.7 million and £43.1 million by 2018/19. This is equivalent to a reduction of 1.05% to 2.05% per year over Q6.

D215 The CAA proposed an overall efficiency target of £32.5 million per year by 2018/19 which is equivalent to a reduction of 1.2% per year and results in a total allowance of £1,378.3 million over Q6. This is equivalent to a 7% reduction relative to GAL's RBP.

Stakeholders' views

D216 The CAA received three responses on this issue.

D217 The ACC stated that the CAA had adopted the lowest point in the range of efficiency savings, highlighting the interpretation of the Helios evidence and stating that the CAA had only adopted 25% of the total savings proposed by its consultants.

D218 The ACC stated that the CAA's reasoning that GAL needed to have a realistic chance of outperformance and other areas such as WACC and passenger forecasts indicated that the CAA placed more weight on the interests of GAL's shareholders than the interests of passengers.

D219 The ACC stated that its proposed efficiency target of 2.8% per year was a challenging but more realistic level of saving considering the large amount of inefficiency embedded in the GAL business plan.

D220 GAL stated that it considered that the CAA's treatment of opex was poorly evidenced, and the judgements were unbalanced. It stated that some of the conclusions were based on errors and had double-counted the scope for efficiency in some areas.

D221 Virgin did not agree that the CAA should 'ensure that GAL has a realistic chance of outperformance' and should base its projections on the efficient costs of running the airport. Virgin was critical that the CAA had failed to find any new efficiency between the initial and final proposals.

D222 Virgin stated that the CAA had not taken account of its evidence. It re-submitted its response to the initial proposals which showed that its suppliers (✂) had been able to reduce costs by between ✂% and ✂% between 2008/09 and 2013/14 in real terms highlighting the contrast with airport charges.

CAA's final view

D223 The CAA has considered each of the points raised by stakeholders in developing its efficiency proposals. The CAA rejects GAL’s statement that its assessment of opex efficiency was poorly evidenced and judgements were unbalanced for the reasons set out in paragraph A16. The detailed justification for the efficiency proposals set out in appendix D. The CAA also rejects Virgin’s statement that the CAA has not taken account of its evidence. The CAA and its consultants have taken account of the evidence provided by both GAL and airlines in developing its efficiency proposals.

D224 A breakdown of the updated efficiency saving associated with each piece of evidence in the high and low stretch scenario is shown below in figure D.3. The updated analysis indicates that GAL could achieve efficiencies of between £23.8 million and £36.4 million per year by 2018/19. This is equivalent to an annual reduction of between 0.62% and 1.54% per year.

Figure D.3: Breakdown of Low and High Stretch Scenario

2011/12 prices	**Low Stretch**	**High Stretch**
£million	**2018/19**	**2018/19**
RBP	301.2	301.2
Other Opex	-4.6	-6.0
Maintenance	0.8	-4.2
Central Services	-0.6	-0.6
Wage efficiency	-13.4	-18.2
Wage growth	-5.6	-5.6
Pension Efficiency	-3.4	-5.0
Pension Deficit	-1.4	-1.4
Frontier shift	-6.0	-7.4
Traffic	+10.2	+10.2
Other	+1.8	+1.8
Total	**-23.8**	**-36.4**
CAA	**277.4**	**264.8**

D225 In coming to a judgement over the appropriate point within the range the CAA has considered stakeholders' views and taken particular account of several factors including:

- evidence that opex per passenger at Gatwick is close to the average of European comparators;
- some of the higher efficiency targets identified in the consultancy studies are based on comparing GAL with the most efficient benchmarks, which may not reflect the typical efficiency of a business operating in a competitive environment;
- evidence of good performance in some areas of GAL's business including security processing;
- the inherent risk in efficiency proposals based on benchmarking evidence, which cannot perfectly account for specific factors at Gatwick;
- evidence that airlines have been able to control costs in some areas more effectively than GAL;

- the need to ensure that GAL has a realistic chance of outperformance as a regulatory incentive, balanced against the interests of passengers not to pay for inefficiency in GAL's operations; and
- the achievability of the opex allowance and the risk for service quality impacts from reductions in opex including the significant pension and pay efficiencies proposed by the CAA.

D226 On balance taking account of the points listed above, the CAA proposes an overall efficiency target of £27.7 million per year by 2018/19. This is slightly below the mid-point of the range, equivalent to a reduction of 0.90% per year and results in a total opex allowance of £1,393 million over Q6.

CAA forecasts

D227 Based on the CAA's decisions above, its projections for GAL's opex allowance over Q6 are set out in Figure D.4 below.

Figure D.4: CAA's final projections for opex (2011/12 prices)

£ millions	2014/15	2015/16	2016/17	2017/18	2018/19	Total
RBP	288	294	297	300	301	1,481
CAA - IP	283	280	277	274	271	1,385
CAA - FP	283	279	276	272	269	1,378
CAA - FV	284	281	279	276	274	1,393

APPENDIX E

Commercial revenues

E1 This appendix discusses GAL's commercial revenues for the Q6 period and includes the CAA's final proposals, a summary of stakeholders' views and the CAA's final view.

E2 The forecasts for GAL's commercial revenues (revenues from retail, car parking and property) are significant as they are deducted from the revenue required from airport charges under the single till approach.

Commercial revenues process to date

E3 To date, the Q6 commercial revenues process has consisted of the following stages.

- GAL published its IBP in April 2012 providing its initial forecast of commercial revenues.
- During the CE process between April and December 2012 the airlines' consultants, Javelin and Airport Commerce and Talent Management (ACTM) considered that there should be more ambition in GAL's commercial revenue projections. There was, however, little discussion on commercial revenues during CE.
- GAL's final commercial revenue forecasts were published in the RBP in January 2013.
- The CAA's initial forecast was discussed in Chapter 7 of the CAA's initial proposals published in April 2013. The initial proposals were based on a phase 2 report from the CAA's independent consultants SDG.
- The CAA's final forecast was discussed in Chapter 6 of the CAA's final proposals published in October 2013. The final proposals were based on a phase 3 report from SDG updated to incorporate, where appropriate, issues raised by stakeholders in their responses to the CAA's initial proposals and the CAA's revised traffic forecast.

CAA's final proposals

E4 The CAA's final proposals forecast total commercial revenues of £1,015.3 million over the Q6 period.

E5 The CAA's final proposals used SDG's commercial revenue per passenger forecasts together with the CAA's traffic projections. This resulted in Q6 commercial revenues that were around 6% lower than forecast by ACC and 12% higher than forecast by GAL. The projections are presented in figure E.1 below.

Figure E.1: Forecasts for commercial revenues in Q6

£m 2011/12 prices	2014/15	2015/16	2016/17	2017/18	2018/19	Total
GAL RBP	183.4	173.4	179.0	181.1	188.0	904.9
ACC*	209.4	208.1	211.1	222.3	233.8	1,084.7
CAA IPs	190.5	185.8	195.2	199.9	209.5	981.0
CAA FPs	196.4	193.4	202.3	207.2	216.1	1,015.3

*Based on Javelin/ACTM's retail and car parking forecasts, SDG property forecast and ACC's June 2013 traffic forecast

Source: GAL, ACC and CAA

E6 Several respondents commented on the CAA's final proposals for the overall level of commercial revenues:

- GAL considered that SDG's forecasts were over-optimistic;
- the ACC considered the forecasts to be somewhat conservative and did not give sufficient consideration to work by its consultants Javelin and ACTM;[101]
- BA, easyJet and Virgin also considered that the CAA had underestimated potential commercial revenues; and
- the airlines generally considered that higher traffic forecasts should drive an increase in the commercial revenues forecast.

101 The response to SDG's commercial revenues forecasts presented by the Javelin Group with consideration of consultancy work by ACTM is further referred to as the Javelin response.

Issues concerning commercial revenues

E7 The CAA has considered stakeholder responses grouped by the main categories of:

- use of SDG's consultancy studies;
- retail;
- car parking;
- property; and
- overall commercial revenues.

Use of consultancy studies

Issue

E8 Stakeholders raised concerns with the CAA's use of consultancy studies.

CAA's final proposals

E9 The CAA based its final proposals on SDG's projections per passenger uplifted with its own traffic forecasts.

E10 SDG's work consisted of three reports - interim, phase 2 and phase 3 reports.[102] In its initial proposals the CAA used SDG's projections per passenger from the phase 2 report from April 2013. In its phase 3 report SDG considered additional evidence put forward by the stakeholders in response to the CAA's initial proposals. In its final proposals the CAA used SDG's projections per passenger from the phase 3 report from September 2013.

Stakeholders' views

E11 GAL considered that all of the CAA's consultancy studies used to derive the fair price were based on inadequate evidence, lacked balance, did not sufficiently address feedback and lacked sufficiently rigorous review by the CAA.

E12 The airlines considered that the CAA did not put sufficient weight on the work done by their consultants Javelin.

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102 Consultants' reports are available from: http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

CAA's final view

E13 The CAA disagrees with GAL and considers that SDG has provided sufficient evidence throughout its reports to support its view that the GAL commercial revenue projections for Q6 were relatively understated.

E14 The CAA notes that in developing the consultancy studies SDG considered the data available and the evidence provided by all parties (including reports by Javelin provided by the airlines). In its final view the CAA considered evidence put forward by all stakeholders.

E15 The CAA notes that the evidence put forward by the airport operator and the airlines is more directly addressed in SDG's phase 2 report. SDG's phase 3 report focused on any updates to the evidence and responding to points made by stakeholders. The CAA considers that SDG took a balanced view between the evidence provided by stakeholders as well as its own analysis.

E16 SDG increased its commercial revenue forecasts in the phase 3 report to reflect changes in the 2012/13 outturn versus GAL's projections, particularly in relation to car parking. This was slightly offset by downgrading certain forecasts (e.g. bookshop revenues) following additional information provided by GAL. The CAA also notes that SDG's revised forecasts also took into account specific adjustments advised by GAL. The CAA considers that the SDG study provided a balanced argument on the key issues concerning GAL's commercial revenue forecasts.

Retail

Issues

E17 The main issues concerning the projections for GAL’s retail revenues were:

- the impact of the Tobacco Display Act (TDA) on duty free sales;
- retail margins, space and reallocation of space;
- bookshops and the challenges deriving from the increase in digital media and e-commerce;
- advertising; and
- other issues - telecoms.

CAA's final proposals

E18 The CAA's final proposals were based on SDG's forecasts, which encompassed:

- a 12% fall in tobacco sales from the TDA and no tobacco ban during Q6;
- an increase in retail margins from striking a different contractual arrangement ✂;
- a reallocation of retail space from catering to retail but with the potential revenue increase reduced by 50% since the initial proposals;
- a reduction in the fall in bookshop revenues with a minor adjustment to the forecasts based on the 2012/13 performance;
- an increase in advertising revenues from additional sponsorship; and
- growth in telecoms income in line with passenger volumes.

Stakeholders' views

E19 GAL considered retail revenues to be overstated by around £25 million over Q6 from a combination of the following:

- an underestimated impact of the TDA: GAL disagreed with SDG's benchmark with Dublin and Birmingham airports and the assumption that other products would replace the lost revenue caused by the decline in tobacco sales;
- the assumption that the decline in bookshop sales can be arrested: GAL noted the decline of performance over the last 18 months until September 2013. At the same time GAL pointed to the recently released WH Smith plc preliminary statement for the year ending 31 August 2013 according to which total sales for the year were flat and like-for-like sales were down 4%. GAL stated the improved gross margins mentioned by WH Smith would not benefit GAL as income is derived from a percentage to sales;
- the claims that additional margin can be driven from contract extensions ✂: GAL considered it unlikely ✂ to give up margin to extend the contract further; and

- failure to take into account margin improvements that GAL already made in speciality shops: GAL disagreed with SDG that higher margins than those included in the RBP can be achieved from retail concessionaries, especially the 22 new stores that will open during 2013 as part of the ST Development as a margin enhancement of +1.8% has already been included for these stores. GAL also disagreed with SDG's assessment of opportunity to improve catering margins in the NT as overly long contract lengths would not allow for a review of performance against evolving consumer tastes.

E20 The ACC did not agree with the reduction in retail revenues per passenger given the expert evidence from their consultants to the contrary and the strengthening economy. The ACC and individually easyJet considered that SDG and the CAA appeared not to have examined Javelin's evidence and experience in the following areas:

- the TDA impact based on experience elsewhere and the ability to offset reduction by reallocating space to growing areas such as cosmetics;
- the potential for more flexible catering arrangements to provide for peak loads rather than dedicating fixed space; and
- the potential for GAL to exploit e-commerce revenues.

E21 The ACC and easyJet considered that the CAA had put too much weight on the criticisms made by GAL based on their stated intentions for developing the retail business. The ACC raised concerns that SDG did not examine the updated business cases for retail projects, but rather generally cited this as a factor, among other “stretch” factors that would allow upside potential, presumably to show that the forecasts were readily achievable. In addition, the ACC also noted that the CAA had cited the strengthening economy as a reason to take account of opex risks, without making a corresponding adjustment for retail revenues.

E22 BA considered forecasts for retail revenues per passenger should be higher based on Javelin's work.

E23 Virgin expressed disappointment that retail revenues have been revised down since the initial proposals despite a more positive economic outlook.

CAA's final view

E24 The CAA notes that no new evidence was presented by stakeholders in relation to the potential impact of tobacco legislation on tobacco sales. In its final proposals the CAA discussed the difference between reducing the size of the tobacco market versus making it harder for buyers to make a purchase. The CAA also clarifies that SDG's assumptions were based on a wide range of benchmarks as set out within their April 2013 (phase 2) and September 2013 (phase 3) reports. The assumption that a reduction in tobacco sales could be mitigated by allocating tobacco space to other product categories was one made by the airlines' consultants and was not included in SDG's financial assumptions. The CAA considered this point when choosing to incorporate the 12% impact of TDA on tobacco sales rather than the 20% impact suggested by SDG.

E25 In relation to bookshop revenues the CAA notes that GAL selectively repeated the negative elements from the August 2012 WH Smith trading statement mentioned in the CAA's final proposals and did not acknowledge the positive aspects, particularly the increase in their share price. This also seems to be the case with WH Smith's more recent announcement of preliminary results for the year ending 31 August 2013.[103] The CAA acknowledges that for GAL the income is derived from a percentage to sales. It needs to be noted that WH Smith's Travel trading profit was up by 5% and an additional £50 million share buyback programme was announced in October after completing the £50 million share buyback announced in August. WH Smith continues to have a positive outlook on the future of their Travel performance. The CAA notes that if all benefits from improved margins go to WH Smith (as mentioned by GAL) and not shared in any way with GAL, it suggests room for renegotiation of the contract with WH Smith to redress the balance.

E26 The CAA notes that the stakeholders have not presented the CAA with any additional evidence to amend its earlier margin target of ✂ over the whole Q6 and therefore the CAA continues to believe this target is achievable.

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103 WH Smith PLC, Preliminary results announcement for the year ended 31 August 2013, available from: http://www.whsmithplc.co.uk/docs/Prelims_Press_Release_2013_Combined_FINAL.pdf

E27 The CAA notes that SDG did acknowledge the strengthening of the economy in its September 2013 report.[104] SDG has since confirmed that the increase between its phase 2 and phase 3 reports was somewhat driven by improved macroeconomic assumptions.

E28 The CAA notes the potential upsides in the macroeconomic environment. However, the CAA considers that the impact on retail revenues per passenger is hard to quantify. The CAA has assumed a direct relationship between commercial revenues and passenger growth which is in part driven by economic growth. However there seems to be little correlation between various macroeconomic factors such as GDP or real household consumption and historic retail revenues per passenger. The CAA also notes that the airlines did not appear to have a methodology to quantify this relationship. The CAA has therefore not assumed a further uplift to its per passenger forecasts for stronger economic growth. The CAA notes that individual measures such as new retail offerings are likely to make a bigger impact on the per passenger forecasts.

E29 The CAA notes that no new evidence was put forward to address e-commerce revenue proposals or the switch between catering and retail space . For the reasons discussed in the CAA's final proposals the CAA considers it appropriate to maintain its previous forecasts[105].

E30 As mentioned in its final proposals the CAA saw a potential upside to its forecasts from GAL's updated business cases for some of its capex projects. Having reviewed the schemes further, the CAA identified improvements in terms of commercial revenues in the following schemes[106]:

- ST IDL Capacity,
- NT IDL Reconfiguration and Expansion, and

[104] Paragraph 2.11.

[105] See paragraphs 6.18-6.20 of final proposals.

[106] The CAA notes that the slight additional non-aeronautical revenue from the revised business case of Additional NT coaching bays is considered to be related to other revenues rather than commercial revenues. As discussed in Appendix F, the CAA based its forecast of other revenues on GAL's forecast (along with own opex efficiency assumptions). As the latest forecast was received from GAL on 22 August 2013 (that is after the revised business cases were provided in June 2013) the CAA assumes the additional revenue from the improvement of this scheme was already accounted for in GAL's forecasts.

- NT Arrivals Transformation.

E31 Despite the CAA's request GAL has not provided a detailed breakdown of the additional revenues. The CAA has therefore based its forecast on the information from the revised business cases.

E32 Once converted to 2011/12 prices the changes in these schemes provide an additional £19 million of revenue over the five years of Q6 or £29 million over seven years.

E33 Total retail revenues have therefore been uplifted to account for the £19 million increase from improved schemes. The impact of this change is shown in figure E.2 below.

Figure E.2: Impact of GAL's improved schemes on commercial revenue projections

£ million	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Impact	-4.06	7.65	3.68	7.46	4.15	4.06	5.57

Source: GAL RBP and revised business cases, CAA analysis

E34 Based on the analysis above the CAA's final view on retail revenues per passenger is as presented in figure E.3 below.

Figure E.3: CAA's final view on retail revenues per passenger

£ per passenger	2014/15	2015/16	2016/17	2017/18	2018/19
CAA FPs	3.68	3.51	3.68	3.67	3.82
CAA FV	3.57	3.71	3.78	3.86	3.92
Difference	-0.11[107]	0.20	0.09	0.19	0.10

Source: CAA

Car parking

Issue

E35 SDG suggested that there was the potential to outperform GAL's revenue forecast for car parking due to:

- increases in long stay pricing for pre-booked products in the peak season;

107 This is due to the fact that the CAA accounted both for increases and decreases between revenue forecasts from the January 2013 business plan and June 2013 revised business cases.

- above inflation increases in long stay roll-up parking;
- additional revenues from the licensing scheme with impact slightly reduced since SDG's earlier report which the CAA based its initial proposals on; and
- enforcement of forecourt pick-up activity into short stay car parks with impact slightly reduced since SDG's earlier report which the CAA based its initial proposals on.

CAA's final proposals

E36 The CAA's final proposals were based on SDG's forecasts. The increase of forecast revenues between the CAA's initial proposals and final proposals was a result of improvement in car parking revenue performance at Gatwick which increased the forecasts for 2013/14 (before the start of Q6) by 3%. This was somewhat offset by a slight reduction in the impact of the enforcement of forecourt pick-up into short term car parks and the off-airport licensing scheme.

Stakeholders' views

E37 The CAA received one response commenting particularly on the forecast level of car parking revenue over Q6. GAL considered car parking revenues to be overstated by £12 million over Q6 from a combination of the following issues.

- The assumption that it is possible to generate additional revenue by raising long stay roll up prices: GAL disagreed with SDG's stretch of £0.1 million per year based on an increase in price and considered the forecast should also be further reduced due to the declining volume trends over the last three years.
- The use of over-simplistic single-point benchmarking to suggest GAL is under-pricing long stay car parking in peak periods: GAL considered SDG's assumption is wrongly based on a belief that GAL's products are closer to terminal than off-airport operators and based on a sample price comparison for one booking date and one entry date. GAL considered that SDG did not understand GAL's strategy to manage price to optimise revenue for the range of products as a whole.

- The assumption that licence agreements from the off-airport approved operator scheme will deliver from £0.7 million to £1.2 million per year from charges to meet and greet (M&G) operators: GAL considered the first year of this scheme which started in July 2013 will deliver about £0.5 million. GAL also considered that all the major operators are already signed up to the scheme and so GAL did not anticipate any further significant operators signing up any time soon.
- The assumption for generating further income from enforcement of forecourt pick-up activity into short stay car parks which GAL saw as unrealistic: GAL considered this activity would bring negligible net benefits as the revenue will be offset by marshalling costs to enforce the forecourt policy and the reduction of pre-booked short stay income to accommodate new roll-up customers.
- The increase in income from e-commerce which did not reflect the cost to GAL of providing free Wi-fi or the fact that GAL already included potential increases of income from additional e-commerce revenues related to car parks such as car wash, lounges, premium security, foreign exchange and the planned introduction of travel insurance.

CAA's final view

E38 The CAA considers that GAL has not provided new evidence against SDG's identified opportunity to increase long stay roll-up prices. The benchmarks from other airport operators quoted in the SDG report continue to provide evidence of higher roll-up prices than those in place at Gatwick.

E39 The CAA notes that SDG's statement that at peak times GAL's car parking products are priced close to or sometimes cheaper than off-airport facilities. It is incorrect for GAL to assume SDG's findings were based on a comparison for one booking date and one entry date. SDG ran several tests on different dates and for different entry dates and the additional findings are mentioned in their September 2013 report.[108] The additional findings supported the previous claims that GAL's prices were cheaper than those of some other operators.

[108] Paragraph 2.98.

E40 In relation to GAL's comment on SDG stating that the off-airport licence scheme will generate from £0.7 million to £1.2 million per year the CAA notes that in response to GAL's point SDG has already reviewed their forecasts and adjusted it by some 4%, reducing revenue by £0.2 million. GAL has not provided additional evidence to further amend this assumption.

E41 The CAA continues to agree with SDG's identified opportunity in enforcement of forecourt activity into short stay car parks. The CAA also notes that following GAL's earlier comments SDG had already reduced its forecasts by 1%. GAL has not provided additional evidence since then to further amend this assumption. The CAA queries GAL's statement that enforcement activity would not bring a net benefit as it would make the undertaking questionable given the cost of introducing enforcement and the potential negative impact on passengers.

E42 The CAA notes that the car parking e-commerce initiatives proposed by SDG and accepted by the CAA in its final proposals applied only to car parking, hence making the provision of Wi-fi service irrelevant.

E43 For reasons discussed in the final proposals and in light of lack of further new evidence from stakeholders to amend previous assumptions, the CAA considers it appropriate to base its final view on the work by its consultants as set out in the final proposals.

E44 The CAA also notes that the increase in car parking revenues between initial and final proposals was due to an update in forecasts to reflect GAL's improved performance. The increase due to improved outturns in the base year is further supported by GAL's interim financial statement for the six months ended 30 September 2013[109] which points towards a 16% period-on-period increase in net car parking revenue per passenger due to increased valet capacity, better yield management at peak times and increased transactions from third party consolidators and third party operators.

[109] GAL, Report and Unaudited Interim Financial Statements for the six months ended 30 September 2013, available from: http://www.gatwickairport.com/Documents/business_and_community/investor_relations/Gatwick_Airport_Limited_Interim_Financial_Statements_30September2013.pdf

Property

Issue

E45 SDG forecast additional property revenues in Q6 based on a combination of:

- further income from re-letting of office and ramp voids;
- ad hoc contractors' accommodation; and
- additional turnover-related income from hotels.

CAA's final proposals

E46 The CAA's final proposals were based on SDG's updated forecasts which maintained increased forecasts of property revenues compared to GAL's RBP but included a minor downwards adjustment from SDG's earlier report following consideration of stakeholders' comments.

Stakeholders' views

E47 The CAA received one response commenting particularly on the forecast level of property revenue over Q6. GAL considered property revenues to be overstated by around £13 million over Q6 from a combination of the following:

- the unachievable assumption for re-letting Concorde House as the magnitude of the surplus office stock in Crawley has not been properly recognised. GAL considered that SDG did not recognise the change of airlines' requirements;
- the unachievable assumption of additional turnover rent from Bloc and Hampton by Hilton hotels. GAL considered that its assumption of earning the minimum guaranteed rent was entirely plausible;

- an incorrect assumption that additional ramp accommodation will be let. GAL disagreed with SDG's assumption that the reintroduction of the Pier 5 ramp accommodation is incremental as GAL is just making available accommodation that was temporarily removed. GAL considered that occupation of the new Pier 6 space would mean the vacation of space in one of the other piers leaving GAL income neutral. GAL additionally noted that a reduction in rents would not attract additional tenants but would lead to all existing occupiers terminating their existing agreements and seeking to negotiate new deals;
- an incorrect double-count of ad hoc income from contractor accommodation as GAL had already made an allowance for additional lettings with the assumption that existing lettings to contractors will remain and no significant additional ones will be achieved.

CAA's final view

E48 The CAA notes that GAL did not provide new evidence to support its statements which the CAA had previously considered in the final proposals. The CAA therefore considers it appropriate to maintain the property revenue assumptions set out in its final proposals.

E49 The CAA notes that following a discussion between SDG and GAL in July 2013 SDG reduced their revenue forecasts for Concorde House. The CAA agrees with SDG's view that there is opportunity for the asset to be re-let during Q6 and therefore proposes no change to the final proposals forecast.

E50 The CAA continues to consider the reintroduction of the Pier 5 accommodation would bring an incremental revenue benefit.

E51 The CAA agrees with SDG that there are opportunities to increase revenues from ad-hoc contractors' accommodation. The CAA welcomes that GAL has already made some allowance for this area to improve but considers SDG's forecasts reasonable.

E52 Based on the analysis above the CAA maintains its view on retail revenues per passenger as forecast by SDG.

Overall commercial revenues

Stakeholders' views

E53 GAL disagreed with CAA's methodology of uplifting per passenger forecasts for property revenues with traffic forecasts noting that not all categories of commercial revenues will rise directly in line with passengers. Given the CAA's higher traffic forecasts, GAL considered the total commercial revenues to be considerably overstated.

E54 Apart from comments relating to forecasts for retail revenues the ACC, BA and easyJet shared a similar view that the CAA had not taken due account of the impact of increased traffic on commercial revenues. Virgin considered there was significant headroom in the commercial revenue forecasts from higher traffic.

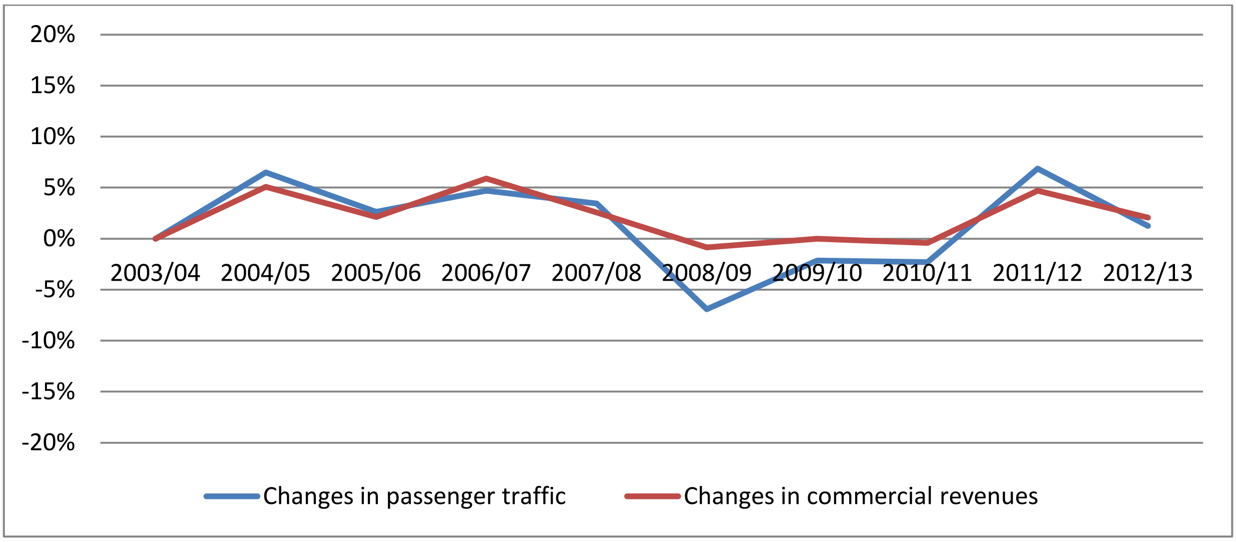
CAA's final view

E55 GAL particularly disagreed with uplifting property revenues with passenger numbers stating that there were much greater forces than pure passenger numbers that drive revenue

E56 The CAA continues to consider its methodology of uplifting the forecasts for commercial revenues per passenger by traffic forecasts appropriate. The CAA acknowledges that the link between property revenues and traffic forecasts is not as direct as that between traffic and retail and car parking revenues. However, the CAA notes that property revenues consist of elements which are linked to passenger numbers. For example, the CAA considers it reasonable to assume that as passenger numbers at the airport increase, there will be room to increase revenues from hotels and airline accommodation. The CAA points out that SDG provided its forecasts on a per passenger basis. The CAA notes that over the last ten regulatory years changes in commercial revenues have been generally aligned with changes in traffic numbers (see figure E.4). The CAA also notes that its methodology of uplifting total commercial revenues per passenger with traffic forecasts is consistent with that used previously by the CC in its Q5 price control review for Gatwick and Heathrow[110] and Stansted[111] as well as the CAA in its Q5 decision.

[110] CC, Heathrow Airport Ltd and Gatwick Airport Ltd Q5 price control review, 2007, available from: http://www.competition-commission.org.uk/our-work/directory-of-all-inquiries/heathrow-and-gatwick-quinquennial-review/final-report-and-appendices-glossary

Figure E.4: Alignment of changes in passenger traffic and commercial revenues



Source: GAL's regulatory accounts, CAA analysis

E57 Since the publication of the final proposals, the CAA has updated its traffic forecasts for GAL. On the basis of the updated forecasts, it has derived its own revised forecasts for commercial revenues. The impact of this change is shown in figure E.5 below. Consistent with the methodology used by the CC in its Q5 price control review for Gatwick, Heathrow and Stansted as well as the CAA in its Q5 decision, this is based on uplifting forecast commercial revenues per passenger in line with traffic.

Figure E.5: Impact of the CAA's revised traffic forecasts on commercial revenues projections

£ million	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Impact	9.0	8.2	8.9	8.1	8.1	7.0	6.1

Source: CAA

111 CC, Stansted Airport Ltd Q5 price control review, 2007, available from: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2008/fulltext/539.pdf

CAA forecasts

E58 The CAA has based its commercial revenue forecasts on the revenue per passenger forecasts provided by SDG, adjusted to reflect the increased revenues from capex schemes and CAA's traffic forecasts, as set out in figure E.6 below. For the two years following Q6 where SDG did not provide projections, the CAA has assumed that the difference between the SDG and GAL per passenger commercial revenue forecasts remains constant.

Figure E.6: CAA's final view on commercial revenues per passenger

2011/12 prices	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
£ per pax							
Retail	3.57	3.71	3.78	3.86	3.92	n/a	n/a
Car parking	1.13	1.10	1.07	1.04	1.04	n/a	n/a
Property	0.68	0.67	0.69	0.75	0.75	n/a	n/a
Total	5.38	5.48	5.53	5.66	5.72	5.67	5.61
CAA final passenger forecast	37.4	38.2	38.8	39.4	39.9	40.5	40.9
£ million							
Retail	133.6	141.7	146.7	152.1	156.7	n/a	n/a
Car parking	42.3	42.0	41.5	41.0	41.5	n/a	n/a
Property	25.4	25.6	26.7	29.7	30.1	n/a	n/a
Total	201.3	209.3	214.8	222.8	228.3	229.2	229.5

Note: numbers may not add up due to rounding

Source: SDG and CAA

E59 The CAA's final view gives total commercial revenues of £1,076.6 million over the five year Q6 period. The breakdown of total commercial revenues for Q6 is as follows:

- Retail: £730.8 million;
- Car parking: £208.3 million; and
- Property: £137.5 million.

E60 This represents a £61 million or 6% increase in the commercial revenue forecasts compared to the final proposals, driven by the higher passenger forecasts and improvement in schemes.

APPENDIX F

Other regulated charges

F1 This chapter considers the appropriate level of other charges to be taken into account in the fair price calculation. Under a single till approach this revenue would be included in the calculation of a RAB-based price control. The revenue is from charges on airlines and other companies operating at the airport for facilities and services that are essential for their operations.[112]

Other charges process to date

F2 CE did not discuss revenues from other charges. GAL included forecasts of revenue from other charges in its January 2013 RBP. As much of the revenue is a recharge of GAL's costs, GAL mentioned that the level of revenue was directly related to its cost forecasts.

F3 The CAA did not take a view on GAL's forecasts in its initial proposals. However, as it needed a forecast to calculate a fair price for Gatwick, it used GAL's January 2013 RBP forecast revenue of £392 million (in 2011/12 prices) over the seven years, without any adjustment for the CAA's efficiency assumptions. The CAA noted that forecast revenues would be lower if it adopted the lower operating costs in the initial proposals.

CAA's final proposals

F4 Respondents (GAL, ACC and BA) supported the CAA's use of GAL's forecasts in the initial proposals. GAL noted that the forecasts should be adjusted in line with the CAA's operating cost forecasts, whilst the

[112] Other charges in GAL's forecasts include revenue from: check-in and baggage, staff car parking, fixed electrical ground power (FEGP), staff identity cards, bus and coach, airside licences, electricity, gas, water and sewerage, heating, PRM, vehicle fuel and oil, and other non-specified revenue.

ACC said it considered there might be opportunities for cost reductions. The CAA used GAL's revised revenue forecasts, adjusted for the CAA's opex forecasts, in its final proposals. The CAA's projections for GAL's revenue from other charges are set out in figure F.1 below.

Figure F.1: CAA's final proposals from other charges (£m in 2011/12 prices)

2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	Total
48.62	50.82	52.09	53.50	53.87	54.50	55.10	368.50

Q6 forecast of other charges

Issue

F5 The CAA needs to decide what the forecasts for other charges should be in the fair price calculation.

CAA's final proposals

F6 In its final proposals, the CAA used GAL's revised revenue forecasts, adjusted for the CAA's opex forecasts.

F7 Figure F.2 below reconciles GAL's revised forecasts with the CAA's forecasts in its final proposals, including an efficiency adjustment.

Figure F.2: Derivation of CAA's final proposals for other charges (£m in 2011/12 prices)

	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
GAL revised forecasts	51.40	53.73	55.09	56.58	56.98	57.65	58.30
Efficiency adjustment	(2.78)	(2.91)	(3.00)	(3.08)	(3.11)	(3.15)	(3.20)
CAA Final Proposals	48.62	50.82	52.09	53.50	53.87	54.50	55.10

Stakeholders' views

F8 The CAA received two responses commenting on its final proposals for other charges.

- The ACC did not consider there was a proper basis for the CAA's significant reductions in forecast revenue in its final proposals. It considered that the cost efficiencies might have been exaggerated. The ACC asked the CAA to provide transparent data to show how it had produced its forecasts. It mentioned that the three main activities: check-in and baggage, PRMs, and utilities, all showed material real increases during Q6. The ACC thought the CAA must enforce upon GAL effective management of its cost base and not pass on cost increases to passengers. It asked the CAA to ensure that all data with supporting material on underlying costs and volumes was provided by GAL to airlines to provide a transparent benchmark which airlines could use to measure any changes during Q6.
- BA considered that the CAA had no proper basis for its reduction in other charges on the basis of the information in its final proposals and by GAL in its charging consultation for 2014/15.

F9 After receiving the ACC's and BA's responses, the CAA provided them with information on how it had derived the forecasts in its final proposals. The ACC thought it had insufficient time to respond to the information and questioned the CAA's use of GAL's forecasts as the basis of its calculations, suggesting instead it should have based them on the most recent full year.

CAA's final view

F10 The CAA set out in its initial proposals that its ORC forecasts would be based on GAL's forecasts adjusted by the CAA's operating cost forecasts, and confirmed the use of this approach in its final proposals. As the ORCs are based on cost recovery, with the majority of the costs being operating costs, the CAA continues to hold the view that the correct way of forecasting revenues during Q6 is to adjust them by its operating cost forecasts. The CAA further notes that with the information provided under the Transparency Condition, the agreement on the principles on which ORCs have been set in Q5 and the annual consultation with users on each of the charges through the Gatwick Charges Group that airlines have had greater transparency over ORCs than GAL's other charges during Q5. The CAA, therefore, has based its forecasts of ORC revenue on GAL's forecasts with the operating costs element (which makes up 78% of GAL's forecasts) adjusted downwards to reflect the lower operating costs that the CAA considers GAL would be able to achieve during Q6.

CAA forecasts

F11 Based on GAL's forecasts and the CAA's opex efficiency assumptions, the CAA's final view on the level of other charges during Q6 are contained in figures F.3 and F.4 below.

Figure F.3: Forecast revenue from other charges in Q6 (£m in 2011/12 prices)

	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Check-in/baggage	18.26	20.21	20.40	21.13	20.95	20.97	20.94
Staff car park	6.80	6.87	6.94	7.01	7.08	7.15	7.22
FEGP	2.43	2.45	2.53	2.52	2.51	2.52	2.53
Identity cards	1.04	1.05	1.05	1.06	1.06	1.07	1.07
Bus & coach	0.64	0.64	0.64	0.64	0.64	0.64	0.64
Airside licences	0.08	0.08	0.08	0.08	0.08	0.08	0.08
Electricity	6.66	6.88	7.30	7.38	7.49	7.63	7.78
Water & sewerage	0.78	0.78	0.77	0.77	0.76	0.76	0.76
Heating	0.23	0.23	0.23	0.25	0.25	0.24	0.24
Gas	0.16	0.17	0.19	0.20	0.21	0.22	0.23
PRM	6.16	5.95	6.27	6.61	6.98	7.37	7.78
Vehicle fuel and oil	2.65	2.66	2.66	2.65	2.66	2.66	2.67
Other non-specified revenue	3.14	3.31	3.49	3.68	3.69	3.68	3.68

Source: GAL revised forecasts adjusted to reflect the CAA's opex efficiency assumptions

Figure F.4: CAA's final projections from other charges (£m in 2011/12 prices)

2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
49.05	51.27	52.56	53.98	54.36	54.99	55.61

APPENDIX G

Q6 RAB

G1 This appendix:

- summarises the CAA's analysis and its final proposals with respect to GAL's RAB; and
- concludes with the CAA's final view for the RAB, which is incorporated in its financial modelling of its final view for the fair price.

Deriving the opening RAB for Q6

Issue: RAB roll forward in the year 2013/14

CAA's final view

G2 GAL's RBP forecast an opening RAB of £2,399.9 million at 31 March 2013. GAL's 2012/13 regulatory accounts provided an actual opening RAB, as at 31 March 2013, of £2,391.6 million. For this reason, the CAA has reduced the opening RAB for 31 March 2013 by £8.3 million to reflect the difference between the forecast and actual capex spend in the year 2012/13. The reduction of the opening RAB has also decreased the revaluation of the opening RAB by £0.2 million.

G3 The CAA has requested GAL provide its updated view on its capex spend in the year 2013/14. GAL did not provide the CAA with an updated view. The CAA therefore has assumed that the capex spend in 2013/14 is broadly in line with the forecast capex in GAL's RBP, which is £200.4 million.

G4 Figure G.1 sets out the GAL's RAB roll forward in the year 2013/14 including the adjustment to the opening RAB as at 31 March 2013.

Figure G.1: GAL's RAB roll forward in the year 2013/14

£ million nominal	CAA's FV	GAL's RBP	Difference
Opening RAB as at 31 March 2013	2,399.9	2,399.9	-
Opening RAB Adjustment	-8.3	0.0	-8.3
Opening RAB Revaluation	62.2	62.4	-0.2
Capital additions	200.4	200.4	-
Regulatory Depreciation	-153.2	-153.2	-
Indexation	0.6	0.6	-
Closing RAB as at 31 March 2014	2,501.7	2,510.2	-8.5

Source: GAL's regulatory accounts year ended 31 March 2013 and GAL's RBP

Issue: Inclusion of pension commutation payment

CAA's final proposals

G5 The CAA's final proposals increased GAL's opening RAB as at 1 April 2014 by £104.7 million to £2,474 million in 2011/12 prices to reflect the commutation payment made by GAL to the BAA pension scheme in 2009 upon the sale of the airport operator.

CAA's final view

G6 The CAA has considered responses from both GAL and the airlines. These issues are discussed in Appendix D: operating expenditure. The CAA's final view is to include the pension commutation payment in the RAB and uplift the amount by inflation of 4.8% to 2011/12 prices, which results in a total amount of £109.7 million to be included in the RAB. Figure G.2 summaries the change in the opening RAB for Q6 between the CAA's final view and the final proposals.

Figure G.2: Opening RAB for Q6 - comparison between CAA's final proposals and final view

£ million	**Price base**	**CAA's FV**	**CAA's FPs**
Closing RAB as at 31 March 2014	2013/14	2,501.7	2,510.2
Price base adjustment of closing RAB		140.0	140.5
Closing RAB as at 31 March 2014	2011/12	2,361.7	2,369.7
Pension commutation payment	2010/11	104.7	104.7
Indexation of commutation payment		5.0	-
Adjusted pension commutation payment	2011/12	109.7	104.7
Opening RAB as at 1 April 2014	2011/12	**2,471.4**	2,474.4

Source: CAA

Deriving the depreciation charges and the RAB for Q6

CAA's final proposals

G7 The CAA's final proposals for the RAB throughout Q6 were based on GAL's forecast net capex, depreciation of the existing assets and depreciation of forecast capex in Q6. GAL's depreciation of existing assets was in line with GAL's regulatory accounts, and GAL's asset lives and depreciation policy were consistent with those in the Q5 decision.

G8 The depreciation of new capex for Q6 was calculated on a straight-line depreciation basis. In its final proposals, the CAA:

- validated the depreciation charges for the existing assets and GAL's projections for the value of capex spent in Q5 - the depreciation charge deducted from the RAB during Q5 is the same as that included in the Q5 decision;
- increased depreciation by £7 million each year to adjust for the pensions commutation payment, which was based on a depreciation period of 15 years, which is longer than GAL's 10-year deficit recovery period to reflect the size of the payment;
- reduced depreciation in line with the reduction in capex in the CAA's final projections compared to GAL's revised capex plan; and

- removed the depreciation profiling between Q6 and Q7, as it does not see merit, in this case, of moving value from one period to another.

G9 The CAA's final proposals for GAL's RAB throughout Q6 are set out in figure G.3.

Figure G.3: CAA final projections RAB for Q6

£m (2011/12 prices)	2014/15	2015/16	2016/17	2017/18	2018/19	5 yr total	2019/20	2020/21	7 yr total
Opening RAB	2,474	2,480	2,521	2,556	2,554	2,474	2,514	2,513	2,474
Net capex	155	198	188	139	111	791	151	202	1,144
Depreciation	(149)	(156)	(153)	(142)	(151)	(751)	(152)	(152)	(1,056)
Closing RAB	2,480	2,521	2,556	2,554	2,514	2,514	2,513	2,562	2,562
Average RAB	2,477	2,501	2,539	2,555	2,534	n/a	2,513	2,538	n/a

Source: CAA

Stakeholders' views

G10 GAL commented that the commutation payment should be depreciated over a 10-year period from the time the payment was made as this was in line with the normal period over which a company would fund a pension deficit.

CAA's final view

G11 The treatment of GAL's commutation payment is discussed in Appendix D. Based on this, the CAA's final view of the estimated depreciation charge on Q6 capex increases depreciation by £7.3 million each year to reflect the inflation adjustment to the pension commutation payment (from £104.7 million to £109.7 million).

G12 Figure G.4 sets out the CAA's final view for the depreciation charge on this basis.

Figure G.4: CAA's final view for the depreciation charge

£m (2011/12 prices)	2014/15	2015/16	2016/17	2017/18	2018/19	5 yr total	2019/20	2020/21	7 yr total
Depreciation - existing assets and Q5 additions	141	134	124	107	104	610	98	90	798
Depreciation - new additions	1	16	22	27	40	106	48	57	211
Depreciation - pensions commutation payment	7	7	7	7	7	37	7	7	51
Regulatory depreciation profiling	0	0	0	0	0	0	0	0	0
Total depreciation	150	156	154	142	151	753	154	154	1,061

Source: CAA

CAA's final view

G13 The CAA's final view for the Q6 RAB is set out in figure G.5 below.

Figure G.5: CAA final view of the Q6 RAB for GAL

£m (2011/12 prices)	2014/15	2015/16	2016/17	2017/18	2018/19	5 yr total	2019/20	2020/21	7 yr total
Opening RAB	2,471	2,476	2,518	2,552	2,549	2,471	2,509	2,524	2,471
Net capex	155	198	188	139	111	791	169	217	1,176
Depreciation	(150)	(156)	(154)	(142)	(151)	(753)	(154)	(154)	(1,061)
Closing RAB	2,476	2,518	2,552	2,549	2,509	2,509	2,524	2,587	2,587
Average RAB	2,474	2,497	2,535	2,551	2,529	n/a	2,517	2,555	n/a

Source: CAA

APPENDIX H

Calculation of a price cap and financeability

H1 This appendix:

- sets out the WACC calculated in the CAA's final proposals;
- sets out the CAA's final view for GAL's WACC following the CAA's consideration of responses to the final proposals;
- summarises the CAA's analysis of the fair price, including comparison to its final proposals with respect to GAL's price cap;
- sets out the CAA's final view for the fair price for GAL for Q6; and
- assesses the extent to which price at this level would enable GAL to finance its projected investment in Q6.

H2 The CAA's analysis of the components of WACC, a summary of the responses to its consultation and its calculation of the total WACC from those components is set out in full in ['Estimating the Cost of Capital: a Technical Appendix to the economic regulation of Heathrow and Gatwick from April 2014: Notices of the proposed licences'[113]]

WACC

CAA's final proposals

H3 The CAA's initial proposal for GAL's WACC was 5.95% on a pre-tax real basis. This equated to a vanilla[114] WACC of 5.10%.

CAA's final view

H4 Based on the analysis contained in the CAA’s Technical Appendix on WACC, the CAA's final view for GAL's WACC is 5.70% on a pre-tax real basis. This equates to a vanilla WACC of 4.90%. The main

113 http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

114 The vanilla WACC is the pre-tax cost of debt and the post-tax cost of equity weighted by gearing. It therefore excludes any adjustments for tax.

reason for the change from the final proposals as set out in the WACC Technical Appendix (published alongside this document) is a reduction in the cost of equity from lower assumed total market returns. This takes into account the additional new evidence set out in the CC's provisional findings on NIE. Combined with the forecast RAB derived in Appendix G of this document, the forecast WACC charge for GAL over Q6 is shown in figure H.1 below.

Figure H.1: WACC charge included within the final view for GAL's Q6 price cap

£m (2011/12 prices)	2014/15	2015/16	2016/17	2017/18	2018/19	5 yr total	2019/20	2020/21	7 yr total
Average RAB	2,474	2,497	2,535	2,551	2,529	n/a	2,517	2,555	n/a
Cost of capital	141	142	144	145	144	717	143	146	1,006

Source: CAA

Fair price calculation

Final proposals

H5 The CAA's final proposal for GAL was to set a fair price equivalent to a maximum increase in average airport charges of RPI+1.6% per year over a 5-year Q6 period, and RPI+0.3% per year, if the final projections are extended to 7 years. Figure H.2 shows each building block component which contributed to the CAA's final price cap proposal.

Figure H.2: CAA's final price cap proposals

£m (2011/12 prices)	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	5 yr total	2019/20	2020/21	7 yr Total
Opex		283	279	276	272	269	1,378	267	266	1,912
Depreciation		149	156	153	142	151	751	152	152	1,056
Cost of capital		147	149	151	152	151	750	150	151	1,051
Total revenue requirement		579	584	580	566	570	2880	569	569	4018
Other revenues		(245)	(244)	(254)	(261)	(270)	(1,274)	(273)	(273)	(1,820)
Net revenue requirement		334	340	326	305	300	1,605	297	296	2,198
Passengers (no. millions)		35.8	36.6	37.2	37.9	38.5	186.0	39.2	39.8	265.0
Unprofiled yield per pax (£)	8.31	9.35	9.29	8.74	8.05	7.80	n/a	7.56	7.44	n/a
Year-on-year change	n/a	12.6%	-0.6%	-5.9%	-7.9%	-3.2%	n/a	-3.0%	-1.6%	n/a
5-year smoothed price cap (RPI+1.6%)										
Profiled yield per pax (£)	8.31	8.43	8.58	8.70	8.78	8.97	n/a	n/a	n/a	n/a
Year-on-year change	n/a	1.5%	1.8%	1.4%	0.8%	2.2%	n/a	n/a	n/a	n/a
7-year smoothed price cap (RPI+0.3%)										
Profiled yield per pax (£)	8.31	8.32	8.36	8.37	8.33	8.41	n/a	8.43	8.45	n/a
Year-on-year change	n/a	0.2%	0.5%	0.1%	-0.5%	0.9%	n/a	0.3%	0.3%	n/a

Source: CAA

H6 The CAA's assessment of the financeability of its Q6 final proposals for GAL indicated that the notionally financed airport operator would meet the requirements of a solid investment grade credit rating.

Stakeholders' views

H7 The CAA received four responses commenting on its final proposals for the calculation of the fair price at Gatwick during Q6. The responses can be summarised into three categories:

- the CAA's approach to calculating a fair price (discussed in Appendix A: introduction to the fair price);
- each RAB-based building block based on which the fair price was derived (discussed in Appendices B to G); and
- the comparison between the RAB-based approach and the commitments framework (discussed in Appendix I: form of regulation).

Deriving a Q6 fair price

H8 The CAA's view of a fair price, in terms of the maximum average level of airport charges, is based on a RAB-based 'building block' approach. The main assumptions in its financial modelling for each of the 'building blocks' relevant to the calculations are set out in the figures below, and take into account stakeholder responses on individual building blocks.

H9 In addition, the CAA's view of a fair price depends on the inflation assumption; the CAA must make a decision on which inflation forecasts to use.

H10 Virgin noted that the ONS[115] had found that:

- RPI overstates actual inflation; and
- the use of the RPI index inflates the airport charges.

H11 The CAA has examined the ONS findings in detail. The ONS concluded that the RPI does not meet international standards, and recommended that a new index be published. This could support the case for making an allowance to reflect an overstatement of the rate of inflation. However, the CAA notes that the ONS also commented that there is significant value to users in maintaining the continuity of the existing RPI's long time series without major change. Based on the ONS's recommendation and the CAA's own assessment, the CAA

[115] http://www.ons.gov.uk/ons/rel/mro/news-release/rpirecommendations/rpinewsrelease.html

has decided to continue the use of RPI-based index, and not to adjust the treatment of inflation, for two reasons:

- the CAA sees considerable merit in regulatory consistency. This provides certainty for investors, management, and customers; and
- many of GAL's cost items, such as wages, are calculated using RPI as it is currently comprised.

H12 Accordingly, the CAA's final view does not contain an adjustment for any overstatement of RPI. The RPI indices the CAA has used are as follows:

- the actual RPI indices (CHAW series) up to October 2013 published by the ONS;
- monthly RPI indices obtained by interpolating the quarterly RPI forecasts from Oxford Economic Forecasting (OEF) for the period November 2013 to December 2017; and
- annual RPI forecasts from Consensus Forecasts (CF) for 2018 (3.8%) and 2019 (3.2%).

H13 Figure H.3 sets out the CAA's projections for the calculation of the RAB and associated depreciation and WACC charge.

Figure H.3: CAA's projections for the RAB

£m (2011/12 prices)	2014/15	2015/16	2016/17	2017/18	2018/19	5 yr total	2019/20	2020/21	7 yr total
Opening RAB	2,471	2,476	2,518	2,552	2,549	2,471	2,509	2,524	2,471
Net capex	155	198	188	139	111	791	169	217	1,176
Depn	(150)	(156)	(154)	(142)	(151)	(753)	(154)	(154)	(1,061)
Closing RAB	2,476	2,518	2,552	2,549	2,509	2,509	2,524	2,587	2,587
Average RAB	2,474	2,497	2,535	2,551	2,529	n/a	2,517	2,555	n/a
Cost of capital	141	142	144	145	144	717	143	146	1,006

Source: CAA calculations

H14 Figure H.4 sets out the depreciation and WACC charges alongside all the other building blocks required to calculate a fair price.

Figure H.4 Components of the RAB-based calculation

£m (2011/12 prices)	2014/15	2015/16	2016/17	2017/18	2018/19	5 yr total	2019/20	2020/21	7 yr total
Opex	284	281	279	276	274	1,393	273	272	1,939
Depn	150	156	154	142	151	753	154	154	1,061
Cost of capital	141	142	144	145	144	717	143	146	1,006
Total revenue requirement	574	580	577	564	569	2,864	570	572	4,006
Other revenues	(250)	(261)	(267)	(277)	(283)	(1,338)	(284)	(285)	(1,907)
Net revenue requirement	324	319	309	287	286	1,526	286	286	2,098
Passengers (m)	37.4	38.2	38.8	39.4	39.9	193.8	40.5	40.9	275.1
Yield per pax (unprofiled) £	8.66	8.37	7.96	7.28	7.17	n/a	7.08	7.00	n/a

Source: CAA calculations

H15 In the final proposals, the CAA smoothed the yield per passenger to avoid unnecessary fluctuations and to simplify the price control. Such smoothing or profiling is done in a Net Present Value (NPV) - neutral manner, i.e. the NPV of the net revenue requirement is the same under both unprofiled and profiled prices.

H16 The CAA is aware that a significant difference between the profiled and unprofiled prices may, in some circumstances, therefore lead to a short-term mismatch between revenues and costs and create liquidity issues for GAL. These issues can have implications for the financeability assessment.

H17 If the resulting yield per passenger is smoothed across a five year Q6 period, it equates to a price change of no more than RPI-1.6%[116] per year (see figure H.5). This compares to GAL's Business Plan of RPI+6.9% per year. Under the CAA's final projections a fair price (in 2011/12 price base) is expected to be £7.62 per passenger in 2018/19 which is £3.94 (or 34%) lower than using GAL's projections.[117]

H18 If the projections are extended to 7 years, the price change is no more than RPI-2.0% per year, see figure H.6. This compares to GAL's commitment proposal of a blended yield of RPI-0% per year. Under the CAA's final projections a fair price (in 2011/12 price base) is expected to be £7.23 per passenger in 2020/21 which is approximately 13% lower than using GAL's commitment proposal.

Figure H.5: Profiled and unprofiled prices

£ (2011/12 prices)	**2013/14**	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**
Yield per pax (unprofiled)	8.31	8.66	8.37	7.96	7.28	7.17	7.08	7.00
Year on year change	n/a	4.3%	-3.3%	-4.8%	-8.6%	-1.5%	-1.3%	-1.0%
5-year smoothed price cap (RPI-1.6%)								
Yield per pax (profiled)	8.31	8.19	8.06	7.93	7.75	7.62	n/a	n/a
Year on year change	n/a	-1.4%	-1.6%	-1.6%	-2.3%	-1.6%	n/a	n/a
- year smoothed price cap (RPI-2.0%)								
Yield per pax (profiled)	8.31	8.16	7.99	7.84	7.63	7.47	7.37	7.23
Year on year change	n/a	-1.8%	-2.0%	-1.9%	-2.7%	-2.0%	-1.4%	-2.0%

Source: CAA calculations

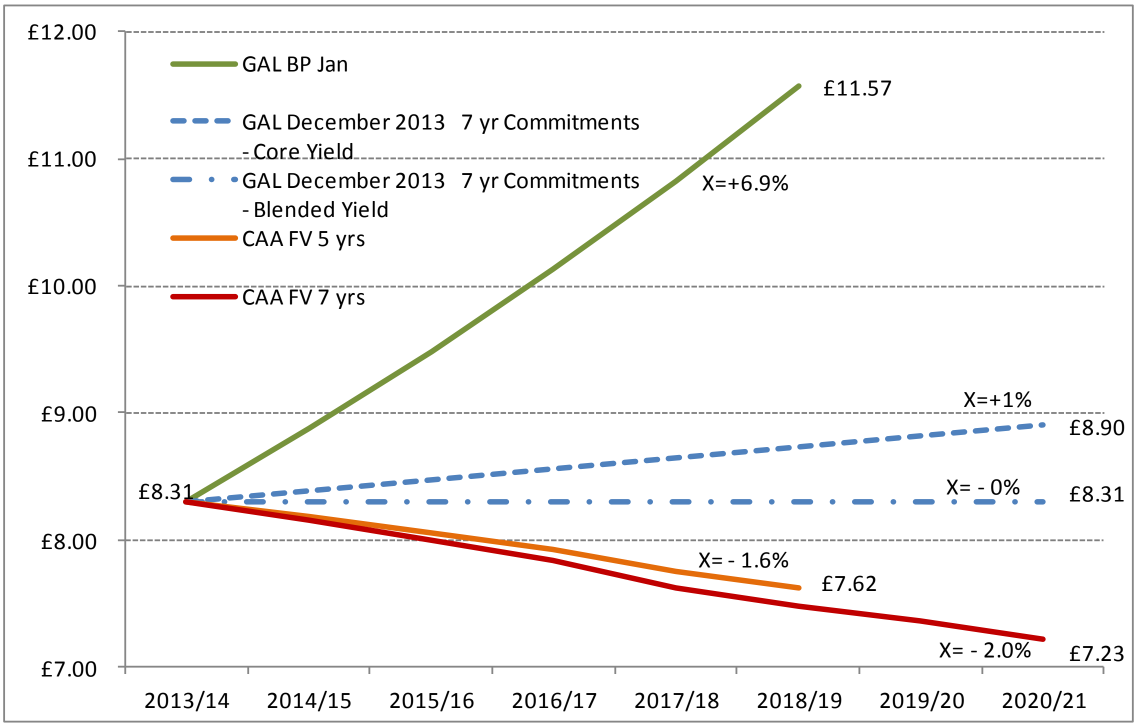
Note: The CAA has used the inflation forecast from Oxford Economics and assumed a long-run inflation rate of 3.8% for 2018, and 3.2% for 2019 to 2021.

116 In the formula RPI±X, RPI is the change in the index and can be negative or positive.

117 The CAA notes that GAL included a P0 adjustment in its RBP, which would reduce the difference at the end of the period but increase it at the start of the period.

H19 Figure H.6 shows how the CAA's projections compare to GAL's view of a RAB-based price cap using a simple average of the yield in each of the five years. Figure H.6 also compares GAL's view of price commitments and CAA's projections based on a RAB-based price cap over a 7-year period.

Figure H.6 Yield per passenger (smoothed)



Source: CAA and GAL

H20 Figure H.7 compares the CAA's final view with the CAA's initial and final proposals, ACC's and GAL's responses to the CAA's initial proposals, and GAL's RBP. For example, the CAA's final view for opex is £1,393 million, which is 1.1% higher than the CAA's final proposals, 5.3% higher than ACC's response to the CAA's initial proposals, 0.6% higher than the CAA's initial proposals and 6% lower than GAL's RBP. The main changes from the final proposals are as follows.

- The WACC has reduced from 5.95% to 5.70%. This is due to a reduction in the cost of equity reflecting a lower total market returns assumption. The gearing and tax assumptions remain unaltered.

- Traffic forecasts have increased by 4.2% over five years resulting from more up to date traffic data and the likely use of larger aircraft from easyJet's purchase of Flybe's slots.
- The opex efficiency assumption has fallen from 1.3% per year to 0.9% per year, due to higher passenger forecasts and an allowance for the CAA's security charge (4.9p per departing passenger).
- Overall total commercial revenues increased by 6.0% to £1,077 million driven by the increase in traffic forecasts and the inclusion of revenue forecasts from improvements in GAL's capex schemes.
- Forecasts for ORCs have increased, from £259 million to £261 million, or 1.0%, due to higher traffic forecasts.
- The opening RAB has decreased by £3 million due to the update of actual capex spend in 2013/14 and the indexation of the pension commutation payment. The changes to the opening RAB and capex have increased regulatory depreciation by 0.2% to £753 million.

Figure H.7: Comparison of building block assumptions over a 5-year Q6

	CAA's Final view (January 2014)	CAA's Final proposals (October 2013)	ACC's response to CAA's Initial proposals (June 2013)	GAL's response to CAA's Initial proposals (June 2013)	CAA's Initial proposals (April 2013)	GAL's Revised Business Plan (January 2013)
	£000	% increase (+) or decrease (-) relative to the CAA's final view				
Opening RAB	**2,471**	-0.1%	4.3%	4.3%	4.3%	4.3%
Capex	**791**	0.0%	82.3%	-25.7%	-0.4%	-13.2%
WACC (%)	**5.70%**	-0.3%	0.8%	-1.4%	0.1%	-0.8%
Cost of capital	**717**	-4.3%	29.0%	-12.1%	4.2%	-9.6%
Opex	**1,393**	1.1%	5.3%	na	0.6%	-6.0%
Regulatory Depreciation	**753**	0.2%	12.3%	9.8%	4.5%	10.4%
Commercial revenues	**1,077**	6.0%	-20.4%	na	9.7%	19.0%
ORCs	**261**	0.9%	na	na	-5.2%	-5.2%
Traffic	**194**	4.2%	1.7%	7.5%	7.1%	10.4%

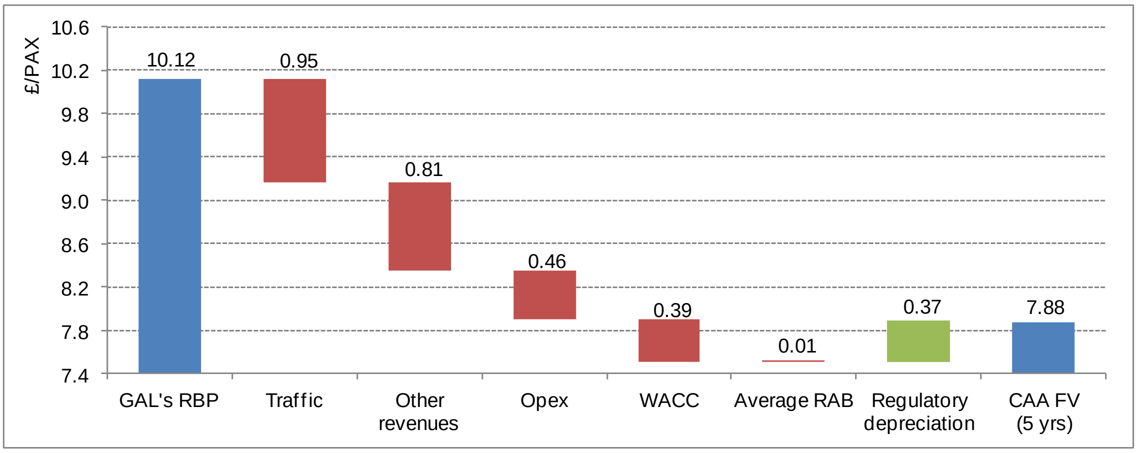
Source: CAA and GAL

H21 Figure H.8 shows the average yield between GAL's RBP (its last forecast of each of the individual RAB building blocks) and the CAA's final view on average over a 5-year period. Each bar in figure H.8 represents a 'building block' per passenger, calculated based on the CAA's final view of traffic. GAL's RBP proposed an average yield per passenger over a 5-year Q6 of £10.12, whereas the CAA's final view of an average yield per passenger over a 5-year period is £7.88. The difference in the yield is due to the difference in GAL's and the CAA's view on each 'building block', for example, the CAA's final view on traffic is higher than GAL's, which reduces the average yield by £0.95.

H22 The CAA's projected depreciation is higher than that of GAL's by, on average about £0.37 per passenger, because the CAA has removed the depreciation profiling between Q6 and Q7. In the RBP GAL profiled depreciation between Q6 and Q7, in effect reducing the depreciation charge and therefore price in Q6 and increasing them in

Q7. The CAA does not see merit of moving value from one period to another.

Figure H.8 Comparison of average annual yield over a 5-year Q6 between GAL's revised business plan and CAA's final view



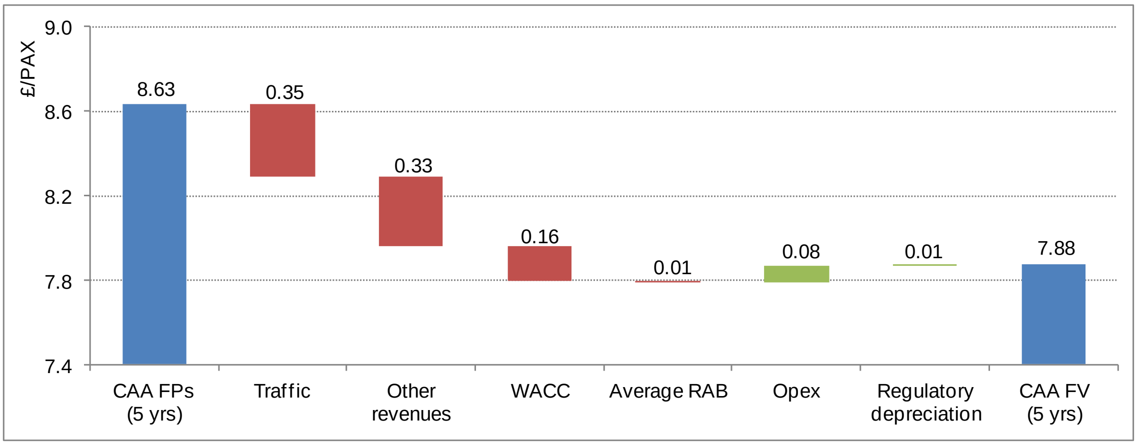
Note: Other revenues equal the sum of commercial revenues and non-regulated charges.

Source: CAA and GAL

H23 Figure H.9 sets out the change between the CAA's final proposals and the final view over a 5-year period. The most significant changes in the building blocks are traffic, cost of capital, other revenues, including commercial revenues and ORCs.

H24 The CAA's view of the fair price in the final proposals was an average of £8.63 over a 5-year period. Since the final proposals, the CAA has a reviewed each 'building block.', impacting on the average yield. For example, the CAA's final view has a higher traffic forecast compared to its final proposals, which reduces the average yield by £0.35; the CAA's final view of the WACC has decreased by 25 basis points, which decreases the average yield by £0.16, and the CAA's final view of opex is higher than its final proposals by £0.08 per passenger.

Figure H.9 Comparison of the average annual yield over a 5-year Q6 between the CAA's final proposals and final view



Note: Other revenues equal the sum of commercial revenues and non-regulated charges.
Source: CAA

Financeability

H25 In addition to proposing maximum levels of airport charges, the CAA has assessed the financeability of its final projections for Q6. The CAA must have regard to the need to ensure that licence holders such as GAL can finance their provision of airport operation services in the area for which the licence is granted when it comes to the exercise of the CAA's functions such as setting price caps. This cannot override the CAA's primary duty. However, the CAA considers that the setting of a price control condition that is aligned with an efficient operator being able to finance its business is consistent and not in conflict, with present and future passengers' interests.

H26 The CAA considers it appropriate to establish whether the Q6 final projections would enable an efficient GAL to finance its operations including the capex programme in Q6 on reasonable terms in the banking and capital markets through some combination of debt and equity.

Stakeholders' views

H27 GAL and the airlines did not express views on the CAA's financeability analysis in their responses to the CAA's initial proposals or final proposals.

H28 Standard & Poor's Ratings Services (S&P)[118] considered the CAA's initial proposal on a RAB-based approach for GAL as credit neutral and viewed the market-based commitments between GAL and the airlines as credit negative for GAL's securitisation. S&P's view was that the RAB represents the value of the securitised assets, which provides a reference point for investors. Without the RAB measure, investors might resort to typical business valuation approaches, which are sometimes volatile. S&P also commented that if the CAA's final decision supports the commitments regulatory framework, S&P will review GAL's earnings before interest, taxes, depreciation and amortisation (EBITDA) volatility or refinancing risk; significantly higher refinancing risk could affect S&P's ratings on Gatwick Funding Limited's bonds. Gatwick Funding Limited is a wholly owned subsidiary of GAL.

CAA's final view

H29 A key assumption in determining the appropriate level of gearing in the CAA’s estimation of the WACC is that GAL should be able to obtain and maintain the requirements of a solid (sometimes known as ‘comfortable’) investment grade rating at an assumed gearing level of 55%.

H30 A solid investment grade rating is interpreted as in the region of BBB/BBB+ (using S&P and Fitch Ratings Limited’s terminology) and Baa2/Baa1 (using Moody’s Investor Service terminology). This is a couple of ‘notches’ above the bottom of investment grade of BBB– or Baa3. The aim of the financeability assessment is for GAL to be in a position to absorb reasonable unanticipated downside risk and still retain an investment grade credit rating.

H31 The CAA has gathered evidence directly from three credit rating agencies; S&P, Moody’s Investor Service and Fitch Ratings. In determining a credit rating, an agency typically considers both qualitative evidence (e.g. business risk and corporate governance) and quantitative evidence (e.g. financial risk and credit ratios).

H32 In forming a view on the business risk of an airport operator, an agency will consider, among other things:

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118 Standard & Poor's Rating Services, *Initial regulatory proposals for UK airports are credit neutral*, 22 May 2013.

- the competitive position of the airport compared with airports owned by competitors, which in turn may include:
  - location (catchment area, local transport links); and
  - customer airlines and the passenger mix, (hub airlines, alliances, destinations of those airlines);
- the regulatory regime, and in particular the rigour and predictability of the regime;
- the diversity of the airports owned or operated by the company;[119] and
- charges (for example landing, passenger and security charges).

H33 GAL would appear to have a stable position from a credit perspective. Gatwick is the world's busiest single runway airport and the second busiest airport in the UK. It has an attractive catchment area, convenient transport links and diversified revenue streams in terms of destinations and airlines.

H34 One of the key assumptions of the CAA's financeability assessment is that the CAA's review will not affect GAL's business risk; therefore, the CAA assumes that the regulatory risk of GAL is unchanged from credit rating agencies' current views. However, the CAA recognises that the fair price could affect the financial risk of GAL.

H35 With response to S&P's comment on the form of regulation, the CAA notes that the commitments framework was proposed by GAL in its RBP. The CAA believes that GAL has a duty of care to its shareholders and is expected to act in good faith to enhance shareholder value; therefore it would be unreasonable to assume the proposed commitments regulatory framework is financially unviable or materially worse than a RAB-based settlement. The CAA has a duty to have regard to the need to ensure the airport operator is financeable over the regulatory period, irrespective of the form of regulation chosen. The CAA's fair price is calculated based on a RAB-based regulatory framework; therefore, the CAA has conducted financial risk analysis on such basis.

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119 The CAA considers the airports on a standalone basis, so while this factor might be important for the credit rating agencies, the CAA's analysis ignores other airports in the same corporate group of companies.

H36 In forming a view on the financial risk of a business it is rating, an agency may consider matters such as:

a) historical and forecast financial performance, including:

i) cash flow and profitability;

ii) revenue diversity and stability;

iii) liquidity and financial flexibility;

iv) capital structure of the company (including gearing);

v) covenants and security including securitisation; and

b) financial policy and strategy of management (including merger & acquisition activity, dividend policy, etc).

H37 The rating agencies place different emphasis on the various ratios. Some of the agencies also differ in their benchmarks (e.g. the value the ratio needs to be for a certain credit rating).

CAA analysis of credit ratios

H38 The CAA has considered whether the forecast performance of GAL under the CAA's final view projections is consistent with a solid investment grade based on assumed gearing of 55% and considered six ratios used by the various agencies.[120]

a) interest cover;[121]

b) funds from operations (FFO[122]) interest cover;[123]

c) post-maintenance interest cover ratio (PMICR);[124]

d) adjusted interest cover (adjusted ICR[125]);

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[120] These ratios and some of the terms used in them do not have agreed definitions.

[121] ICR = (EBITDA – tax paid – 2% of total RAB)/interest paid. NB: the rating agencies using this metric assume that 2% of total RAB is required to maintain the regulatory assets.

[122] FFO= Net income from continuing operations adding back depreciation, amortisation, deferred income taxes and other non-cash items, less any changes to operating components of working capital.

[123] FFO/interest expense = FFO (as above) + gross interest paid on debt/gross interest expense on debt.

[124] PMICR = (EBITDA – corporation tax paid – regulatory depreciation)/interest paid.

[125] Adjusted ICR is FFO + interest expense – regulatory depreciation + profiling adjustment

e) FFO to debt;[126] and

f) regulatory asset ratio (RAR[127] or gearing) (debt divided by RAB).

H39 The CAA has used a separate section in GAL's financial model, which was created to provide illustrative calculations of the above financial ratios. These are set out in nominal terms[128] as this tends to be the basis used by rating agencies.

H40 The CAA has undertaken the analysis on the basis of the notional capital structure consistent with the CAA's cost of capital proposals. This assumes:

a) a constant gearing level of 55%, with the level of dividends being the balancing item used to keep gearing at this level;[129]

b) a nominal cost of debt of 5.9%. This is based on a real cost of debt of 3.0% (excluding fees) and an inflation rate of 2.9%;

c) index-linked debt making up 35%[130] of the total debt balance; and

d) a cost of index-linked debt of 3%.[131]

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divided by interest expense.

126 FFO/net debt, where FFO is as defined above and net debt = closing RAB x gearing ratio.

127 RAR = debt less cash and authorised Investments/total RAB.

128 In contrast, the rest of the GAL model used for the price control was specified in real terms.

129 The CAA relaxed this assumption and after allowing for a modest dividend yield, gearing was in the range of 55% to 56%.

130 Ofgem assumes 25% of each network company's debt is index-linked. In the Q5 price control review, the CAA assumes that the proportion of index-linked debt is 25%. The CAA has also calculated the actual proportion of GAL's index-linked debt, based on GAL's financial statements. The calculated proportion is approximately 55%. Taking into account all the available evidence, the CAA takes the conservative point of 35% in the range of 25 per cent to 55 per cent.

Ofgem, 17 December 2012, '*RIIO-GD1: Final Proposals - Finance and uncertainty supporting document*', p. 25.

GAL, 'Report and unaudited interim financial statements for the six months ended 30 September 2012', p. 15.

131 The cost of index-linked debt of 3% is consistent with the CAA's point estimate of 3.32% less fees of 20bps (excluding fees). The nominal cost of debt includes inflation of 2.8%.

H41 The CAA has made some additional assumptions and adjustments in order to derive the financial ratios in figure H.10.

H42 Based on these results, the CAA considers that a notionally financed and efficient GAL would be likely to achieve and maintain a solid investment grade credit rating.

Figure H.10: CAA financial ratios for GAL in Q6

Key financial ratios: benchmarks and calculations[132]								
	Benchmark		CAA 5yr			CAA 7yr		
Key financial ratios	Moody's (Baa2)	Fitch (BBB+)	Ave.	Min	Max	Ave.	Min	Max
PMICR a		1.5x	1.8x	1.8x	1.8x	1.8x	1.8x	1.8x
Net debt/EBITDA	n/a	7.0x	4.7x	4.6x	4.9x	4.7x	4.6x	4.9x
ICR	1.4x -1.6x	n/a	3.3x	3.2x	3.3x	3.3x	3.2x	3.3x
RAR - Net debt/RAB	68% - 75%	n/a	55%	55%	55%	55%	55%	55%
Other financial ratios								
FFO interest coverage	2.25x - 3.0x	n/a	3.3x	3.2x	3.4x	3.3x	3.2x	3.4x
FFO to net debt	6-10%	n/a	20%	19%	20%	20%	19%	20%

Source: CAA analysis

Note: Fitch's rating thresholds can be found on its credit report: 'Fitch affirms Gatwick Funding's bonds at 'BBB+'; outlook stable, 22 January 2013'.

H43 The CAA has evaluated a broad range of credit ratios (set out in figure H.10), in particular the PMICR and Net debt to EBITDA. The Net debt to EBITDA ratios are all below 7.0, indicating that GAL is able to generate sufficient earnings to finance its debt. The PMICR ratios are all above 1.5, which is Fitch's threshold of 'BBB+' rating, suggesting that the notionally financed airport operator would meet the requirements of a solid investment grade credit rating. In addition, the CAA has assessed the ratios for a 7-year period, and conducted analysis by incorporating a variable dividend payout ratio. The CAA considers that its conclusions are not sensitive to changes in these assumptions.

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132 Unfortunately S&P does not share the details of key financial ratios which they consider important.

H44 The CAA has used GAL's financial model to calculate the Q6 fair price and analyse price cap profiling and financeability. GAL's model, including assumptions, logic, internal consistency and formulae has been externally audited.

H45 The CAA's Q6 price cap calculations have been internally audited and the excel model has been checked by calculating the price cap using alternative models.

CAA final view of fair price

H46 The CAA's final view of the fair price for GAL is RPI-1.6% per year over five years and RPI-2.0% per year over seven years.

APPENDIX I

Form of regulation

I1 The overall model or form of economic regulation for GAL should be designed in a manner that furthers the CAA's statutory duties and reflects the market power held by GAL and the risk of abuse.

I2 The current GAL Q5 price control is based on a RAB-based framework. As an alternative to licence regulation in future, GAL has put forward proposals for airport commitments to airlines. These commitments, which GAL is proposing to include in its COU set out limits on airport charges, a service quality regime and commitments on consultation, investment, and operational and financial resilience. As part of its response to the final proposals GAL provided revised commitment proposals which reduced the price in the commitments to RPI+0% (blended) and RPI+1% per year (published), with improved terms regarding the treatment of second runway costs and premium charges and a number of other measures to meet the concerns identified by the airlines.

I3 This appendix discusses the merits of GAL's proposed commitments and alternative forms of licence regulation that could apply from April 2014 for GAL.

Process to date

I4 In November 2009, the CAA commenced work with stakeholders to identify and assess alternative forms of regulation.

I5 In March 2011, the CAA issued a stock-take on this work and narrowed down the options and identified a number of potential improvements to the regulatory design within, and beyond, a standard RAB-based framework. The CAA consulted on the merits of these options in its July 2011 setting the scene document.

I6 In the May 2012 Q6 policy update, the CAA consulted on a further narrowed down set of potential options.

I7 In the April 2013 Q6 initial proposals the CAA concluded that "the CAA hopes that a commitments and limited licensing framework could be the preferred form of regulation for GAL. This would be on the basis that the enforcement concerns about the commitments concept were addressed through enforcement under the licence; and that the commitments were amended to address the other concerns ..., so that they are reasonable and effective. In the absence of a satisfactory proposal for commitments, and due to the concerns raised around the other potential options, the CAA considers that it would be most appropriate to base its initial proposals on a RAB-based framework."

Final proposals

I8 GAL's revised commitments provided in September 2013 imposed limits on the maximum average revenue yield over seven years based on published prices at RPI+1.5% per year and average prices (taking into account published prices and bilateral contracts) at RPI+0.5% per year. The latter price is also known as the 'blended price'.

I9 The CAA reviewed the price in the September 2013 commitments against the CAA's assessment of the fair price in the final proposals. The commitments would reduce average charges by 3% over the next 5-year period compared to the fair price based on a 5-year RAB-based price control, the most likely regulatory alternative. The commitments would also lock in the benefits of lower charges in the first two years of the next control period, which have a risk of being eroded over time as new cost pressures emerge. The commitment blended price was also comparable to the 7-year fair price (RPI+0.5% per year compared to RPI+0.3% per year).

I10 The CAA considered whether the benefits of GAL's commitments were such that a licence-based framework was not required at all. While noting that this question was primarily addressed as part of Test C in the market power assessment with regard to GAL, the CAA concluded that it could not be confident about fulfilling its statutory duties by relying on commitments without a licence. This is because of the relatively weaker enforcement regime;[133] because the lack of

[133] The commitments would be enforced by airlines rather than by the CAA and therefore the enforcement regime is likely to operate in the interests of airlines more effectively than in the

any licence would limit the CAA's ability to respond to future events;[134] and because the commitments that had been offered by GAL did not provide effective protection around financial resilience and created risks to passengers in other areas.

I11 Accordingly, the CAA considered what form of regulation should be implemented under a licence. The CAA considered 7-year commitments within a limited licensing and monitoring framework. The licence would include provisions that enable the CAA to enforce the commitments and prevent GAL from altering or withdrawing its commitments. This would address the CAA's enforceability concerns with GAL's commitments. The CAA also considered that financial resilience obligations would be required in the licence, given the potential passenger detriment if shortcomings arose.

I12 The CAA considered that while there were risks in other areas, for example on capex (where GAL had committed to minimum capex of £100 million per year, around half that proposed by GAL and assumed in the fair price calculations) and service quality, its concerns were best addressed through monitoring GAL's performance. If issues did arise, the CAA considered it could introduce new licence conditions on a case by case basis.

I13 In reviewing alternative forms of regulation, the CAA did not consider that long-run incremental costs (LRIC) or airport comparator benchmarks would be sufficiently robust to be used to set price caps. Furthermore, the CAA did not consider that price monitoring alone, in particular in the absence of reasonable and effective commitments, would offer sufficient protection given the issues identified in the minded to market power assessment, for example around enforceability. The CAA accepted that price monitoring combined with commitments in a licence could be a more effective form of regulation, however much of the burden of preventing abuse would fall on GAL through its compliance with the commitments themselves. Consequently, simply including commitments in a licence was likely to be a more appropriate form of regulation, particularly in terms of enforceability.

interests of users. The CAA has a duty to further the interests of users rather than airlines.

134 For example, on future second runway costs or repeated service quality failures.

I14 Given the potential improvements that are available under the Act, and the degree of market power held by GAL, the CAA considered that an enhanced RAB-based framework could be an appropriate form of regulation for GAL. A RAB-based framework is well understood and widely used across regulatory sectors. It provides price and service quality protection to passengers, while providing incentives for efficiency and has support from airlines. Unlike Stansted, there is less uncertainty over individual building blocks with Gatwick and the value of the RAB of the airport operator does not appear to be out of line with the investment requirements of passengers.

I15 On balance, the CAA considered that commitments within a limited licensing framework and effective monitoring would further passengers' interests and, where appropriate, promote competition. In the case of GAL, commitments offered a number of benefits over a RAB-based framework from the additional flexibility and greater potential for bilateral contracts which could allow better tailoring of airport operation services by GAL to the needs of individual airlines and their passengers. That would not only enhance choice and value to passengers, but would also facilitate airport competition at the margin. The commitments would also provide other benefits above a RAB-based framework from:

- the greater certainty to airlines and their passengers as they are for seven rather than five years and would lock-in the benefits of lower charges in years six and seven;
- the strengthening of the airline and airport operator commercial relationship as the commitments are given to airlines rather than the CAA; and
- avoiding some of the direct costs and distortions to incentives that would be present under a RAB-based framework.

I16 A supporting licence and monitoring regime would ensure that GAL would comply with the commitments in a manner that furthered passengers' interests. The licence and monitoring regime allowed the CAA to enforce the commitments so that the additional flexibilities in the commitments were furthering passengers' interests and not just the operator's or airlines' interests.

I17 The CAA considered that the commitments, licensing and monitoring regime would be consistent with the better regulation principle that regulation should be proportionate and targeted only in cases where action is required. It would mean that the CAA could step in to increase regulation if GAL cannot develop the positive relationships with airlines that would be important for an effective regime. On this basis the CAA's final proposals recommended commitments within a licensing and monitoring framework.

Issues

I18 Stakeholders raised concerns in four main areas on the CAA's assessment of the form of regulation:

- the evaluation criteria;
- the assessment of the commitments and the benefits of licence regulation;
- the comparison of the fair price with the commitments price; and
- the assessments of other forms of regulation.

I19 The following sections set out the CAA's consideration of these issues, together with other new information, in particular around the commitments and the fair price. Where new issues have not arisen, the CAA has not repeated its assessment and the CAA's assessment is as set out in the final proposals.

Evaluation criteria

Final proposals

I20 The CAA reaffirmed its intention to assess alternative forms of regulation based on a set of evaluation criteria drawn from its statutory duties. The CAA did not accept GAL's criticisms made in its response to the initial proposals regarding the CAA's assessment of the form of regulation, around its evaluation criteria. The CAA continued to consider it should be based on its statutory duties and should take account of stakeholder confidence. The CAA agreed with GAL that price protection should focus on passengers and that reductions in price to airlines would, to some extent, be passed onto passengers.

I21 The CAA also did not accept GAL's arguments that it had placed too little weight on the promotion of competition as:

- the CAA had included the promotion of competition as one of the key criteria in its evaluation framework;
- the duty to promote competition includes the term "where appropriate" and so is subsidiary to furthering passengers' interests;
- when evaluating passengers' interests the CAA had placed greatest weight on the cost of airport operation services as this is where the risk of abuse of SMP was greatest;
- when evaluating the benefits to different groups of passengers the CAA had sought the outcome that provided the greatest overall benefit;
- while GAL stated that the CAA should take account of increasing competition, the CAA had been conscious of the need to prevent the risk of abuse of SMP, while promoting competition where it was appropriate to do so, and noted that additional capacity at Gatwick over the next control period is unlikely to alleviate the severe capacity constraints at Heathrow and to a lesser extent Gatwick;
- while the CAA accepted that bilateral agreements were less likely under RAB-based regulation, they were not prevented and the CAA did not accept that its regulatory process had frustrated the agreement of bilateral contracts or GAL's ability to attract and retain new customers;
- the CAA did not accept GAL's argument that the CAA's proposals had held it back from the delivery of its vision of the airport and considered that regulation needed to provide adequate protection against the risk of abuse of SMP, which could lead to too little investment; and
- RAB-based regulation had not prevented some service innovations, such as self service check-in.

Stakeholders' views

I22 GAL stated that it continued to have concerns with the CAA's evaluation criteria and that the CAA had not addressed the concerns set out in its response to the initial proposals. In particular GAL considered that the requirement for regulatory activities to be carried out in a way that is transparent, accountable, proportionate and consistent is more clearly directed at regulatory outcomes as well as process. In its view the CAA's focus appears to be much more on process than outcome. GAL also considered that the CAA had not adequately explained why stakeholder confidence is a requirement of this duty.

I23 The ACC welcomed the CAA's evaluation criteria as a helpful and pragmatic evaluation framework.

CAA's final view

I24 The CAA continues to consider that it has addressed GAL's concerns on the evaluation criteria, as set out above and in more detail in paragraphs 10.13 and 10.19 to 10.47 of the final proposals.

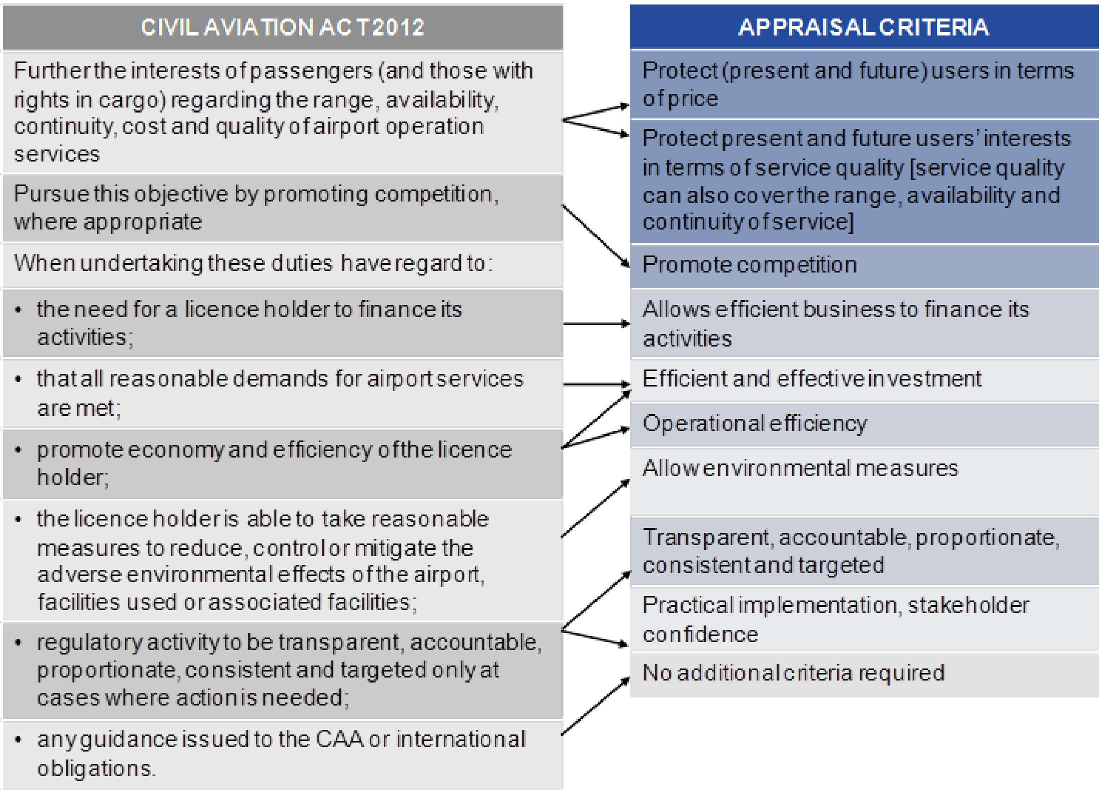
I25 Section 1 of the Act requires the CAA to have regard to the regulatory objectives and principles whenever it carries out its functions in Chapter 1 of the Act and when it complies with its general duty to further users' interests and promote competition.[135] Those functions include the decision to grant a licence, the assessment of alternative forms of regulation and determination of the content and effect of any licence conditions imposed. In carrying out its functions, the CAA must have regard to the principle of its regulatory activities being transparent, accountable, proportionate and consistent as well as targeted where necessary. Those requirements apply just as much to process as they do to the substance of the form of regulation and the regulatory outcome. The CAA has not confined itself to procedural compliance but has had regard to those regulatory objectives and principles in determining the most appropriate and proportionate form of regulation for GAL.

I26 On stakeholder confidence the CAA considers it is difficult for the CAA to be accountable and consistent if its regulatory activities, substantive decision making and procedures do not instil stakeholder confidence. Furthering passengers' interests requires both airlines and the airport operator to put effort into optimal operations. So the conflict and distraction in constant stakeholder arguments via formal regulatory processes is an indicator that passenger outcomes are likely to be

135 Sections 1(3)(g) and (4) of the Act.

neglected. In addition the CAA does not consider that numerous complaints under the ACRs, AGRs or competition law would provide adequate protection to users and would not be consistent with accountable and consistent regulatory activities. The CAA has reviewed its other evaluation criteria and its assessment, and for the reasons set out in the final proposals continues to consider it appropriate. The CAA's evaluation criteria are therefore unchanged from the final proposals and are set out in figure I.1.

Figure I.1: Appraisal criteria for assessing regulatory design



Source: CAA

CAA assessment of GAL's commitments proposals in the absence of a licence

GAL's revised commitments proposals

I27 The CAA continues to consider that GAL's airport commitments are a positive step. The commitments could potentially provide a number of safeguards for airlines and passengers against the potential risk of abuse of SMP. The key features of GAL's revised commitments proposals submitted on 5 December 2013 are set out in figure I.2.

GAL considered that these revised December 2013 commitments proposals have sought to address previous concerns expressed by the airlines and the CAA regarding second runway costs, premium services, the security cost pass through and consultation with the PAG.

Figure I.2: GAL's revised December 2013 commitments proposals

Issue	Commitments proposal
Contractual basis	GAL commits to include the commitments in the COU
Duration	7 years, with GAL providing 2 years' notice of its intention with regards the continuation of the commitments
Change mechanism	Ability to change price path profile and service quality regime following consultation and if agreed by GAL and airlines carrying at least 67% of passengers (and paying by reference to published charges) and 51% of airlines responding to the consultation
Price	No price cap but the average revenue yield limited to RPI+1.0% per year based on published charges and RPI+0% per year based on average charges over the duration of the commitments, with a limit on over or under recovery in any one year. Variations to price cap to pass through changes in security costs (either way) and the costs of the second runway and hold baggage screening
Capital Consultation	Publish rolling five yearly capital plan, consult on major projects and report on annual expenditure. Consultation with airlines and the PAG
Service quality regime	Similar rebate scheme as Q5, with introduction of new outbound baggage measure and reweighting of attributes (both agreed with airlines). Monthly rebates the same as Q5 and would be increased by 25% if service quality failures persist for more than six months (although no rebates f there are more than six failures in a financial year). Airline service quality penalties on check-in and arrivals bag performance, which would be funded by netting off airport rebates. There is no bonus for outperformance. Rebates on passenger-facing measures are capped at 2.85% of charges.
Investment	Minimum capex spend of £100m and explain material differences between the latest forecast, the prior year forecast and the forecast included in the CAA's price review
Operational resilience	Develop, maintain and consult on an operational resilience plan and so far as reasonable and practical coordinate and cooperate with all relevant parties to deliver the operational resilience plan

Issue	Commitments proposal
Financial resilience	Provide an annual confirmation of adequate financial resilience, prepare and maintain a CSP, and not to amend, vary or supplement any of its finance documents in respect of credit rating requirements unless it has given prior written notice to the CAA
Accounts	Publish same information as in the 2011/12 statutory accounts

Approach to the assessment

Final proposals

I28 The CAA considered that GAL's commitments could, in principle, be taken into account within the statutory framework as evidence to support a conclusion that it was not appropriate to introduce licence regulation. For this to be the case the regime created by the commitments would need to be suitable and effective for passengers, so that the benefits of licence regulation would be outweighed by the adverse effects.

Stakeholders' views

I29 GAL has raised concerns that the CAA is requiring GAL's commitments to be better than regulation in order not to introduce licence regulation. GAL considered that this was too high a hurdle and was not consistent with Test C which required commitments to provide sufficient protection.

I30 GAL considered that its commitments placed it in a similar position to Stansted Airport Limited (STAL) as the commitments provided protection to 100% of passengers compared to over 90% of passengers that were protected by bilateral agreements at Stansted. In the Consultation on STAL's market power assessment issued in November 2013, the CAA expressed its provisional view that due to the existence of these contracts the MPT may not be met in relation to Stansted. GAL considered that its commitments meant that Test B and C should not be met in relation to Gatwick and so a licence was not required.

I31 The ACC disagreed with GAL's view that the commitments placed it in a similar position to STAL where bilateral agreements had been agreed with airlines as the commitments were not a commercially agreed contract and the airlines did not accept the terms offered.

CAA's final view

I32 Both GAL issues relate to the MPT rather than the form of regulation. The CAA has not changed its view on the approach to the assessment from the final proposals which is set out above and in more details in Appendix J to the MPD.

I33 The CAA notes that at Stansted bilateral agreements have been freely agreed between the airport operator and airlines. The CAA understands that the terms of bilateral contracts have been agreed or are in late stage negotiations with airlines representing 56% of passengers; Norwegian, Emirates, Thomson, ✂ and ✂.[136] The bilateral contracts that have been agreed or are currently in discussion appear to be a function of the commitments and the CAA's final proposals rather than being pursued in their own right.

- Under the commitments framework, if GAL does not agree bilateral contracts then the published yield will be the same as the average yield. Consequently, GAL will have an incentive to agree bilateral contracts as this is more likely to deliver traffic growth and higher overall revenues. Airlines will also have an incentive to agree bilateral contracts as GAL only needs some airlines to agree bilateral contracts, with other airlines paying the higher published tariff.

[136] CAA statistics, 2012, ✂.

- GAL appears to have actively pursued bilateral contracts only since the CAA published its final proposals which supported a commitments framework. The CAA notes that GAL indicated at the start of 2011 that it wanted to agree bilateral contracts in that year. The CAA subsequently structured its process so as to allow time for these negotiations to take place. Over two years elapsed and no bilateral contracts were concluded which contrasted with the rapid progress that Manchester Airports Group has made in reaching agreement with easyJet and Ryanair at Stansted since it acquired STAL in February 2013. GAL stated that progress in agreeing long term contracts was made after the CAA published its final proposals and airlines became substantially more engaged. Airline responses have indicated that it is only since the publication of the CAA's final proposals that GAL has actively pursued bilateral contracts. Regardless of whether GAL or airlines became more involved in bilateral contract discussions after the CAA published its final proposals for licence backed commitments, this indicates that the discussions were strongly linked to the CAA's final proposals.
- The bilateral contracts are conditional on the CAA's acceptance of the commitments. If the CAA's final proposals for a commitments and licensing approach change, or if the price in the commitments changes, then the bilateral agreements do not stand.
- A number of terms in the bilateral contracts are explicitly linked to the commitments, both in terms of price and service offering (for example in relation to airport charges, charges for ancillary services, airport service quality standards etc).

I34 The commitments themselves are GAL's proposals rather than being agreed by the airlines or the CAA. Importantly there is some airline opposition to the commitments as they do not accept that they go far enough. Consequently it is important for the CAA to review the enforceability and the substantive terms of the commitments to identify whether they are likely to displace the benefits of licence regulation with the effect that the potential adverse effects of licence regulation are no longer justified.

Potential benefits of the commitments

Final proposals

I35 The CAA considered that the commitments were more likely than a RAB-based price control to lead to bilateral contracts which facilitate growth and increase choice and value for users. The commitments would also provide additional flexibility which would allow greater tailoring of airport operation services by GAL to the particular needs of individual airlines and their passengers. As the commitments extend over seven rather than five years then this could provide greater certainty to airlines and greater incentives to GAL to outperform assumptions on commercial revenues, efficiency and traffic growth. The commitments could also reduce some of the direct costs of regulation and confer benefits from avoiding management distraction as they would be better linked to commercial negotiations, and remove some of the perverse incentives that may occur under a regulatory RAB regime.

Stakeholders' views

I36 GAL stated that the commitments provide the opportunity to create win-win contractual opportunities to benefit both passengers and airlines, which would facilitate greater tailoring and value generating opportunities rather than based solely on costs, without the need for regulation. GAL stated that the CAA's assessment fundamentally undervalued the benefit of the commitments to generate win-win situations which should be included in the calculation.

I37 The ACC stated that the commitments (based on the September 2013 commitments) did not satisfy the CAA's appraisal criteria.

- The commitments did not properly protect users from GAL's ability to exploit its pricing power as the price is higher than an efficient RAB price and GAL is able to increase prices by passing on second runway costs and premium charges.

- The commitments would not promote competition as GAL has market power and many airlines do not have realistic alternatives (and those that do cannot discipline airport operator behaviour). Pricing flexibility, product differentiation and growth incentives are all possible under a RAB-based approach and, should the airport operator wish flexibility and the benefits of a longer settlement to facilitate bilateral contracts, would also be available under a 7-year RAB-based approach.
- The commitments are not more proportionate than a RAB-based approach given the work necessary to establish the fair price and the continued CAA effort to monitor and enforce the licence and the burden on airlines from having to enforce the commitments which are more complex than RAB-based regulation.
- The commitments suffer from practical implementation issues as even the CAA's preferred approach removes the CAA's ability to adjust the terms of the commitments.
- The commitments have failed to inspire stakeholders, with little or no support for the framework from airlines and with GAL not supporting the CAA's proposed licence framework which the ACC/CAA regard as essential.

I38 The CAA notes that some of these points relate to the price in the commitments, the terms in the commitments and the CAA's final proposals for licence-backed commitments. These points are considered in the relevant sections below.

I39 Virgin stated that it did not consider that the commitments had been thoroughly thought through either by the CAA or GAL, with a number of outstanding details which were yet to be addressed which meant that there were significant risks to passengers that have failed to be mitigated. Virgin therefore considered that the latest proposals fail to meet the CAA's primary duty and are not in the best interests of passengers. Virgin supported the work of the ACC.

I40 BA stated that the CAA's proposal to accept commitments was based on serious errors both in the comparison of price outcomes and the assessment of the benefits of a commitments based approach. BA in particular raised concerns on the assessment of the fair price and the weakness of the CAA's proposed approach which in BA's opinion only gave the CAA the option to accept or reject the commitments, despite the concerns over the terms of the commitments. BA considered that this strengthened GAL's already strong bargaining position over airlines when attempting to secure the available discounts under bilateral contracts. BA also considered that the CAA's belief that bilateral contracts were more likely under commitments than a RAB-based approach was based on the assumption that the RAB-based control must retain the structure of the previous quinennia when there was no particular reason for it to have to do so. BA stated that the new Act provided the CAA with an ability to extend the price control for seven years (consistent with the commitments), eight years (in line with the approach taken by Ofgem) or even a 10-year period so as to match the supposed duration of a bilateral contract.

CAA's final view

I41 GAL has proposed that these commitments might be combined with bilateral contracts for some individual airlines. GAL considers that the conclusion of bilateral contracts will be more likely with the airport operator's commitments in place than under a traditional price cap as the commitment is longer term (seven years compared to a traditional 5-year price cap).

I42 The CAA has considered BA's point that a RAB-based framework could be extended for period of more than five years. The CAA acknowledges that the Act provides the CAA with the potential to either shorten or lengthen the duration of the price control and it raised this issue in earlier consultations. In the Q6 policy update the CAA noted that most regulators tend to adopt a standard 4 or 5-year duration for price controls, although there are variations. In the case of energy network regulation, Ofgem has recently decided to consider durations of up to eight years for a RAB-based control to encourage greater investment certainty where there are significant infrastructure investment requirements. Equally, where the price control is seen as a transitional safeguard pending competition being sufficiently effective to protect consumers, the duration of the price control might be shorter as was the case with retail energy price controls and retail telecommunications price controls. The CAA notes that the Ofgem approach allows a review of key parameters after four years and so may not lead to price certainty over the entire period. The CAA also notes that:

- the investment requirements for GAL are lower than in the previous control period;
- no airlines have actively supported a longer duration RAB approach for GAL, for example in response to the CAA's initial proposals, which used a 5-year RAB-based control; and
- all previous price controls were for a period of five years.

I43 The CAA therefore considers a 5-year RAB-based assessment as the most likely counterfactual.

I44 The CAA considers that bilateral contracts are not ruled out under a RAB-based approach, and the CAA notes that GAL itself has provided discounts for new long-haul routes under the existing RAB approach. However the CAA continues to consider that bilateral contracts are more likely under commitments than under a RAB-based framework, as the commitments would:

- include a specific average price cap relating to the blended price, which is below the average published price cap, thereby providing a financial incentive to both GAL and airlines to enter into bilateral contracts;
- reduce the risk for GAL and the airlines concerned that the terms offered in a typical 10-year bilateral might not be consistent with regulation over more than one control period;
- provide a longer period for an early sacrifice of margin to be compensated later; and
- enable a more flexible capital plan which would support differentiated services under bilateral contracts.

I45 The CAA notes that as set out above, the bilateral contracts that have been agreed or are being discussed appear to be a function of regulation as well as the commitments themselves.

I46 The CAA considers that bilateral contracts are likely to enable price/volume deals which would facilitate growth, increasing choice and value for passengers.

I47 Airlines and passengers at Gatwick are more diverse than at other airports where the operator is subject to economic regulation. It is therefore unlikely that one size would fit all and the commitments may provide benefits over a licence in the form of additional flexibility which would allow better tailoring to the needs of individual airlines and their passengers.

I48 A combination of airport commitments and bilateral contracts could therefore better further the interests of passengers as it could be tailored more to the business needs of individual airlines and their passengers, providing greater flexibility while still providing protection to all passengers. There could also be advantages from a reduction in complexity and a refocus of relationships towards airlines and away from the CAA.

I49 The commitments would also provide **more certainty** to airlines and GAL as the commitments would last for seven rather than five years, providing GAL with **greater incentives to outperform** assumptions on commercial revenues and efficiency and to grow traffic.

I50 The CAA continues to consider that the additional flexibilities under the commitments may help to promote competition in airport operation services, due for example to the increased potential for bilateral contracts, although the CAA acknowledges that GAL has SMP and any competition is likely to be limited in scope.

I51 The CAA considers that the commitments would have benefits over a licence, in that they would avoid the **direct costs** of staff and consultancy associated with a regulatory review. GAL estimates that its costs associated with RAB-based regulation are currently around £8 million per year (excluding CAA costs), although the CAA considers that these costs are overstated.[137] The CAA considers that there could be cost savings from a commitments approach and while it acknowledges that the burden of enforcement of the commitments would rest with airlines rather than the CAA, it considers that this would be more in line with normal commercial practice where bilateral contracts are enforced by the parties. Consequently if the commitments are operating effectively the incremental burden on airlines should be small compared to a normal commercial environment. However potential cost savings from commitments would be significantly reduced if there is not effective partnership working between the airport operator and airlines, and for example there are numerous complaints to the CAA under competition law, the

[137] See Appendix J of the Market Power Determination for GAL.

ACRs or the AGRs. The CAA acknowledges that airline feedback on the commitments has been mixed.

I52 The commitments would also have benefits in terms of: **avoiding management distraction**, as the enforcement of the commitments would be linked to commercial negotiations; and removing **some perverse incentives** that may occur under a regulatory regime, for example potential distortions to capex incentives under a RAB-based framework (which could lead to capex being taken forward that is not in passengers' interests), or the potential for regulatory gaming (although the CAA notes that a bid and counter-bid approach is present in normal commercial negotiations and has been reflected in the improvement of the commitments offer over time).

Enforcement of the commitments

Final proposals

I53 The CAA considered that there were a number of concerns with the enforceability of the commitments. First, the commitments were enforced by airlines whose interests may not always align with passengers. Secondly, there was inadequate protection for users against the risk of repeated service quality failures, where the increase in rebates was unlikely to be sufficient to ensure compliance. Third the absence of a licence limited the CAA's ability to respond to future events in a timely or proactive manner. For example if the flexibilities in the commitments were not being operated in passengers' interests, such as on the pass through of second runway costs, the CAA would not be able to intervene to further those interests.

Stakeholders' views

I54 GAL stated that the CAA did not have grounds to be concerned over the enforceability by users, which GAL considered to be a theoretical rather than practical concern, as airlines' and passengers' interests align and GAL will be competing for passengers and will therefore be incentivised to best suit the interests of airlines.

I55 GAL also stated that the introduction of a licence to protect against the possibility of non-compliance with a policy on second runway costs that was not yet finalised was neither reasonable nor proportionate.

GAL stated that if the CAA had concerns over future GAL behaviour then it could carry out a new market power assessment.

I56 The ACC considered that if the commitments were introduced then a licence would be required. In its response to the CAA's proposed licence conditions in August 2013, the ACC stated that a licence was required to allow the CAA to enforce the commitments, in line with the requirements under the Act, to prevent GAL from modifying or altering the commitments and to prevent further detriment to passengers. In its response of November 2013, the ACC expressed support for the CAA's use of licence conditions to address problems with the commitments if GAL is unwilling to make changes.

I57 On 27 November 2013, the CAA asked whether airlines' views on market power or the need for a licence had changed following recent bilateral negotiations.

- ✂.
- easyJet stated that it had been trying to negotiate with GAL for over 18 months but until October 2013 there had been no meaningful engagement. easyJet considered that GAL negotiating did not indicate a change in GAL’s market power or that GAL did not have SMP. easyJet stated that the aim of licence-backed commitments was to provide room within the regulatory regime for the airline and airport operator to negotiate more commercially and prevent the airport operator charging excessive prices. GAL’s refusal to negotiate a price relative to a final commitments price was an example that GAL was negotiating within a regulatory structure.
- ✂ had concerns with the negotiations that illustrated GAL had SMP.
- Thomson/TUI did not consider that a possible bilateral agreement altered their previous representations made as part of the ACC response to the Consultation.

- Virgin raised concerns that the proposed form of regulation did not offer as much protection as a RAB regime and removed the protection for airlines and passengers, that the commitments did not constitute a ‘fair’ price or support the CAA’s primary duty, that those not signing up to bilateral deals would be punished by paying the maximum price, ✂ Virgin continued to consider GAL held SMP. ✂.

CAA's final view

I58 The CAA continues to have concerns over the enforceability of the commitments in the absence of a licence.

I59 The commitments are with, and **enforced by, airlines**. Passengers are not privy to those contractual arrangements and have no contractual rights as third parties. Without a licence, the CAA would have no right to enforce the commitments on their behalf. It cannot be assumed that airlines will challenge GAL for altruistic motives. While airlines' interests may generally be aligned with those of passengers, this may not always be the case.[138] GAL's position is an over-simplification of the issues which may vary from airline to airline and from issue to issue. It cannot be assumed that airlines will necessary stand in the same position as passengers nor that GAL will address divergent interests over range, price and quality of services in one step.

I60 In addition, an airport operator with SMP will not be subject to the same incentives to satisfy passengers' interests as an airport operator in a competitive situation. The CAA considers that the commitment to consult with the PAG on the capital plan does not offer appropriate protection to passengers as passengers’ interests will be affected by much more than the level of capital investment. Consequently the CAA does not consider that the commitments would offer the same level of protection to passengers compared to a licence enforceable by the CAA, which has a statutory duty to protect their interests.

I61 The commitments do not provide **adequate protection against repeated service quality failures.** The commitments include a requirement to increase service quality rebates by 25% if failures

[138] See, for example, paragraph 3.24 of Q6 policy update, CAA, May 2012. This document can be accessed at: http://www.caa.co.uk/docs/5/Q6PolicyUpdate.pdf

continue for more than six months and to develop an improvement plan. The CAA continues to have concerns in this area, for example as the increased rebates would only apply if failures are spread across two financial years and that rebates reduce to zero if there are six consecutive months' of failure in one financial year. The CAA also notes that the user detriment could be many times the rebate paid. This does not appear to be in passengers' interests unless, as with Q5, there was a backstop of a CAA investigation if failures persist for more than six months.

I62 The commitments do not include **sufficient protection** in certain areas, for example in terms of the pass through of second runway costs and financial resilience, and if problems arose in these areas then significant consumer detriment could occur before issues could be rectified. The CAA does not consider that the fact that a specific policy has not been finalised on second runway costs negates the benefits of a licence and makes it disproportionate. Licence-backed commitments provide GAL with a number of flexibilities which can be used to create an appropriate and targeted approach to particular policies. While these flexibilities contribute towards the benefits of commitments they also create risks for passengers, providing a further reason for the backstop of licence regulation if these risks transpire.

I63 The commitments have been put forward by GAL following discussions with the CAA and airlines. If airlines do not agree with the terms in the commitments, then there is no mechanism (similar to that for licence conditions) for them to appeal the conditions in the commitments to the CMA, **removing important protections in the Act**. This could work against passengers' interests and be detrimental to passengers as it would make the process both more expensive and lengthy.

I64 In the absence of a licence there are concerns over the **speed of regulatory intervention** which can only take place once abuse against passengers' interests has occurred. The commitments provide GAL with considerable flexibility, for example in terms of the capital plan. If GAL uses this flexibility to abuse its market power then, in the absence of a licence, the CAA may need to undertake a full market power assessment to introduce potential controls in the form of a new licence (without a licence, the CAA would have no ability to amend the commitments directly). The whole process of introducing a licence is likely to take two years including appeals. A long period to reintroduce controls could allow abuse to go unchecked for some time with potentially significant user detriment.

I65 In contrast, by incorporating the terms of the commitments within the statutory licensing framework, the CAA would have a range of **regulatory and enforcement measures**, for example by either enforcing the commitments as a condition of the licence itself or modifying and/or introducing new licence conditions as required (subject to the safeguard of appeals). In appropriate cases, the CAA would be entitled to proceed with interim remedies or to impose penalties for breach. A licence is therefore likely to lead to a quicker, more efficient resolution of issues. Importantly, a breach of the licence backed commitments could lead to a directly actionable right of damages for any person affected by the breach (including passengers and cargo owners as well as airlines).[139] Accordingly, there are real benefits from the licence framework in terms of enforcement and deterrence that are not provided by the contractual commitments on their own.

I66 Based on the above the CAA does not consider that, in the absence of a licence, the commitments on their own offer sufficient protection in terms of enforceability to be able to operate in passengers' interests.

The comparison of the fair price with the commitments price

Final proposals

I67 GAL's commitments provided limits on the maximum average revenue yield over seven years based on published prices at RPI+1.5% per year and average prices (taking into account published prices and bilateral contracts) at RPI+0.5% per year. The latter price is also known as the ‘blended price’.

I68 The CAA reviewed the price in the commitments against the CAA's assessment of the fair price in the final proposals. The CAA considered that the most appropriate comparison was between the blended price in the commitments, as this would be the average price paid by airlines, and a 5-year fair price (based on a RAB), as this was

[139] Civil proceedings can be brought following a breach of a CAA enforcement order or urgent enforcement order.

the most likely regulatory alternative. On this basis the commitments would reduce average charges (relative to the fair price) by 3% over the next 5-year period. The commitments would also lock in the benefits of lower charges in the first two years of the next control period, which have a risk of being eroded over time as new cost pressures emerge (which would need to be taken into account if the CAA was undertaking a subsequent RAB-based calculation for these years). The commitments blended price was also comparable to the 7-year fair price (RPI+0.5% per year compared to RPI+0.3% per year).

Stakeholders' views

I69 GAL stated that while the blended price reflected the cost to airlines it did not encompass the value generating benefits of the commitments framework, which effectively released benefits to airlines beyond the blended price.

I70 The ACC stated that the commitments did not properly protect users from GAL's ability to exploit its pricing power as the price is higher than an efficient RAB price. The ACC also stated that there were a number of issues with the CAA's comparison between the fair price and the commitment price.

- time period: the CAA should be comparing consistent time periods and not a 5-year RAB versus 7-year commitments;
- capex: the commitments only included a commitment to £100 million capex per year compared to £160 million capex per year included in the RAB-based fair price;
- use of blended price: it is not appropriate to compare the blended price in the commitments as this includes bilateral contracts where the lower prices are only available if airlines agree to conditions that are different to those assumed in the RAB-based approach;
- the commitments price is different as GAL is able to pass on runway 2 costs, premium service charges and security cost increases but not decreases, which would not be the case under the commitments; and
- the commitments price is on a different basis, for example it includes a slightly broader basket of prices (i.e. including selected ancillary service charges).

I71 The ACC stated that if these issues were taken into account then the commitments price was higher than a RAB-based price.

I72 The ACC (and BA) considered that the issues pointing towards accepting a commitments price above the fair price were weak and insufficient to overcome a significant price difference under the two approaches as:

- there is less price certainty under the commitments as GAL is able to demand various additional payments and either side could benefit from a price control of 7 years;
- forecast reductions in prices in the subsequent control period were speculative and, in any case, no price reductions were proposed and instead prices would increase above inflation for longer, which could benefit the airport operator rather than airlines;
- it is not obvious that the benefits of the commitments in terms of flexibility and greater tailoring to individual airline needs actually exist and there should be no assumption that the RAB-based structure should retain the structure of previous quinquennia.

CAA's final view

Time period for the assessment

I73 The fair price is based on a single till RAB approach. For the reasons set out in paragraph I42 to I43 the CAA considers a five yearly RAB is the most likely counterfactual.

I74 Second, the CAA's calculations for a 5-year fair price are based on a detailed bottom up assessment of individual building blocks. The 7-year fair price was developed for comparison with the commitments and took into account changes forecast by GAL in the two years following a traditional 5-year control (2019/20 and 2020/21). There are also some issues that might point to a higher 7-year price that have not been included in the calculations, for example the impact of the greater traffic risk over seven years on the cost of capital. The 7-year price can therefore be regarded as less certain. The CAA therefore considers that it is relevant to take into account both comparisons, but to place the greatest weight on the 5-year price as this is the effective RAB alternative.

Comparison of the fair price with the blended price in the commitments

I75 The CAA considers that the most appropriate comparison between the CAA's fair price and GAL's commitments should be between the fair price and the blended price under the commitments as:

- the fair price is calculated on the basis that this would be the average charge paid by airlines and their passengers;
- the blended price is the average price under the commitments, which would be paid by airlines and ultimately their passengers.

I76 The blended price under the commitments also takes into account the prices under bilateral contracts. Lower prices under bilateral contracts often result from volume/growth discounts. The CAA does not consider it appropriate to value the price paid to passengers that benefit from growth deals as being any lower than that paid by other passengers. The CAA also notes that if bilateral contracts are not agreed with airlines then the blended price would apply to all passengers.

I77 The CAA acknowledges that bilateral contracts may have different terms than the commitments. While the CAA acknowledges that these terms could benefit passengers, for example through the provision of a more tailored service offering, or place constraints on airlines, the CAA does not consider it is possible to quantify these benefits beyond those reflected in the blended price and has considered these benefits in the round.

Potential impact of the bilateral contracts agreed/being discussed

I78 GAL has provided details of the bilateral contracts that it has agreed or is in the process of discussing with airlines. Based on the agreed and discussed bilaterals, GAL is forecasting that it will obtain an average blended price between ✂ per year over the commitments period. ✂. The bilateral contracts provide GAL with significant flexibility to vary the level of discounts by altering the structure of charges as in general the discounts to airport charges are on winter charges only. The CAA also notes that GAL does not need to agree all of the bilateral contracts currently being discussed, and the commitments only require GAL to obtain a blended price of RPI+0% per year. The CAA has therefore not taken account of any incremental reductions in price from bilateral contracts being discussed.

Capital expenditure assumptions under the commitments and licensing approach

I79 The CAA acknowledges BA's concern that the commitments include a minimum capex spend of £100 million per year, compared to around £160 million per year in the fair price calculation. While the commitments capex is a minimum and GAL could spend more, without a licence there is no guarantee that this would take place. Under a licence the CAA will monitor GAL's capex and if GAL is not undertaking capex which would be in passengers' interests then it could introduce enforcement action or introduce new licence obligations. A capex difference of around £60 million per year would reduce the fair price by 2% per year over five years.

The impact of differential terms in the commitments

I80 The CAA acknowledges that the commitments include different terms, for example on the treatment of second runway costs, than those that would apply under a licensing approach, which could impact on the overall price paid by airlines and their passengers. The impact of these terms is considered in the following section which considers the terms in the commitments.

The basis of the commitments price

I81 The CAA accepts that the commitments price is calculated on a different basis to the RAB-based fair price as it includes selected ancillary services (staff ID, airside licences, FEGP, airside parking and hydrant refuelling). These ancillary services increase the base net yield in the commitments by 1% (core service charges are £8.80 per passenger and selected ancillary service charges are £0.094 per passenger). In the absence of the commitments, airlines would still be required to pay for selected ancillary services, although this would be outside the fair price cap. On this basis the CAA does not consider that the inclusion of selected ancillary services in the commitments average yield cap materially affects the comparison with the RAB-based fair price.

Comparing the 7-year commitments price with the 5-year fair price

I82 The CAA has compared the 7-year blended price in the commitments with the 5-year fair price. The CAA considers that there are some issues that point towards accepting a commitments price that is below the fair price:

- the greater flexibility to GAL in pricing where it can recoup any previous shortfalls over the 7-year period, although the resulting increase in uncertainty to airlines is likely to be relatively small compared to the flexibility GAL has to set its structure of charges within the current price cap; and
- the greater flexibility to GAL from being able to flex its capital plan rather than having to deliver projects to meet specific trigger dates.

I83 There are also some issues that point towards accepting a commitments price that is above the fair price.

- The longer time period (seven years as opposed to a 5-year control period) provides a greater period of certainty to airlines and consequently greater risks to GAL. While GAL will benefit from the greater incentive to outperform from a 7-year control period, it will also bear increased risks from the longer time period, in particular around traffic growth. The CAA has not taken account of the greater risks to GAL in for example the cost of capital from its 7-year fair price calculation. The potential for GAL to demand additional payments is considered in the section on other price benefits of a licence.
- The commitments would lock in the forecast reductions in prices in the subsequent control period. In GAL's RBP its RAB-based price for Q6, the next 5-year control period was RPI+6.9% per year with falling real prices for the following control period. By extending the Q6 control period for seven years this locks in the assumed lower increase in prices for the following control period, which often have a tendency of not transpiring, with new cost pressures emerging so the actual price ends up higher, for example due to the emergence of new risks and/or obligations.

- The other benefits from the commitments from the greater likelihood of bilateral contracts and the benefits this would bring to passengers in terms of flexibility and greater tailoring to individual airline needs which are not reflected in the fair price calculation and could not be obtained through traditional RAB-based regulation, even with the greater flexibilities under the Act.

I84 Based on the above assessment the CAA considers that the most appropriate basis for comparison is the 7-year blended commitments price with the 5-year fair price, with consideration given to the comparison between the blended price and the 7-year fair price.

I85 Both airlines and GAL have made comments on the appropriate level of the individual RAB-building block in the CAA's fair price calculations. These comments are considered in Appendices B to H which set out the fair price calculations. Based on this analysis the CAA considers that the 5-year fair price, which the CAA considers to be the most appropriate comparator, is RPI-1.6% per year and the 7-year fair price is RPI-2.0% per year. This compares to a commitments average price of RPI+0% per year and RPI+1% per year based on published charges. The difference between the commitments average price and the 5-year fair price benchmark is around £21 million per year, or 7% of average airport charges over seven years.[140]

Other terms in the commitments

Final proposals

I86 The CAA highlighted a number of concerns with the terms in the commitments:

- the commitments would only have regard to rather than follow CAA guidance on the treatment of second runway costs;

[140] This assumes that charges reduce by RPI-1.6% per year under the fair price benchmark. The revenue impact does not take account of any impact on passenger numbers of the change in airport charges.

- the service quality regime may operate against passengers' interests due to the limits placed on total rebates payable, the absence of rebates if failures continue for more than six months and the offsetting impact of airline service quality failures on GAL's liabilities;
- the commitments did not include a commitment to outputs from the capital plan, the security cost pass through only passed through increases and not decreases from changes in security requirements;
- the financial resilience conditions did not provide adequate protection to passengers;
- the commitments did not include a requirement for the calculation of the RAB;
- the operational resilience conditions in the commitments would only have regard to CAA guidance and required airlines to comply with GAL's code of conduct; and
- the commitments allowed GAL to introduce additional, unspecified premium charges.

Stakeholders' views

I87 The ACC stated that the commitments may not result in efficient and effective investment because without a RAB and triggers there would be little incentive for GAL to invest where there was no incremental benefit to the airport operator. The ACC also set out a number of specific concerns with the commitments. This was based on the September 2013 commitments version. These concerns were:

- various typographical and other errors which appear to be mistakes (including an obvious major error in the formula for service rebates);
- unbalanced waiver and indemnity clauses;
- unreasonable restrictions in the dispute resolution mechanism with a short limitation period and a ban on launching court proceedings before exhausting the process;
- the ability for GAL to impose premium charges on top of the price commitment, outside contracts and without agreement or approval;

- serious inadequacies with the definitions of key price/revenue terms, which have the effect of creating ambiguity about key provisions and allowing GAL to determine and change at will what services are or are not covered by the price commitments;
- a problem with the security cost pass through formula, which already fails to allow for security cost reductions and would also allow major price increases even when costs over the period fell below the level assumed by the CAA in its “fair price” calculation;
- a failure to protect selected ancillary charges from the 10% annual price increase cap;
- GAL’s right to recover unlimited costs of developing a second runway regardless of whether or not the expenditure is necessary, efficient or appropriately timed; and
- a provision automatically excluding airlines from service rebates if they have a bilateral contract that varies any of the commitment terms – unless expressly included in the bilateral agreement.

I88 The ACC expressed support for the CAA's attempts to resolve the concerns on second runway costs and premium services by proposing licence conditions in these areas. BA, easyJet and Virgin supported the ACC's position.

I89 Virgin cited additional concerns on:

- the change mechanism which it viewed as unworkable;
- the airlines would remain the insurer of last resort with GAL having no contractual liability for the direct costs incurred by airlines through GAL's underperformance or negligent actions;
- the efficiency of the pass through of the costs of changes in security requirements of HBS; and
- the reduced ability of airlines to challenge GAL's actions on capital investment plans or behaviours.

I90 easyJet emphasised concerns on the commitments treatment of second runway costs (in particular requesting that the pass through of second runway costs is appealable to the CC), premium service charges and security costs. BA highlighted specific concerns with the absence of capex commitments, beyond the commitment to

£100 million of expenditure per year. In particular BA was concerned that under the commitments GAL would not take forward Pier 6 South and would skew any investment towards projects that delivered commercial revenues (which would be uncapped). BA considered this could be used to compel airlines to pay more so that specific investments are undertaken.

I91 The ACC, BA, Virgin and easyJet helpfully set out their main concerns on the terms in the commitments in interim submissions which were passed on to GAL for consideration in the development of its final proposals (the November 2013 commitments).

I92 GAL stated in its final proposals that it had included a number of amendments in the November 2013 commitments to address airline concerns over:

- second runway costs, where it would follow rather than have regard to CAA guidance;
- premium charges, where it had provided a definition of charges covered by the core service charge; and
- security costs, whereby it allowed the pass through decreases as well as increases in costs of changes in security requirements.

I93 In its response of 25 November 2013, the ACC set out its remaining concerns with GAL's November 2013 commitments. The ACC continued to consider that the commitments price was too high, the fair price calculation was too high and the CAA had wrongly concluded that the commitments price was comparable to the fair price. While the ACC acknowledged progress on the terms of the commitments it had the following outstanding concerns:

- the lack of mutual waiver/indemnity;
- the lack of simultaneous alternative recourse to the courts in addition to the proposed dispute resolution mechanism;
- the lack of detail on the consultation on operational resilience, with a need for at least two consultations a year on operational resilience;
- GAL should not require airlines to undertake actions allocated by GAL to them during disruption;

- unclear definition of core service and premium charges;
- definitions are required of RPI, Masterplan and Tollgates
- pass through of security compares to previous year rather than base year;
- amendment of the price path needs to be based on consensus as far as possible;[141]
- given their potential scale second runway costs should be subject to a full re-opener requiring a licence change;
- all airlines should have access to the SQR scheme, whether they have agreed a bilateral agreement or not;
- airline standards are anti-competitive and should be removed;
- pier service should be 95% with reductions by agreement for major works;
- the service quality measurement manual should include the new metric on aerodrome congestion and a daily outbound baggage measure and should be agreed with the airlines and included with the commitments;
- there should be a stronger commitment from GAL to consult on capex

I94 In its further response BA stated that the November 2013 commitments had not addressed its concern over the lack of capex commitments.

I95 On 5 December 2013 GAL provided its final commitment proposals. This reduced the price to RPI+1% per year (published charges) and RPI+0% per year (blended rate based on bilaterals and published charges). GAL also revised a number of terms in the commitments in response to airlines' concerns:

- it removed the GAL indemnity from the commitments;

141 In its response to GAL's August 2013 commitments Virgin stated that agreement should be reached with 90% of airlines responding to the consultation and representing 90% of passengers.

- it allowed simultaneous alternative recourse to the courts in addition to the proposed dispute resolution mechanism and made the adjudication process non mandatory;
- it provided two consultations a year on operational resilience and stated it would consult in a fair and timely manner with relevant information;
- airlines were to use best endeavours during periods of disruption and were not required to undertake actions allocated by GAL to them during disruption;
- it improved the definition of core service charges;
- it provided definitions of RPI, Masterplan and Tollgates; and
- it provided airlines with access to the SQR scheme under bilateral agreements.

I96 GAL did not seek to address further airline concerns on second runway costs, capex and consultation, or the level of airline agreement required to change prices and airline service quality standards. GAL also made progress with agreeing the service quality measurement manual with airlines, although no agreement had been reached on pier service levels.

CAA's final view

I97 The CAA is pleased that in revising the terms of the commitments GAL has attempted to deal with the most significant concerns cited by airlines, in particular around **second runway costs** and **premium service charges**. The CAA is also pleased that GAL has made the **security cost pass through** symmetric.

I98 The CAA does however have a number of concerns with the commitments in the absence of a licence.

I99 While the commitments state that they will follow CAA guidance on **second runway costs,** they do not provide GAL, the airlines nor their passengers a right of appeal regarding the treatment of second runway costs or the scale and the efficiency of the costs that are incurred. Given the potential scale of costs, which GAL has estimated at £5 billion to £9 billion, there is no mechanism for users to secure adequate protection in terms of value for money from the cost of this development.

I100 The commitments do not include a commitment to any outputs from the **capital plan** apart from maintenance of the service quality regime and a commitment to a minimum spend of £100 million per year over the term of the commitments. GAL's proposed spend under a RAB-based framework is around £200 million per year and many of the schemes produce outputs that are not reflected in the service quality regime, for example the early bag store will provide the ability for early check-in; the IDL schemes will provide increased circulation space and new children's and outside areas; the check-in schemes will provide new bag drop facilities; the NT arrival scheme provides a much enhanced arrival area etc. While GAL has committed to provide an explanation as to any material differences between the latest CIP forecast and both the prior year forecast and the forecast incorporated in the CAA's 2013 price control review, it has not committed to any programme of specific capex. The CAA is therefore concerned that GAL could significantly reduce capex and not deliver the outputs that the CAA considers are in passengers' interests.

I101 The **service quality regime** in the commitments includes monthly rebates at the same level as those included in the Q5 settlement. The CAA is concerned that if failures continue for more than six months in a financial year, the absence of rebates might reduce GAL's liability for repeated service quality failures, which may act against passengers' interests.

I102 The status of **pier service standards** in the commitments is unclear. The CAA understands that GAL and the airlines have not been able to agree pier service standards and this raises the risk that GAL imposes pier service levels that are opposed by the airlines and inconsistent with the funding provided.

I103 GAL states the service quality measurement and exclusions process remains the same as in Q5 and the subsequent joint letter from GAL/ACC on 7 August 2013, unless GAL and the ACC subsequently agree to changes. This addresses earlier CAA concerns in this area although there appears to be a lack of precision in the latest version that could lead to disputes.

I104 The service quality regime includes **airline service quality penalties** on check-in queues and arrivals bag performance. The CAA supports coordination on service standards across the airport campus where this does not distort the functioning of an effective market.

I105 The CAA continues to have concerns about the **financial resilience** conditions in the commitments.

- The commitments include a requirement to notify the CAA of any variations in the banking ring fence that relate to the credit rating requirement. However if the protection in the banking ring fence changes, in the absence of a licence, there would be nothing the CAA could do to replace that protection. This commitment therefore would only be effective if the commitments were underpinned by a licence.
- The commitments include a requirement for the directors to provide an annual certificate of adequate financial resources. There is no indication in the heads of terms or the COU of the time period to be covered, although GAL's response states that this could be 12 months or possibly as much as 18 months. The CAA considers that the certificate should cover a period of at least two years otherwise there would a risk that there would be insufficient time for remedial action to be taken if issues arose.
- The commitments do not include a requirement to obtain a holding company undertaking. GAL questioned the benefit of a holding company undertaking given the ownership structure of GAL. The CAA considers that a holding company undertaking is required to prevent the airport operator from being open to pressure by a holding company to do something which is not consistent with passengers' interests. The CAA does not consider that GAL's current ownership, which could change during Q6, negates the need for this requirement.

I106 The commitments do not include a restriction on business activities as GAL stated that the finance documents include a similar restriction. The CAA is concerned that the finance documents could change, and in the absence of licence protection, remove the protections to passengers.

I107 The commitments include a requirement to publish the value of the **asset base** and the underlying assumptions and calculations. GAL has stated that, although it does not consider it necessary for GAL to prepare a shadow RAB, GAL will maintain such a calculation for the benefit of the CAA as part of its ongoing monitoring regime, up to the review scheduled for late 2016. This provision does not appear in the

COU. The CAA continues to consider that a shadow RAB calculation is required throughout the period should any subsequent re-regulation be required.

I108 The commitments include **operational resilience** conditions. However these include a requirement to have regard to, rather than comply with, any guidance issued by the CAA when developing operational resilience plans. The CAA considers that this could allow GAL to develop operational resilience plans that are not in passengers' interests.

I109 The CAA does not consider the commitments raise issues in other areas identified by the airlines.

- **Definitions of key price/revenue terms**. The CAA considers that the change in the definition of core service charges addresses the principal concerns of the airlines around premium services.
- A failure to protect **selected ancillary charges** from the annual price increase cap. Under the commitments selected ancillary service charges would be subject to fair reasonable and non-discriminatory provisions and so would not necessarily increase in line with the average price cap in the commitments.
- The airlines have stated that changes in security requirements should only be passed through if **security costs** are higher than the 2013/14 base year. The CAA does not consider that this is correct. GAL's security costs will vary year by year, in particular as a result of changes in the level of efficiency. These costs will also vary up or down with changes in security requirements. The security cost pass through allows security requirement cost increases and decreases to be passed subject to a deadband. The CAA considers that this is the correct approach and is consistent with the approach used for HAL's price control. If only cost increases above the base year were passed through then GAL would be exposed to the risk that it would lose some of the efficiency gains that it had made since the base as these would be used to offset the increased cost of security requirements.

- **Service quality requirements under bilateral contracts**. The commitments provide backstop protection to all airlines on price and service quality. It is up to airlines if they want to agree a service quality regime within a bilateral contract and it is not for the CAA to dictate whether they should do so.
- The CAA considers that the **threshold for airline support** at 67% for making changes to the price and service quality regimes is sufficient to prevent a single airline or one or two airlines being able to push through changes to the regime that would not be in the interests of passengers in general. The CAA considers that the modification provision should therefore not act against passengers' interests.
- The airlines remain the **insurer of last resort**. GAL has removed the indemnity from the December 2013 commitments. The CAA notes that the waiver and operator liability arrangements remain, although these are part of the COU rather than the commitments themselves.

Overall assessment of the commitments

Final proposals

I110 The final proposals welcomed GAL's commitment proposals but the CAA considered that, in the absence of a licence, the enforcement and substantive terms in the commitments would not provide sufficient protection to be in passengers' interests.

CAA's final view

I111 The CAA has also considered airline concerns on the assessment of the commitments.

I112 As set out previously, while the CAA considers that GAL has addressed airlines' concerns on the treatment of premium service charges in the revised December 2013 commitments, the CAA has concerns about whether the price in those commitments or the treatment of second runway costs would operate in the interests of passengers. The CAA considers that in the absence of a licence, there is no guarantee that investments that do not directly impact on outputs covered in the SQR or that generate net financial revenues would be taken forwards. As explained above, the CAA also acknowledges the ACC's concerns over whether commitments in themselves would lead to efficient and effective investment given the lack of output commitments provided by GAL.

I113 The CAA acknowledges that the commitments initially failed to inspire stakeholders with confidence although it notes that GAL has made a number of improvements to the commitments to address earlier concerns voiced by the airlines and the CAA. The CAA also notes that a number of airlines have been having bilateral discussions with GAL under the framework of commitments (albeit on the assumption it is backed by a licence). However, if there was a concern with the commitments from passengers' perspectives, the CAA would not be able to alter the terms of the commitments as these are GAL's commitments to airlines.

I114 The CAA considers that commitments could, if they provided adequate protection, be capable of being more proportionate than RAB-based regulation. The better regulation principles require regulation to be targeted only at cases where action is required. The CAA also sees benefits as this would strengthen the airline and airport operator relationship and would better reflect a normal commercial environment where airlines would protect their own interests. However the CAA has concerns over the enforceability of the commitments in the absence of a mechanism allowing the CAA to enforce the commitments in passengers' interests.

I115 Overall the CAA welcomes GAL's commitment proposals. However, despite a number of improvements made by GAL, the CAA continues to consider that in the absence of a licence the enforcement and the terms of the commitments would not provide sufficient protection to be in passengers' interests. Consequently the CAA considers that the benefits of licence regulation are likely to outweigh the adverse effects. The full details of this assessment are set out in Test C of the MPT in relation to GAL.

Figure I.3: Appraisal of GAL's proposed commitments

Criteria	Assessment
Price protection	The price in the commitments is above what the CAA considers to be a fair price, and while bilateral contracts might deliver a lower price there is no guarantee that this will be the case.
Service quality protection	The commitments include much the same of the SQR scheme as used

Criteria	Assessment
	for Q5. In the absence of a licence the commitments do not provide adequate protection against repeated service quality failure.
Promote competition	The commitments could avoid distortions to competition, for example if a price cap is set too low then this could distort charges and investment at other airports and bilateral contracts could be more likely under commitments, although they are not ruled out under licence regulation. However as GAL has SMP any competition in airport operation services is likely to be limited in scope.
Allows efficient business to finance its activities	GAL is unlikely to propose commitments that would not allow it to finance its activities.
Efficient and effective investment	Investment would be driven by the service quality scheme and GAL's vision for the airport. Commitments would avoid some of the perverse incentives from RAB-based regulation particularly around investment incentives. Consultation arrangements are similar to those in Q5. However there is no guarantee that investments that do not directly impact on outputs covered in the SQR scheme would be taken forwards.
Operational efficiency	Potential benefits to efficiency incentives from the retention of benefits for longer (at least seven years compared to a typical 5-year RAB-based control).
Allows environmental measures	The commitments do not prevent the introduction of environmental measures.
Transparent, accountable, proportionate, consistent and targeted	The commitments would only be enforceable by airlines and so may not offer the adequate protection to passengers. There is no direct enforcement or intervention mechanism by the CAA. Commitments could provide substantial cost savings compared to licence regulation, although cost savings would be significantly reduced if there is not effective partnership working between the airport operator and airlines. Given the concerns over enforceability, the process for reintroducing a licence could take two years, allowing significant user detriment to occur during this time. The process of reintroducing price controls would be hampered as GAL has not committed to calculating a RAB throughout the commitments period.
Practical implementation and stakeholder confidence	The concerns over the enforceability of the commitments could make practical implementation difficult. Airline feedback on the commitments has been mixed and while some stakeholders have expressed support for commitments, most have raised concerns over the terms of the

Criteria	Assessment
	commitments. Nevertheless a number of airlines have been discussing and/or agreed bilateral contracts with GAL, and GAL appear to have addressed some of the more significant stakeholder concerns with the commitments.

Source: CAA analysis

Commitments backed by a licence framework

Final proposals

I116 The CAA considered that commitments backed by a licence and monitoring regime could provide clear benefits in terms of enforceability and speed of response. The licence would include conditions making the commitments conditions of the licence and allowing the CAA to enforce the commitments in passengers' interests. The licence would also allow the CAA to monitor the flexibilities in the commitments, for example around the capex plan and introduce additional licence conditions if required. It would also allow the CAA to introduce licence conditions directly where monitoring may not be effective, for example around financial resilience. On this basis the CAA considered that licence-backed commitments could form an appropriate form of regulation for GAL, and could avoid some of the perversities that can occur from alternative forms of regulation.

Stakeholders' views

I117 GAL stated that it did not consider a licence was required, as it would introduce the commitments irrespective of whether they were included in a licence. GAL stated that it had addressed the principal concerns with the commitments and so additional licence conditions were not required. GAL also considered that the commitments provided protection to all passengers, whereas at Stansted the CAA was considering not requiring a licence as airlines covering over 90% of the passengers at the airport had entered into bilateral contracts.

I118 The ACC stated that it did not support the CAA's final proposals for commitments backed by a licence and monitoring regime, as the price was too high and the commitments were one-sided as they were proposed by the airport operator without any CAA locus to amend them; and flawed, in particular (but not limited to) the protection of passengers against the costs of a second runway and premium service charges. The ACC stated that its concerns whether the commitments satisfy the CAA criteria are also pertinent to licence-backed commitments. These concerns (based on the September 2013 commitments) were that:

- the commitments do not properly protect users from GAL's ability to exploit its pricing power as the price in the commitments is too high;
- the commitments would not promote airport competition as GAL has market power and pricing flexibility, product differentiation and growth incentives are all possible under a RAB-based approach;
- the commitments may not result in efficient and effective investment as without a RAB and triggers there would be little incentive for GAL to invest where there was no incremental benefit to the airport operator;
- the commitments are not more proportionate than RAB-based regulation as the work required to establish the fair price is the same and there is an increased need for monitoring and an additional burden on airlines to enforce the commitments;
- the commitments suffer from practical implementation issues as even the CAA's preferred approach removes the CAA's ability to adjust the terms of the commitments; and
- the commitments have failed to inspire stakeholders with confidence, with little or no support from the airlines, and with GAL not supporting the CAA's proposed licence framework which the ACC/CAA regard as essential.

I119 While the ACC supported the CAA's intention to reduce regulatory costs, target regulation and promote competition it concluded that the proposed approach based on GAL's September 2013 commitments would not achieve this.

I120 BA stated that the CAA should not adopt GAL's commitments rather than a RAB-based calculation due to errors in the comparison of the price outcomes and an overestimation of the benefits of commitments. BA further stated that the calculation of a "fair price" is the appropriate mechanism to develop a licence-based price control using a RAB framework, whether as a modified version of GAL's commitments, or as a HAL-style price control mechanism. BA supported the ACC's position.

I121 Virgin supported the ACC position and stated that while it was open to alternative forms of regulation the commitments provided GAL with much the same protection as under a RAB approach whilst removing most of the protections for airlines and passengers. Virgin therefore considered the CAA's proposals for licence-backed commitments failed to meet the CAA’s primary duty and were not in the best interests of passengers.

I122 easyJet did not support the CAA's final proposals due to concerns with the ability of GAL to pass on second runway costs, without a right of appeal, the scope of GAL to move charges/revenues outside the scope of the regulated charge, and the flaw in the treatment of the security cost pass through. easyJet stated that these flaws should either be addressed through changes in licence conditions or through additional licence conditions.

I123 Monarch broadly supported the CAA's final proposals but cited a significant concern that smaller UK based airlines should not be disadvantaged by larger airlines using their dominant position to leverage a better bilateral agreement. Monarch also cited support for the CAA's proposals to back commitments with a licensing and monitoring framework.

I124 London First welcomed the CAA's response to changing market conditions but remained of the view that the CAA had not met the burden of proof required to grant a licence to GAL. London First considered that if the CAA granted a licence then it should explicitly set a glide path for deregulation and guard against additions and modifications to the licence which risk accumulating over time.

CAA's final view

I125 The CAA has considered the points raised by GAL and other stakeholders. Given the concerns it has highlighted with the commitments, the CAA continues to consider that there are good grounds for commitments to be backed up by a licence. The CAA considers that such a framework could provide clear benefits in terms of enforceability and speed of response. It could also allow the concerns highlighted with the terms in the commitments set out in paragraphs I98 to I108 to be addressed through a licensing and monitoring regime.

I126 Under such a framework the CAA considers that as a minimum a licence should include:

- a condition that makes the commitments a licence condition. This would enable the CAA to enforce the commitments within the statutory framework, including interim remedies, penalties for breach and an actionable right of damages for any person affected by the breach;
- a condition that GAL shall comply with the commitments in a manner designed to further the interests of passengers. This would allow the CAA to enforce the commitments in passengers' interests; and
- a condition that prevents GAL from unilaterally varying the commitments and prevents modification outside the instances set out in the commitments as it is a requirement under the Act that the type and circumstances of licence condition self modification provisions are set out in the licence.

I127 Given the ACC's concern about the CAA's ability to amend the commitments, the CAA has also included a requirement in the licence that requires GAL to amend the commitments so that they are consistent with the provisions in the licence.

I128 The CAA considers that with the above licence conditions, if the commitments-based approach was not working the CAA could, if the statutory tests were met, undertake urgent enforcement action to prevent passenger detriment while a full price control condition was introduced.

I129 While the above conditions would address a number of concerns associated with the enforceability of the commitments, they would not address concerns associated with the terms on offer in the commitments themselves. Under a licence there is potential for the CAA to monitor GAL's performance, investigate any underperformance, enforce the commitments and introduce additional licence requirements if required. This could be used to address the CAA's (and the ACC's) concerns over the flexibility in the capex plan, service quality performance and the areas where GAL would only have regard to rather than follow CAA policy, for example on operational resilience. The CAA could also ask GAL to continue to calculate a RAB beyond the period specified in the commitments.

I130 Given the scale of difference between the fair price and the commitments blended price of 1.6% per year and the scope for GAL to amend bilateral contracts that are yet to be agreed and for altering the level of discount through variations in the structure of charges, the CAA considers that its concerns over the price in the commitments would be best addressed through monitoring the price in the commitments to ensure that it reflects the CAA's view of the fair price. This would avoid cutting across existing bilateral contracts and would provide GAL with an added incentive to meet the needs of passengers and airlines so it can increase passenger growth, so allowing airlines to take advantage of discounts, reducing the delivered average price. If GAL does not reduce prices in line with the fair price then the CAA considers that it could introduce licence conditions to cap price changes or prevent GAL from altering the structure of charges.

I131 There are two areas where the CAA considers additional licence conditions are required given the scale of passenger detriment that could occur. Firstly on second runway costs, the CAA considers that the pass through of expenditure over a set minimum, even if it follows CAA guidance, should be subject to a licence amendment. This would allow the CAA to properly consider the appropriate costs to pass on to users and provide both GAL and airlines a right of appeal if they consider that the CAA has not treated the costs appropriately. The other area where the CAA considers additional licence protection is required is financial resilience, given the implications for passengers if problems arise in this area.

I132 The CAA would not see a licence associated with commitments covering airline service quality performance, as the licence is for GAL rather than airlines, nor GAL's pricing principles as this could fetter the CAA's discretion as the CAA is the appeal body under the ACRs and AGRs.

I133 The CAA considers that licence-backed commitments would make use of the flexible and pragmatic forms of regulation intended by the Act. The CAA considers that such an approach would be more proportionate than RAB-based regulation as the airline enforcement would be more closely aligned with normal commercial negotiations and management distraction and perverse incentives would be reduced. The CAA considers that the main incremental cost of the monitoring regime would be to the CAA as much of the information required for monitoring would already be produced by GAL under the commitments. The main additional information required would be the shadow RAB calculation. Given that GAL has already committed to identifying changes to the asset base (and in its response committed to producing a shadow RAB calculation up to 2016) the CAA does not consider that this would impose significant additional costs. Over time, if the regime is successful the CAA considers that its costs could reduce as the required level of monitoring will reduce.

I134 Based on the above analysis the CAA continues to consider that a framework of commitments backed by a licence could provide a suitable form of regulation for GAL. Figure I.4 summarises the appraisal of a commitments and licensing framework for GAL.

Figure I.4: Appraisal of commitments and licensing framework for GAL

Criteria	Assessment
Price protection	By monitoring prices, with the potential to introduce additional licence conditions if GAL is not pricing in line with the fair price the CAA considers that this would provide adequate protection to passengers. The additional licence condition on the treatment of second runway costs would ensure that the pass through of these costs would be in line with passengers' interests.
Service quality protection	GAL's good recent track record, combined with service standards in the commitments, should ensure good continued service. The ability of the CAA to monitor service quality performance with the potential for introducing additional licence conditions if required should provide adequate protection to passengers.
Promote competition	The additional flexibility under the commitments approach should promote competition in airport operation services.
Allows efficient business to finance its activities	GAL is unlikely to propose commitments that would not allow it to finance its activities.
Efficient and effective investment	The ability of the CAA to monitor investment and introduce additional licence conditions if required should provide adequate protection to passengers.
Operational efficiency	Potential benefits to efficiency incentives from the retention of benefits for longer (at least seven years compared to a traditional

Criteria	Assessment
	5-year RAB-based control).
Allows environmental measures	The commitments would not prevent the introduction of environmental measures.
Transparent, accountable, proportionate, consistent and targeted	Including licence conditions that allow the CAA to enforce the commitments prevents GAL from amending the commitments without good reason or withdrawing them and should ensure that GAL is held properly to account for its actions. These licence conditions are focused on areas of concern and so are proportionate. Even with the changes outlined above a commitments and licence framework should provide cost savings compared to other forms of licence regulation. Sharing information with airlines on costs and revenues, cumulative revenue difference calculations, the transparency of costs of specified activities and investment consultation should provide the necessary transparency.
Practical implementation and stakeholder confidence	Allowing licence enforcement of the commitments should overcome the concerns over practical implementation and increase stakeholder confidence, although some stakeholder concerns are likely to remain.

Source: CAA analysis

RAB-based regulation

Final proposals

I135 The CAA considered that a RAB-based framework could be an appropriate form of regulation for GAL. The CAA stated that a RAB-based framework was well understood and widely used across regulatory sectors. It provided price and service quality protection to passengers, while providing incentives for efficiency and has support from airlines. Unlike the position at Stansted, the CAA noted that there was less uncertainty over individual building blocks and the value of the RAB did not appear to be out of line with the investment requirements of passengers.

Stakeholders' views

I136 GAL welcomed the CAA's acknowledgement of the drawbacks of RAB-based regulation but stated that the CAA had failed to acknowledge that where the RAB is used in other sectors it is in the context of the regulation of natural monopolies where there is an absence of competition. GAL also considered that a RAB-based approach disincentivised the tailoring of service and contractual arrangements because any value generated for the airline or airport operator was lost at the end of the relatively short control period.

I137 Airlines, with the exception of Monarch, supported a RAB-based framework. The ACC stated that there was no particular reason for a RAB-based control to retain the structure of the previous control period given the flexibilities in the Act which allowed for a longer control period and more tailored arrangements. In addition the capex provisions could be altered to reduce the bureaucratic procedural arrangements and allow more flexibility.

CAA's final view

I138 Throughout the Q6 process the CAA has stated that, where it applied a RAB-based approach in the future, it would consider doing so flexibly, which would take advantage of the flexibilities under the Act, for example in terms of duration, capital incentives and the ability to respond to exceptional circumstances.

I139 Many regulators use a RAB-based framework to set price caps. A RAB approach is widely used across regulatory sectors. One of its main advantages is that it sets prices equal to a measure of costs. Where other regulators have departed from a RAB approach, for example Ofcom, this is generally to facilitate competitive entry and the development of competition. As set out in the market power assessment, the CAA considers that there is limited scope for competition at GAL, in particular due to capacity constraints. Consequently the CAA does not consider that allowing prices to be significantly higher than determined through a RAB approach would have a significant impact on competition. Consequently the CAA does not consider that applying a RAB-based price control to GAL would be inconsistent with the approach used by other regulators.

I140 A RAB-based framework at Gatwick has advantages in that it is well understood by stakeholders, and supported by airlines (but not GAL). There is also less uncertainty on individual building blocks, in particular traffic, than there is at Stansted. Also unlike Stansted, the historic investment, and consequently the value of the RAB, does not appear to be out of line with the needs of the airlines and passengers that use Gatwick. A RAB-based approach can provide good protection to passengers through a price cap, SQR scheme, efficiency incentives and capex triggers and consultation requirements.

I141 The CAA acknowledges that there are drawbacks with a RAB-based approach. A RAB-based price cap can be costly and time consuming to calculate as it requires the regulator to have a lot of information to overcome information asymmetries. It can distort investment incentives, either by encouraging too much investment (which will need to be addressed in the periodic review by the regulator) or by distorting investment decisions at airports that potentially compete with Gatwick. Neither of these problems appear to be the case in practice for the current control period. A RAB-based approach can also introduce rigidities into the capital planning approach and from the SQR scheme. The CAA considers that, using the flexibilities in the Act it may be possible to overcome these, to a degree, through a more flexible RAB-based approach, for example using a core and development capex approach. The CAA acknowledges that under the Act it may be possible to extend the duration of a RAB-based price control, however for the reasons set out in paragraphs I42 to I43 it does not consider it is appropriate at this time. However for the reasons set out in paragraph I44 the CAA considers that bilateral contracts may be less likely under a RAB-based price control, although they would not be prevented.

I142 The CAA considers that GAL currently has SMP and this will endure for Q6. Given the protections provided by a RAB-based approach, the CAA considers that such an approach could be an appropriate form of regulation for GAL, although it may not be the most appropriate approach.

Figure I.5: Appraisal of flexible RAB-based approach for GAL

Criteria	Assessment
Price protection	A RAB-based price cap can ensure that users only pay for efficiently incurred costs, and provides both users and the airport operator with certainty and stability. At Gatwick there is a reasonable level of certainty over key inputs, increasing the robustness of RAB-based calculations.
Service quality protection	Service quality requirements can be specified as part of a decision/licence although care is needed to ensure that they meet the needs of users. This provides a one size fits all approach, which may

Criteria	Assessment
	not be right for individual airlines or their customers. Nevertheless it secures a minimum level of service which can be effectively enforced.
Promote competition	Depending on how it is set, RAB regulation can distort investment incentives at both regulated and unregulated airports which can have an adverse impact on competition. This does not appear to be the case for GAL given the investment plans of GAL and airports which potentially compete with Gatwick. A RAB approach could discourage commercial agreements, although it does not prevent such agreements. In cases where the airport operator has SMP, by setting an appropriate price cap, a RAB-based approach can help to ensure that any commercial agreements are fair.
Allows efficient business to finance its activities	The regulated business would receive a preset return on current and future investment although it would be subject to some traffic risk.
Efficient and effective investment	A RAB approach can promote investment as the regulated business will earn a return on investment and lead to the promotion of investment over opex-based solutions. A more flexible RAB approach may improve incentives for the planning, delivery and efficiency of capex.
Operational efficiency	Some incentive to outperform regulated settlement due to the retention of gains during the regulatory period.
Allows environmental measures	A RAB-based framework would not prevent environmental measures from being introduced.
Transparent, accountable, proportionate, consistent and targeted	Setting of a price cap is transparent and consistent. The focus of regulation can be targeted on areas of harm, although a RAB approach can be complex, time consuming and introduce rigidities into processes. Nevertheless a RAB-based framework should provide some certainty and stability for stakeholders and is proven in other markets where operators have SMP.
Practical implementation and stakeholder confidence	A RAB-based framework is well understood by stakeholders and is used in relation to airports and across a number of other regulated sectors. A RAB approach has strong support from airlines although it is not supported by GAL.

Source: CAA analysis

Long-run incremental costs approach

Final proposals

I143 In the final proposals the CAA stated that a LRIC approach would have conceptual benefits from being linked to a notion of future competitive prices. However the CAA was concerned that a combination of the following meant that the implementation of a LRIC-based control at Gatwick could undermine its primary duty: the data intensity and practical difficulties in its calculation; the specifics of airport capacity in the South East that may render it inappropriate and the significant sensitivity of the calculation to regulatory judgement. On balance, therefore, the CAA considered that LRIC was not suitable for regulating GAL's airport charges in Q6 given the risk it could undermine, rather than support, protection for passengers and the promotion of competition.

Stakeholders' views

I144 GAL stated that the CAA and its advisers had not addressed sufficiently its previous concerns on the analysis of LRIC.

I145 GAL's previous concerns were as follows:

- while LRIC could lead to volatile charges this does not mean that this would limit the protection to users as the CAA has not explained why increasing prices, where there is insufficient capacity, would be detrimental to passengers' interests;
- while LRIC could lead to under- or over-recovery in a particular period, why this under- or over-recovery is an issue or why LRIC would not be indicative of the competitive price; and
- GAL does not understand the CAA's statement that LRIC is not an effective proxy for competitive prices, where investments are lumpy and for example may not reflect the capacity cycle.

I146 GAL stated that the CAA's cited drawbacks around the uncertainty over the appropriate increment, the remuneration of investment and volatility are overstated and in any case are based on uncertainty and volatility which are key features of competitive markets.

I147 GAL stated that for regulation to promote competition it needs to reflect more than a competitive outcome but to also allow the market dynamics to reveal solutions and innovations to meet passengers' needs.

I148 GAL considered that the reduced incentives towards capex spending from a LRIC approach to be a positive rather than the implied negative factor in the CAA assessment.

I149 GAL stated that the CAA’s consultants, Europe Economics (EE), had not fully reflected GAL's comments in its revised report. The CAA understands that GAL's concerns around the EE analysis were as follows:

- EE continues to largely dismiss the relevance of increment 2 (a new runway);
- EE continues to assume for increment 3 (the modern equivalent replacement cost of the airport) that the new airport is full from the first day of operation;
- EE estimates continue not to include all material costs, EE has made some adjustments to its input cost assumptions, but these are not fully comprehensive;
- EE recognises the relevance of ranges, however there is focus on the central estimate such that the analysis appears to be focused on a point estimate, and this appears to be the basis on which it has been interpreted by the CAA;
- EE has underestimated the costs associated with new runway capacity and the modern equivalent valuation costs as highlighted by GAL's submissions to the Airports Commission; and
- EE has not reflected quality uplift in its estimates and GAL did not consider that there should be no increase in quality in line with passengers' and airlines' expectations.

I150 In his paper for GAL, Professor Littlechild queried whether LRIC reflected a theoretical competitive price and stated that setting prices in relation to long run costs is not what markets do in practice.

I151 The ACC did not comment on the use of LRIC in response to the final proposals but when responding to the initial proposals supported the conclusions drawn by the CAA.

CAA's final view

I152 Price caps based on LRIC have been used by some UK sector regulators. LRIC can be calculated in a number of ways. Typically, these include:

- future incremental costs divided by future incremental demand over the asset life, which can involve a small increment, such as changes to make the maximum use of existing facilities, or a large increment such as a new terminal or runway; and
- using the modern equivalent asset value (MEAV) or replacement cost of the existing assets. Ofcom has used current cost accounting for its review of mobile termination charges. This could also be seen as an amendment to a RAB-based approach.

I153 A LRIC-based price cap can include many of the aspects that characterise the current RAB-based framework, such as a SQR scheme, although features such as capex triggers would not be included given the focus on future rather than current investment.

I154 The CAA has further reviewed EE's response and the response set out in the final proposals. The CAA considers that it has sufficiently addressed the points raised by GAL and notes that GAL has not been specific about which concerns it considered the CAA had not addressed. For the reasons set out below the CAA continues to consider that LRIC-based prices are not an appropriate basis for setting price controls for GAL.

I155 The main potential benefit of a LRIC approach is that, in principle, it could signal the long-term average price that might emerge from a ‘competitive’ market, in that it reflects the costs that a new entrant would have to incur to provide equivalent capacity.[142] Price protection for users is assured by setting a price cap based on LRIC and fixing it for a number of years.

I156 The CAA’s consultants EE provided advice on the application of LRIC estimates to Gatwick and Stansted.[143] EE suggested that LRIC

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[142] LRIC has tended to be used to set the cost standard for multiproduct firms to test potential abuse of SMP.

[143] Europe Economics, December 2012, *Advice on the application of long run incremental cost estimates for Gatwick and Stansted*, http://www.caa.co.uk/docs/1350/Europe%20Economics,%20Advice%20on%20the%20applic

provides the best indication of the competitive price where it is based on the MEAV.[144] In addition EE suggested a LRIC approach may increase efficiency as the regulated company will only be reimbursed for efficient investment.

I157 There are a number of concerns associated with using a LRIC approach to proxy the competitive price.

- As LRIC is a long-term forward-looking measure, there is a risk of over- and under-recovery in a particular period. This means LRIC may not be well-suited as a benchmark to indicate whether a particular price is proximate to the competitive price at any given time. Charging a flat LRIC price over time also raises similar issues as any other 'smoothing' effect, which is that existing passengers may resist being asked to pay for future improvements where they may not benefit.
- A LRIC approach is data intensive and requires regulatory judgement to define the increment (although this might be less for a replacement cost approach). This can lead to significant uncertainty over future price profiles and it may be possible to generate large price increases or decreases depending on the assumptions used, limiting the protection to users and introducing variability owing to regulatory judgements.
- It has been argued that it is not an effective proxy for competitive airport prices where investments are very lumpy.[145] The CAA continues to consider that when setting prices it is important to take account of the effects of the capital-intensive nature of airports and of the 'lumpiness' of capacity increments.[146]

ation%20of%20long%20run%20incremental%20cost%20estimates%20for%20Gatwick%20and%20Stansted%20-%20nonconfidential%20version.pdf

144 Although this to some extent depends on how demand relates to available capacity.

145 CAA, Review of price regulation at Heathrow, Gatwick and Stansted airports, (Q6) Policy update, May 2012.

146 In principle, short-run prices in a well-functioning airport market would be expected to fluctuate around a long-term average, depending on the level of spare capacity available in the market: when capacity tightens, prices could be expected to increase with the resulting high prices triggering the development of new capacity by competing airports and subsequent fall in prices. Under such circumstances, pricing above the competitive price for a period of time might be considered a normal feature of a well functioning market.

I158 EE identified a number of drawbacks from using a LRIC approach for GAL which included the following issues.

- Difficulties in determining the appropriate increment to use. As noted above, EE considered that the most credible increment would be the replacement of an airport (rather than, for example, a small amount of incremental capex or a new runway).
- Greater uncertainty (and loss of accuracy) due to the need to make a judgement as to the efficient levels and types of investment required rather than using historical values that were spent.
- The potential for greater uncertainty of remuneration of investment. As charges are not related to historical investment costs, then this increases uncertainty to the regulated company over the remuneration of investment, particularly if the current configuration of the airport is not ideal.
- Greater potential for volatility, for example if input prices or technology changes.

I159 EE's analysis identified that any model that is used to estimate LRIC would be sensitive to the inputs and the assumptions that underpin it. In particular, EE's sensitivity analysis indicated that changes to the inputs and assumptions could lead to quite significant changes in a LRIC estimate. More fundamentally, the relevance of a LRIC-based price, given the level of government involvement in planning of airport capacity particularly in the south east of England is substantially reduced.[147]

I160 With respect to GAL's specific concerns with EE's methodology, the final proposals examined these issues.[148]

- The dismissal of increment 2 was based on a concern about the relationship between the incremental cost of additional capacity and assessing the competitive price level for an airport as a whole.[149]

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147 EE, 'Advice on the application of long run incremental cost estimates for Gatwick and Stansted'.

148 EE, 'Advice on the application of long run incremental cost estimates for Gatwick and Stansted; Response to comments by Gatwick Airport Limited, pages 1 to 18'.

149 It also noted that its LRIC estimate for increment 2 of £17 was the upper estimate and that this should be lower as the construction of the runway would most probably be phased over

- EE's approach did not include quality uplift as part of any new build as a hypothetical entrant would offer exactly the same experience as the exiting airport and its inclusion would not be appropriate.
- EE's LRIC calculations were based on a 'brownfield site', which assumes that the land is already set up for an airport, including all planning permission, land acquisition and connection utilities – an approach consistent with the approach adopted by GAL's consultant (FTI Consulting LLP (FTI)).
- The costs associated with transport links are already included in the accounts of GAL, upon which the airport replacement costs are based (and only where the airport operator incurs these costs can they be reimbursed via the RAB).
- The index that GAL proposed to increase land values by was quite high and was not appropriate. Furthermore, EE indicated that a more appropriate index may be lower than the one that it used in its modelling (but which it had retained in the revised version of its model).

I161 Importantly, the assumption that a replacement airport would be full from day one was based on the premise that this airport would replace Gatwick (or in other words Gatwick would close), with all existing traffic migrating to the new airport. This assumption is not unreasonable and a similar assumption was used by FTI in its estimation of a replacement cost airport for GAL.[150]

I162 EE's study also highlighted that LRIC estimates using additions to capacity could be used in certain circumstances, such as a comparison of the costs of additional capacity at different airports, but that using the costs of a replacement cost airport speaks directly to the cost of providing these services.[151]

more time in line with demand. Source: EE, 'Advice on the application of long run incremental cost estimates for Gatwick and Stansted; Response to comments by Gatwick Airport Limited', page 6.

150 FTI Consulting, 'LRAIC for Gatwick Airport: Presentation to CAA workshop', 7 December 2011.

151 EE, 'Advice on the application of long run incremental cost estimates for Gatwick and Stansted; Response to comments by Gatwick Airport Limited', page 7.

I163 The CAA does not, therefore, agree that EE has softened its position with respect to the appropriate increment. Rather, EE has indicated that the use of a non-replacement increment could be useful in specific circumstances, circumstances that do not currently include the one that the CAA is currently facing.

I164 On GAL's concern with the cost of capital assumption, the CAA does not consider that this is too low. A range of factors were carefully considered in determining this assumption and these factors were outlined in detail in the initial proposals.[152]

I165 On GAL's concern with the low capital investment cost assumption, EE based its estimates on the 'minimum cost option' devised by ASA consultants for the CC for the SG2 Plan at Stansted. This decision was made in agreement with the CAA, and is justified as ASA was in a better position than BAA (or GAL) to provide a third party independent assessment of likely costs.[153]

I166 GAL has also suggested that 'the high costs associated with the building of an airport in the south east is also evident from the various cost estimates emanating through the Airports Commission process, including [its] own submissions on the costs of additional capacity.'[154] In addition, GAL has 'estimated that the costs for a second runway and associated facilities at Gatwick are likely to range between £5 billion and £9 billion (in 2013 prices), depending on the option selected.'[155]

I167 The CAA considers that in the current circumstances GAL is not best placed to provide an independent assessment of the likely costs associated with airport replacement. In addition, GAL has indicated that the estimates that it provided to the Airports Commission carry a large contingency:

152 This document is available on the CAA's website: http://www.caa.co.uk/docs/33/CAP%201027%20Economic%20regulation%20at%20Heathrow%20from%20April%202014%20initial%20proposals.pdf

153 EE, 'Advice on the application of long run incremental cost estimates for Gatwick and Stansted; Response to comments by Gatwick Airport Limited', page 18.

154 Source: GAL.

155 GAL, Airports Commission: Proposals for providing Additional Runway Capacity in the Longer Term, Gatwick Airport Limited response, July 2013, page 37.

"At this stage Gatwick has produced a series of estimates at a facility level, which is consistent with a class 5 – conceptual estimate and relevant for strategic planning. This type of estimate therefore carries a risk/contingency level of 20% or greater." [156]

I168 Given the above, the CAA considers that GAL's estimates have to be treated with the appropriate level of caution and are not suitable for use in estimating a LRIC, which already has a number of concerns associated with it.

I169 Options associated with Gatwick expansion were also appraised as part of the South East Regional Air Services (SERAS) study. In this study, the £1.8 billion (in 2000 prices) for the narrow spaced option increases to £2.8 billion once adjusted for construction price inflation (2012 prices). This is slightly above the costs used by EE (£2.3 billion) but is broadly reflective of the costs that have been used.

I170 GAL also considers that any estimate of LRIC should be considered a lower bound estimate of the competitive price as it does not consider factors such as location, brand and scarcity. The CAA does not agree with this view and considers that the evidence suggests that any LRIC should instead be the higher bound estimate. This view was outlined by EE, who noted that, taking increment 2, the increment that generated the highest LRIC estimate for GAL, that:

"[T]he figure calculated by our model for Increment 2 (£17.00) is already an overestimate as the model does not take into account the phasing of capital expenditure. Our model assumes that the full capital costs of the second runway at Gatwick would be incurred upfront, with demand growing slowly over time. In reality, the construction of the runway would most likely be phased over time more in line with demand. Thus, the present value of capital costs should be lower, and the LRIC estimate for Increment 2 would be below £17.00."[157]

[156] GAL, Response to long term option, proposal clarification questions – Commercial submission by Gatwick Airport Limited, August 2013, page 4.

[157] EE, 'Advice on the application of long run incremental cost estimates for Gatwick and Stansted'; Response to comments by Gatwick Airport Limited, page 18.

I171 With respect to GAL's concerns with respect to location, brand and scarcity the CAA considers that these issues have also been addressed and does not consider that EE's model should be changed:

- EE considered 'certain factors beyond resource costs may add value to services, but in a competitive market it does not necessarily follow that higher prices can be charged. Particularly where an operator has market power, regulators should not be concerned with what can be charged for a service, but with what it costs to provide the service.'[158]
- Scarcity may mean that the market clearing price is likely to be significantly above the competitive price. However, the competitive price should be the price that would hold under conditions of competition in which operators are able to vary capacity in response to excess demand.
- While the value of non-price factors may be able to be passed through (ultimately to consumers), this will depend on the level of available capacity at Gatwick and at other airports (see Appendix E), the level of competition in downstream markets and how sensitive passengers are to price changes. As GAL is not operating in a perfectly competitive market, and as Gatwick is not currently full, these non-price factors may be more appropriately captured through other mechanisms such as the value of slots or the value of the airport (when exchanged).
- Assuming that these factors have not been captured and the CAA considered it appropriate to do so, estimating these factors would introduce a level of subjectivity which could lead to significant uncertainty and therefore large price increases or decreases depending on the assumptions used, limiting the protection to users and introducing greater variability.

I172 In response to Professor Littlechild's comments, EE stated that a LRIC approach can reflect prices in a normally competitive market as it would reflect the forward-looking avoidable costs of supply.[159]

[158] EE, 'Advice on the application of long run incremental cost estimates for Gatwick and Stansted'; Response to comments by Gatwick Airport Limited, page 18.

[159] Littlechild, May 2013, Regulation of an increasingly competitive airport sector, http://www.gatwickairport.com/Documents/business_and_community/Public%20Regulation%20Pages/Economic%20regulation/2013/LGW-BQ5-238%20-

However, for the reasons stated in paragraph I157 above, the CAA does not consider that for airport operators LRIC would necessarily reflect the competitive price.

I173 The primary conceptual benefit of using a LRAIC approach to set price caps is that it proxies the price that might emerge from a competitive market over the long run.[160] However, the CAA continues to consider that there are a number of concerns associated with using LRIC for airport operators. The CAA continues to be concerned that a combination of the following will mean that the implementation of a LRIC-based control for GAL could undermine its primary duty: the practical difficulties in its calculation; the specifics of airport capacity in the South East that may render it inappropriate; the significant sensitivity of the calculation to regulatory judgement; and the data intensive nature of the calculation. On balance, therefore, the CAA considers that this option is not suitable for regulating GAL's airport charges in Q6 given the risk it could undermine, rather than support, protection for users and the promotion of competition.

Figure I.6 Appraisal of a LRIC approach for GAL

Criteria	Assessment
Price protection	Provides some protection against charges above the competitive level over the long term (although noting for airport operators it may not reflect competitive prices at a specific time), although calculations are subject to considerable uncertainty.
Service quality protection	Service quality requirements can be specified as part of a decision/licence although need to ensure users' interests are considered.
Promote competition	In theory LRIC better reflects competitive outcomes, although the practical issues highlighted above may limit the extent to which this is the case. A LRIC approach may not reflect the dynamic aspects of competitive prices although, given the constraints on new capacity, this

%20Regulation%20of%20an%20increasingly%20competitive%20airport%20sector%20-%2026%20May%202013.pdf, paragraph 21.4.

160 CAA, Review of Price Regulation at Heathrow, Gatwick and Stansted airports ("Q6"), Policy update, page 56 and Europe Economics, http://www.caa.co.uk/docs/1350/Europe%20Economics,%20Advice%20on%20the%20application%20of%20long%20run%20incremental%20cost%20estimates%20for%20Gatwick%20and%20Stansted%20-%20nonconfidential%20version.pdf, page 7.

Criteria	Assessment
	may be less relevant issue for airports in the South East.
Allows efficient business to finance its activities	The move away from a historical cost RAB would create the risk of capital gains and losses, which would increase business risks and financing costs.
Efficient and effective investment	A LRIC approach would reduce the incentives towards inefficient capex spending as the company would not be compensated for over-spending.
Operational efficiency	If used within fixed term control periods then there should be an incentive to outperform the regulatory settlement (and as with a RAB approach roll-over provisions could ensure that incentives are maintained towards the end of the control period).
Allow environmental measures	Would allow individual prices that contribute towards the cap to be adjusted to incentivise improved environmental performance. Environmental measures could be included within the future capital programme as long as additional outputs are explicit.
Transparent, accountable, proportionate, consistent and targeted	LRIC estimates require judgements about the most appropriate increment or the modern equivalent values. Some stakeholders are concerned that a LRIC approach can be complex, time consuming and lead to uncertain future price paths with a high level of regulatory discretion. This may reduce transparency and consistency
Practical implementation and stakeholder confidence	Introducing a LRIC price cap would require a long-term commitment from the regulator to move from the current RAB approach and to even out under- and over-recovery over time. Stakeholders raised concerns whether sufficiently precise results could be obtained and whether the transfer from a RAB to a LRIC control had sufficient benefits to justify it given the long-term horizons.

Source: CAA analysis

Price caps based on pegging tariffs to comparator airports

Final proposals

I174 In the final proposals the CAA stated that linking prices to a benchmark index of peer group airport charges had the potential advantage of a linkage to what might be considered a market-based competitive price. However this approach suffered from considerable debate over the composition of the index, the equivalence of comparators, the frequency of adjustment etc and consequently was not an appropriate basis for setting price caps for GAL.

Stakeholders' views

I175 GAL continued to have a number of substantial concerns with the LF analysis undertaken for the CAA on price comparators and how this was used by the CAA. GAL's concerns were based on a report by consultants FTI, which raised concerns in the following areas:

- the purpose and status of the LF analysis;
- the conceptual robustness of the LF analysis;
- the uncertainty in the LF analysis;
- how the CAA had taken into account the uncertainty in the LF analysis;
- the weight placed on benchmarks of aeronautical revenue and published charges;
- the criteria used to select comparator airports;
- the robustness of the econometrics employed; and
- the use of a dynamic process to identify comparators.

I176 These concerns followed earlier concerns cited by GAL in response to the initial proposals.

I177 The airlines did not comment on the use of comparators in the response to the final proposals but in the response to the initial proposals the ACC supported the conclusions the CAA had drawn.

CAA’s final view

I178 Pegging tariffs to comparator airports would set a price cap based on an index of the airport charges of a set of comparator airports. Airports within the index could be weighted in relation to their relevance to the comparator, for example size, type of traffic and level of underlying demand.

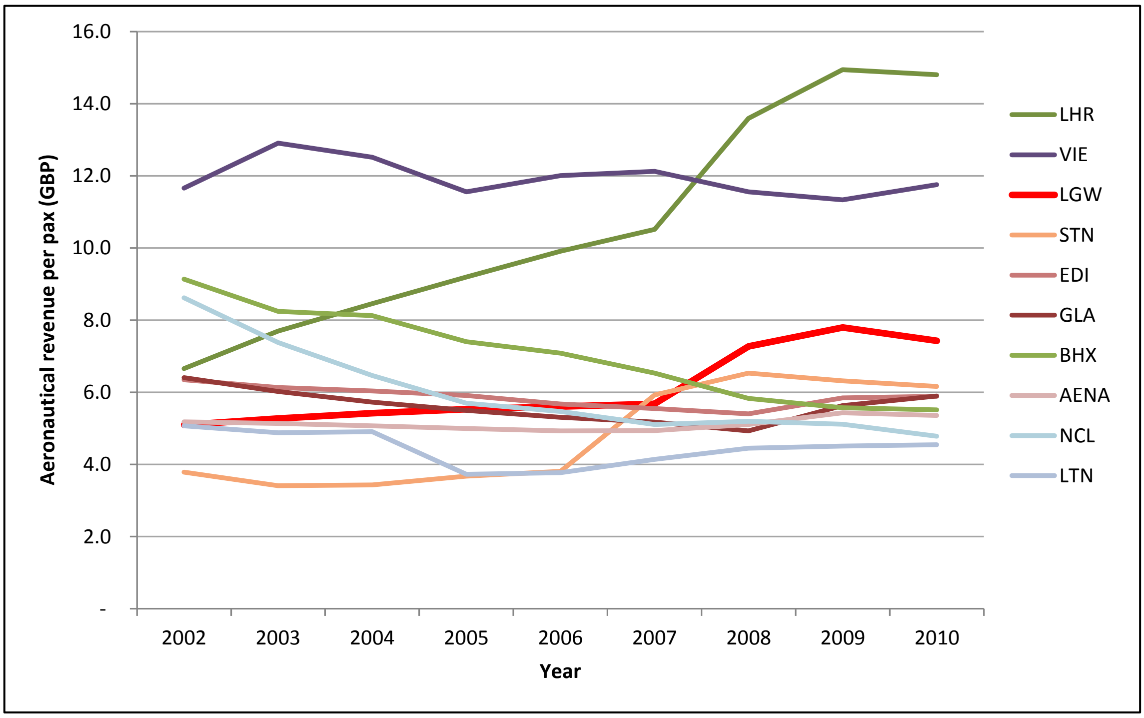
I179 Pegging tariffs in this way should provide some protection to passengers by setting a direct link between charges and a proxy for the competitive price. It avoids the complexities of scrutinising the bottom up cost and revenue information required by price caps based on RAB and LRIC type methodologies. As well as a price cap, the regime could also include other output requirements such as a SQR scheme and investment requirements.

I180 In its May 2012 Policy Update document, the CAA considered that a comparator benchmark approach had some merit. In particular, the CAA wanted to explore further whether it could allow the setting of sufficiently precise and appropriate price caps, or whether it would be more helpful as a cross check on a price control calculated by another approach.

I181 The CAA commissioned consultants LF to identify whether it was possible to benchmark prices at comparable airports in order to regulate airport charges at Gatwick and/or Stansted. LF identified a potential comparator set of airports separately for Stansted, Gatwick and Heathrow. The comparator set for Gatwick reflects the range of airlines that use Gatwick and includes Heathrow, Edinburgh, Glasgow and Barcelona which are used by BA and Luton and Stansted which are predominately used by Low Cost Carriers (LCCs).

I182 Based on this comparator set, LF benchmarked GAL's aeronautical revenues over the last ten years. This showed that GAL's average aeronautical revenues per passenger increased over the period and were now around average for the group. The results however are sensitive to the inclusion or exclusion of Heathrow from the comparator group. If Heathrow was excluded from the group then GAL's charges would be above the average, although still with the 10 to 15% range of uncertainty identified by LF.

Figure I.7: Aeronautical revenue per passenger for the Gatwick comparator basket



Source: LF: Note: AENA includes both Madrid Barajas and Barcelona which are both comparators to Gatwick

I183 In developing the comparator basket LF found that trends in aeronautical revenue per passenger were robust against variations in the airports chosen (apart from Heathrow) and changes in the way the index was calculated. However, if used for setting a price cap, due to the additional precision that would be required, LF identified a number of issues that would need to be addressed, in particular:

- whether the comparator basket is held constant or is allowed to change over time, depending on how different airports evolve;
- how the comparator basket is chosen, in particular the cut-off for the inclusion of airports, and whether particular parameters are included;
- how the index is calculated, for example whether airports should be weighted and the treatment of exchange rates;
- inherent uncertainties in the accuracy of the data, especially where estimates have had to be made for example in relation to air traffic control costs and freight revenues; and

- ensuring that the precise portfolio of activities that generate revenue is consistent across airports to ensure a like for like comparison.

I184 In total, LF considered that the resulting range of uncertainty from the benchmarks was ±10 to 15%. LF stated that this range did not reflect the inclusion or exclusion of additional comparator airports. LF considered that potential issues with comparator based price caps could be reduced by averaging across airports and be resolved through agreement on the comparator set and/or parameters between the airport operator and airlines. Nevertheless LF recommended that it may be better for the comparator benchmark to be considered as a range rather than a point estimate.

I185 LF responded to the concerns raised by GAL on the initial proposals.[161]

- Size and composition of the comparator sample. LF stated that the comparator sample reflects not only airport characteristics but also the traffic mix and the diverse range of airlines that use Gatwick. The choice of comparators reflects the purpose of the study (and so is therefore different to that undertaken by LF at Melbourne) and that airport size is only one of a range of factors that is important in determining the comparator sample.

161 Leigh Fisher, August 2013, Addendum Note: Comparing and Capping Charges at Regulated Airports, http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

- Exclusion of significant variables. LF repeated the points raised in their final report: that different types of airlines have different service quality demands and so the inclusion of traffic mix in the determination of comparators should reflect different customer demands; that the study was benchmarking prices and not costs and the inclusion of costs could create a circularity where inefficient costs could be used to justify high prices, investment will not impact on prices in any one year but will be spread over time and the benchmarking has been considered over a period of ten years; the balance between capacity and demand is reflected in the criteria through runway utilisation; the impact of affordability of charges has been taken into account by adjusting charges by purchasing power parity exchange rates; and regional subsidies reflect the matching of charges to demand and can often affect costs as well as charges.
- The assessment of regulation was undertaken at a high level to allow the drawing of general conclusions and there are a myriad of different arrangements across airports.
- The assessment is based on like for like comparisons and the revenue data has been normalised across airports based on the experience of publishing airport benchmarks over many years.
- LF acknowledged the practical difficulties in benchmarking aeronautical revenues but do not consider the 18-month timelag is that significant and audited results for all airport operators were not available for the most recent year. LF also acknowledged the difficulties in using group level data but considered that time series data was required to allow a reliable split of group data and to avoid compromising other parts of the analysis. LF considered that the 15% uncertainty range accounted for these factors.

- LF stated that any approach to benchmarking is open to interpretation and it is easy to assemble a different set of comparators to draw different conclusions. LF stated that this does not mean that the CAA should not use benchmarking as part of its analysis but it should be used carefully and as stated in the final report, definitive conclusions based on spot prices should not be drawn. LF stated that they considered an approach similar to that used LF had used at Melbourne but were concerned that this could be criticised as too simplistic. LF considered that the 15% range around the comparator benchmark provides a basis to inform the CAA's work.
- LF considered that outputs from the benchmarking could usefully inform the consideration of the competitive price within a range and noted that during the consultation process there was general support for the use of price benchmarking to inform the regulatory process.
- LF considered that their assessment of catchment areas is appropriate, that runway utilisation is the ultimate constraint on airport capacity and that the consideration of the regulatory environment is necessary broad brush but is appropriate for the purposes of the study.
- LF considered that the goodness of fit of the regression is reasonable for this kind of cross sectional analysis and disagreed that signs of the coefficients were counterintuitive and that the specification of the regression was inappropriate to inform the choice and weighting of variables in the selection of comparators.
- LF considered that they could have introduced more variables into the analysis and greater complexity in the weightings but considered that could add greater uncertainty in the results and considered the simple average approach taken, together with the 15% uncertainty band covered a range of outcomes under different approaches and so would be appropriate.

- LF considered that the multivariant regression approach which calculated a norm for each airport would avoid some of the problems of the simple benchmarking approach used in the report but would require a significant data gathering exercise to produce time series estimates and could also introduce problems associated with the regression itself.

I186 LF did not change their benchmarks for each of the airports or the conclusions that they drew.

I187 The CAA has considered the concerns raised by GAL's consultants FTI. These concerns appear in the main to be related to the CAA's use of airport comparators to establish a range for the competitive price which has been used in the market power assessment. These concerns are therefore dealt with in more detail in the market power determination for GAL[162] The CAA notes that FTI's concerns repeat many of the concerns previously considered by LF. The following paragraphs summarise the CAA's response.

I188 **The purpose and status of the analysis**. The terms of reference are clear that the work is to "identify suitable comparator airports that would provide an indication of airport charges at Heathrow, Gatwick and Stansted in a reasonably competitive environment". LF are clear that "reasonable inferences can be drawn from the identified ranges for each airport". The terms of reference also require LF to "Identify issues and appropriate mitigating measures in the development of a basket of comparator airport charges for capping charges at Gatwick and Stansted". The CAA considers that the LF report has addressed these issues.

I189 **The conceptual robustness of the analysis.** The CAA has reviewed the draft guidance provided by the EC on the use of airport benchmarks to assess relevant market prices. While the EC raised some concerns with using benchmarks at the present time it did not rule it out in the future. In many ways the LF analysis builds on rather than is inconsistent with the concerns raised in the draft guidance.

I190 **The uncertainty in the LF analysis.** FTI's concerns in this area largely repeat earlier points made by stakeholders and have been previously addressed by LF in their addendum report and are

162 See Appendix H of the GAL Market power determination

summarised in paragraphs I183 to I186 above and set out in detail in Appendix H of the market power determination. LF considered that the range identified reflected the uncertainty in the estimation of the benchmarks. LF stated that reasonable inferences could be drawn from identified ranges for each airport, although it accepted that its results were not sufficiently robust to draw inferences on the spot charge estimates or to use as the basis for pegging tariffs at regulated airports.

I191 **How the CAA had taken into account the uncertainty in the LF analysis.** The CAA has taken into account the uncertainty in the LF analysis and has only made inferences on the competitive price from the ranges estimated by LF and it only forms part of the CAA's analysis of the competitive price. The CAA has also undertaken a number of sense checks on the LF analysis in terms of the comparators selected and the robustness of the analysis (for example if specific airports are removed and the stability of the analysis over time). Further the CAA notes that the LF analysis was subject to an industry workshop and consultation. The LF analysis also takes account of the impact of regulation and the scarcity of runway capacity.

I192 **The weight placed on benchmarks of aeronautical revenue and published charges.** Part of the rationale for single till regulation is that an airport operator in a competitive environment takes into account non aeronautical revenue when setting the level of airport charges. The CAA, however, sets caps on airport charges and not total revenues. Consequently, it is the level of airport charges that is being benchmarked as part of this process rather than total revenues and hence the CAA has focused on the benchmark of aeronautical revenues (which for the most part are made up of airport charges). Furthermore the CAA does not consider weight should be placed on published charges as these do not include discounts. The CAA is concerned in the interests of all users and is therefore interested in the average charge paid by users whether the airline they are travelling with is receiving a discount or not. The CAA has therefore placed weight on the benchmarks of aeronautical revenues rather than published charges.

I193 **The criteria used to select comparator airports.** LF considered whether to include quality of service, input costs and investment cycles and rejected these for the reasons set out in their report and briefly in paragraph I185 above

I194 **The robustness of the econometrics employed**. The issues raised by FTI appear to be a list of common problems that could arise out of any regression and FTI do not provide any evidence that these are problems in this case. In addition the regression was only used to inform the selection of variables which were used as an input to the weighting process and was not used to define the benchmark itself. LF did not consider that the regression was sufficiently robust for this latter purpose.

I195 **The use of a dynamic process to identify comparators.** The benchmarks have been based on the most recent years of data, the same year in which weights were derived. The time series analysis is used to identify robustness.

I196 Based on the above response, the CAA continues to consider that comparator benchmarks provide a useful indicator of the possible range for the competitive price. This is consistent with the purpose of the LF work, which was in part "to identify suitable comparator airports that would provide an indication of the level of airport charges at Heathrow, Gatwick and Stansted in a reasonably competitive market". The CAA does not consider that it would be appropriate to set precise price caps based on comparator benchmarks. The CAA notes that this view is consistent with that of Littlechild in his paper for GAL, who considered that the comparator benchmark could be used as a cross check against the terms offered in the commitments. A summary of the CAA's evaluation against its criteria is given in figure I.8.

Figure I.8: Appraisal of pegging tariffs to comparator airports for GAL

Criteria	Assessment
Price protection	In principle the price cap ensures users only pay a proxy for the competitive price, however due to potential measurement and statistical issues the benchmark may not be sufficiently precise to set price caps. There is no guarantee that charges are cost reflective.
Service quality protection	Service quality requirements could be specified as part of a licence although care will be needed to ensure they meet users' requirements. The choice of the comparator group implicitly takes account of the needs of different users by including structural criteria such as the

Criteria	Assessment
	passenger, carrier and destination mix, and airport size in the choice of comparator airports. If higher than typical service quality standards are set then there may be a need for prices to be adjusted. If service quality requirements are not specified then improvements may be avoided if they result in higher prices.
Promote competition	Setting prices in relation to comparator airports could remove distortions from a RAB-based approach as prices would be based on a proxy for the competitive price.
Allows efficient business to finance its activities	Pegging tariffs removes the direct link between charges and costs and so care will be needed to allow an efficient business to finance its activities.
Efficient and effective investment	As the price cap is essentially reactive to changes in charges at other airports there may be uncertainty over future prices which might disincentivise investment.
Operational efficiency	As prices are delinked from costs then this should create incentives for efficiency as GAL will effectively be a price taker rather than price maker. GAL will therefore retain any gains made from reducing opex, it would extend over the long term and would not be limited to a 5-year regulatory period.
Allow environmental measures	While it should be possible to pursue environmental measures such as the differentiation of charges according to noise impact, funding specific environmental investment may be more difficult if the same requirements are not present across the comparator set.
Transparent, accountable, proportionate, consistent and targeted	As the price cap is based on tariffs at other airports it should be transparent and the costs of regulation may be greatly reduced. Maintaining the same comparator set across the control period may provide consistency.
Practical implementation and stakeholder confidence	LF has demonstrated it is possible to identify a set of comparator airports for Gatwick, which include a number of airports that operate under light handed regulation. The comparator benchmark is also robust to some changes in the comparator set, although the inclusion or exclusion of Heathrow can have a significant impact. Nevertheless the choice of comparators is likely to be disputed by those parties that do not agree with the resulting benchmark. The benchmark could be vulnerable to unexpected shocks, which might be considered unfair by the airport operator and other stakeholders.

Source: CAA analysis

Price monitoring (in the absence of GAL's commitments)

Final proposals

I197 In the final proposals the CAA stated that a price monitoring and transparency regime would not set out an explicit price cap but would provide a backstop for regulatory action if behaviour was out of line with expectations. The CAA considered that this would have the advantage of encouraging greater discussion between airlines and the airport operator but raised concerns that, given the degree of market power held by GAL, significant passenger detriment could occur if GAL abused its market power before tighter controls could be reintroduced. The CAA was also concerned that unless it resolved the issue of an acceptable price now, this would create uncertainty to both GAL and airlines and would simply defer the assessment of an acceptable price. The CAA therefore considered that price monitoring on its own would not provide sufficient protection to be in passengers' interests.

Stakeholders' views

I198 Stakeholders did not provide any responses on price monitoring alone in response to the final proposals.

CAA's final view

I199 Price monitoring would not involve the CAA setting an explicit price cap to apply from April 2014. Instead, the CAA would expect GAL to exercise self-discipline and self-regulate its actions and take steps to ensure that it does not abuse its market power against a framework of a regulatory backstop to incentivise this behaviour.

I200 The CAA's role would be to monitor GAL's performance including its prices, service quality, investment and efficiency - with the threat of reintroducing tighter regulation if GAL's performance raised concerns about the exercise or abuse of its SMP.

I201 In principle, where there is a need for regulation to address a risk of exercise or abuse of SMP but that risk is relatively low, the threat of the regulator intervening may be sufficient to incentivise GAL to act as if it faced effective competition. If monitoring is effective, it would incentivise GAL to act as if it were subject to competitive constraints so as to bring acceptable prices and performance to customers without the need for direct regulatory intervention.

I202 Monitoring, if effective, has a number of benefits in terms of greater flexibility, reduced regulatory specification and reduction of the regulatory burden. If effective, it would also encourage GAL and the airlines to develop a more cohesive relationship than relying on the regulatory process for setting prices.

I203 The CAA's consultants FE developed and assessed alternative forms of a monitoring regime. FE identified three generic types of monitoring regime.

- Option A: a regulatory regime where the airport operator’s charges are monitored against an external price, benchmarked and automatically capped if beyond a pre-defined level.
- Option B: an annual ex-post review of prices and outcomes, without a prescriptive ex-ante price cap but with transparency on a range of monitoring indicators on charges, financial performance, investment and service quality and a set of high level criteria against which CAA would assess performance.
- Option C: a light touch approach, with the airport operator entering into a voluntary code of conduct before the start of Q6 with less frequent reviews of prices and outcomes. Such a code of conduct would go well beyond the requirements of the ACRs and would involve meaningful commitments to cost transparency, information provision, dispute resolution and agreement on charges.

I204 FE considered that of the three options, option A, would be less beneficial than the other options. FE considered that as option A included an automatic movement to ex-ante price control regulation it would effectively be considered by the airport operator as a price cap. The cap could also be subject to unexpected shocks or changes in charges at individual comparator airports. In addition the time lag to comparative data becoming available would mean that assumptions would need to be made on prices in individual years, with adjustments in subsequent years. This would create uncertainty for the regulated airport operator, its investors and customers.

I205 FE did not express a preference between options B and C, although it suggested that option C, the lightest touch option, would require the airport operator to face meaningful competitive constraints across a significant proportion of its revenue base. The CAA would also need to be convinced that the airport operator was committed to working with its customers in a normal commercial manner and could reach agreement with them without regulatory involvement.

I206 The CAA's market power assessment for GAL indicates that it is likely that it will not face effective competitive constraints across a significant proportion of its revenue base. Given the diverse mix of airline business models at the airport, GAL is more likely to reach bilateral agreements with individual airlines rather than an agreement with all airlines on overall charges as required under option C. Consequently the CAA has focused its assessment on option B, price monitoring based on an annual ex-post review of prices and outcomes.

I207 FE considered that price monitoring could be an effective form of regulation, if:

- the airport operator accepts and understands the need for self-regulation (within a price monitoring regime);
- there is a credible and understood threat of price control re-regulation, if the airport operator is found to be abusing its market power;
- the reputational consequences to an airport operator of being found to have abused its SMP are unattractive; and
- the financial consequences of ex-ante price control regulation should be unfavourable.

I208 The CAA has considered two options for price monitoring: price monitoring in the absence of commitments, and price monitoring with commitments. The CAA considers it unlikely that GAL, with its degree of market power, would discipline itself and withstand the temptation to take advantage of the freedoms that the removal of ex-ante price controls and a switch to ex-post monitoring would give it. The CAA notes GAL's behaviour identified in the market power determination, in particular that:

- GAL has argued throughout the review that its prices are too low, i.e. below the competitive level, and would need to increase; and

- airlines that represent a significant volume of traffic at Gatwick appear to have little countervailing buyer power, with GAL largely setting the terms that an airline will receive in any negotiations so that the scope for negotiation is limited. The CAA notes that the bilateral contracts that have so far been agreed appear to be a function of the commitments and the CAA's final proposals.

I209 Against this backdrop, it is not clear how a switch to a price monitoring regime, in the absence of reasonable and effective commitments at Gatwick, could work.[163] GAL has clearly set out its reading of the market and signalled its pricing intentions. If the CAA were now to remove GAL's price cap and give the airport operator the freedom to set prices at a level of its choosing, in the absence of reasonable and effective commitments, subsequent disagreements between GAL and the CAA about the exercise of market power could be inevitable. This would most likely cause the CAA to challenge GAL's price increases and seek some form of remedy or tighter regulation.

I210 The CAA is of the view that it is better for all parties to resolve the difference of views that GAL and the CAA have about prices now as part of the Q6 review process (for example through the use of an explicit benchmark price) rather than in 1-2 years' time as part of an ex-post investigation into actual pricing behaviour under a monitoring regime. This will ensure that avoidable detriment is not imposed on users. It will also give greater certainty to GAL and users about the appropriate price path for the next five years.

Figure I.9: Appraisal of price monitoring type ex-post licence conditions for GAL

Criteria	Assessment
Price protection	Price monitoring leads to self-regulation of prices. If self-discipline is not evident then there will be a switch to default price caps and more formal price control regulation, although given the issues identified in the market power assessment significant passenger detriment could occur before price controls are reintroduced.
Service quality protection	Service quality could be transparently monitored where poor

[163] If the CAA considered that GAL's commitments were reasonable and effective in the absence of a licence and therefore in passengers' interests then it is unclear why a licence was required at all.

Criteria	Assessment
	performance could lead to a switch to default price caps and price control re-regulation. Although given the issues identified in the market power assessment significant passenger detriment could occur before price controls are reintroduced.
Promote competition	The intention of this option is that the airport operator would behave in the same way as airport operators without SMP. From the market power assessment it is not clear that GAL would behave in this manner.
Allows efficient business to finance its activities	There is no reason why an airport operator would set prices at a level that does not permit it to finance its activities.
Efficient and effective investment	An airport operator would not be constrained from bringing forward efficient new investment plans, which could be taken into account when setting prices.
Operational efficiency	Cost efficiency would be one of the indicators that could trigger a switch to default price caps and, ultimately, ex-ante price control regulation. Although again this would depend on the level of prices and the incentive they place on being efficient.
Allow environmental measures	There is no reason why environmental measures could not be introduced under a price monitoring regime.
Transparent, accountable, proportionate, consistent and targeted	There should be no reason why the rules in this option would not be understood clearly by all parties, it therefore is capable of satisfying the better regulation principles. There could however be uncertainty over when the CAA may choose to introduce greater regulation. Airlines are likely to argue that the controls in price monitoring are likely to be insufficient to control the market power held by the airport operator.
Practical implementation and stakeholder confidence	This option requires stakeholders to believe that an airport operator will behave responsibly. It cannot be guaranteed that stakeholders will have this belief.

Source: CAA analysis

Price monitoring combined with GAL's commitment proposals

Final proposals

I211 In the final proposals the CAA stated that price monitoring (which would be in a licence) combined the GAL's commitments regime (which would be outside the licence) would have benefits above price monitoring alone from the additional protection provided by the commitments but much would rest on the commitments themselves and a commitments and licensing regime would have additional benefits from greater enforceability.

Stakeholders' views

I212 GAL stated that given its commitments a price monitoring regime was unnecessary. There were no other stakeholder responses on price monitoring.

CAA's final view

I213 Price monitoring might, if combined with GAL's commitment proposals, be a more effective form of regulation than price monitoring alone. The annual report under price monitoring would allow transparency on the main information that airlines might need to negotiate on behalf of users. It would also allow a quicker enforcement route for airlines compared to the commitments alone.

I214 GAL does not provide reasons why it considers that price monitoring is unnecessary with the commitments. The CAA notes that this is contrary to the position of GAL's own consultant Professor Littlechild who supported a monitoring regime to be associated with the commitments. The CAA also notes that in response to the initial proposals GAL stated that the CAA should have placed more evidence on the presence of the commitments in its assessment of price monitoring. As set out earlier in this appendix the CAA considers that the commitments provide GAL with a number of flexibilities. While these flexibilities provide GAL with scope to tailor the offer to individual airlines and their passengers, they also increase risks that GAL could abuse its position of SMP.

I215 Given the points raised above on the potential risks of abuse, much of the burden from preventing abuse of SMP would rest on the commitments rather than the price monitoring regime itself, in particular as the commitments provide a range of protections normally provided in a regulatory settlement. Consequently the CAA considers it will be important to ensure that the terms in the commitments are reasonable and effective from the perspective of users. As set out above the CAA has concerns with the enforceability of the commitments and with a number of terms within the commitments. Consequently, price monitoring with commitments is likely to suffer from as many of the enforceability issues as commitments alone, albeit that the monitoring will improve transparency and the licence will provide some benefits from being able to intervene in the interests of end users and improving the speed of response. Nevertheless, there will continue to be issues with the enforcement of the commitments in the absence of effective licence conditions. It would also not be clear to GAL or the airlines whether the CAA considered the price or terms in the commitments were consistent with an effective market. This option is therefore likely to be less beneficial than a commitments and licensing framework on grounds of enforceability. It would also not include the licence protections proposed for the licence-backed commitments regime on second runway costs and financial resilience. There would also be similar costs from the price monitoring regime itself. Consequently, the CAA does not consider that price monitoring with commitments should be taken forward.

Figure I.10: Appraisal of price monitoring with commitments for GAL

Criteria	Assessment
Price protection	Given the issues identified above, much of the burden for preventing the abuse would rest on the commitments and the terms in the commitments would need to be fair to airlines and users. Price monitoring will not be able to enforce the commitments directly and so is likely to be less effective than a commitments and licensing framework.
Service quality protection	Much of the burden for preventing the abuse would rest on the commitments and the terms in the commitments would need to be fair to airlines and users. As above price monitoring would not be able to directly enforce the commitments and so is likely to be less effective than a commitments and licensing framework.
Promote competition	The intention of this option is that the airport operator would behave in the same way as airport operators without SMP. While the commitments would provide some additional protection they would need to be reasonable and effective for airlines and users. The CAA does not consider that this is the case.
Allows efficient business to finance its activities	There is no reason why an airport operator would set prices in commitments at a level that does not permit it to finance its activities.
Efficient and effective investment	The commitments or the price monitoring regime would not constrain the airport operator from bringing forward efficient new investment,

Criteria	Assessment
	although consultation arrangements would be needed to ensure that this would be in users' interests.
Operational efficiency	Operational efficiency incentives are more likely to be dependent on the terms in the commitments rather than the threat of re-regulation through price monitoring.
Allow environmental measures	There is no reason why environmental measures could not be introduced.
Transparent, accountable, proportionate, consistent and targeted	There should be no reason why the rules in this option would not be understood clearly by all parties, it therefore is capable of satisfying the better regulation principles. Airlines may have greater confidence in this regime than in price monitoring or commitments alone, however much of the protection would come from the commitments themselves and licence enforcement of these may be a more proportionate response although it may not be transparent when the CAA would intervene.
Practical implementation and stakeholder confidence	This option requires stakeholders to believe that an airport operator will behave responsibly. The commitments provide an indication of what can be expected from GAL, however as a price monitoring regime would not directly enforce the commitments, concerns with enforceability may remain.

Source: CAA analysis

Conclusions

I216 The Act provides an opportunity for the CAA to introduce flexible and pragmatic forms of economic regulation that are better tailored to the risks of abuse of SMP and the interests of passengers. The CAA's minded to market power assessment found that GAL holds SMP.

I217 While not acknowledging that it has SMP, GAL has put forward airport commitment proposals which offer many of the same protections to airlines and passengers that would be available under a regulatory settlement. The CAA welcomes these proposals, and in particular the changes that GAL has made to the commitments to address the previous concerns raised by airlines and the CAA. However, the CAA remains concerned that the enforceability and some of the terms of the commitments are such that, in the absence of a licensing and monitoring framework, they would not offer sufficient protection against the risk of abuse and/or would not further passengers' interests.

I218 The CAA has therefore considered what form of regulation should be implemented under a licence. The CAA considers a 7-year commitments and limited licensing framework could be an effective form of regulation for GAL. This is on the basis that:

- the enforcement concerns about the commitments concept would be addressed through the statutory enforcement process applicable from the licence;
- there would be additional licence conditions to ensure that significant costs incurred on the second runway costs are subject to full regulatory treatment and enforce financial resilience; and
- there would be an effective monitoring framework to ensure that the additional flexibility of the commitments promotes passengers' interests.

I219 As set out in the final proposals the CAA does not consider that LRIC, airport comparator benchmarks or price monitoring would provide adequate protection and they would not be in passengers' interests.

I220 Given the degree of market power held by GAL, the CAA continues to consider that a RAB-based framework could also be an appropriate form of regulation for GAL. A RAB-based framework is well understood and widely used across regulatory sectors. It provides price and service quality protection to passengers, while providing incentives for efficiency and has support from airlines. Unlike at Stansted, there is less uncertainty over individual building blocks and the value of the RAB does not appear to be out of line with the investment requirements of passengers.

I221 On balance, the CAA considers that a commitments plus limited licensing framework and effective monitoring would better further passengers' interests and, where appropriate, promote competition (although the CAA acknowledges the scope for competition is limited). In the case of GAL, commitments offer a number of benefits over a RAB-based framework from the additional flexibility and greater potential for bilateral contracts which could allow better tailoring to the needs of individual airlines and their passengers. This would not only enhance choice and value to passengers, but would also facilitate airport competition although given that GAL has SMP this is likely to be limited in scope. The commitments would also provide other benefits above a RAB-based framework from:

- the greater certainty to airlines and their passengers as they are for seven rather than five years;
- the strengthening of the airline and airport operator relationship as the commitments are to airlines rather than the CAA which would reduce management distraction; and
- avoiding some of the distortions to incentives that would be present under a RAB-based framework, for example in relation to investment incentives, and it would encourage rather than crowd out a more commercial approach.

I222 A commitments and licensing and monitoring regime would also reduce the direct costs of regulation compared to RAB-based regulation. In particular the CAA considers that GAL's costs of regulation would be reduced from less management distraction, a greater focus on airport operator-airline relationships and the increased flexibility around capex. The CAA considers that the additional costs to GAL and airlines from licence-backed commitments would be small compared with a commitments only regime given the main focus of the licence is to ensure the enforceability of the commitments. In this regard a licence could actually reduce costs as it would reduce the risk of legal disputes. This contrasts with a RAB-based approach which would still involve significant costs even if costs could be reduced through improved flexibilities and a less onerous capex consultation process. The CAA does not however consider that a licensing and monitoring regime would reduce its annual direct costs compared to a RAB given the need for on-going monitoring, however these costs should reduce over time if the regime is successful and the costs of any periodic review would be spread over seven rather than five years.

I223 A supporting licence and monitoring regime would ensure that the commitments furthered passengers' interests by requiring GAL to comply with the commitments in a manner that furthered their interests. In addition it would allow the CAA to enforce the commitments and so ensure that the additional flexibilities in the commitments were furthering passengers' interests. The statutory framework applicable to a licence confers a range of intervention tools, ranging from modifying and/or introducing new licence conditions to enforcement. In appropriate cases, the CAA would be entitled to proceed with interim remedies or to impose penalties for breach. Importantly, a breach of the commitments would result in a direct actionable right of damages for any person affected by the breach (including passengers and cargo owners as well as airlines). Accordingly, there are real benefits from the licence framework in terms of enforcement and deterrence that are not provided by the voluntary contractual commitments on their own.

I224 The CAA considers that the commitments, licensing and monitoring regime would be consistent with the better regulation principle that regulation should be targeted only in cases where action is required, for example on second runway costs and financial resilience, while allowing the CAA to increase regulation if GAL cannot develop the good relationships with airlines that would be important for an effective regime. On this basis the CAA considers that its final view for the regulation of GAL should be based on commitments and a licensing and monitoring framework.

I225 The CAA emphasises that the conclusion that a commitments, licensing and monitoring regime is the most appropriate form of regulation for GAL is based on the specifics of the airport operator and its market position. It is also based on the regime as a whole and there should not be any read across that any elements of the regime, for example the service quality or operational resilience requirements, would be relevant to the specific circumstances of other airport operators or regulatory regimes.

APPENDIX J

Shadow RAB calculation

Purpose and basis of the calculation

This appendix specifies the detail of the formulae that GAL will need to use for tracking the RAB.

The equations set out below are based on the projections made by the CAA in reaching its final decision on the charge conditions for the control period after 1 April 2014.

Each year, each RAB is expressed in actual end year price levels. The modelling used fixed 2011/12 price levels and the figures below must be uplifted to current price terms each year.

Retail Price Index ("RPI") Growth t from 2011/12	=	The RPI (as defined in the Condition) at the end of the financial year t divided by the average of the monthly RPI figures for the financial year 2011/12,which (based on the All Items index[164] and based on 13 January 1987 = 100) equals 237.3
Annual RPI Growth t	=	The RPI at the end of the financial year t divided by the RPI at the end of the financial year t-1
Within Year RPI Growth t	=	The RPI at the end of the financial year t divided by the average of the monthly RPI figures for the financial year t

164 All Items (CHAW) index, source ONS.

This section describes how GAL's RAB will be rolled forward from one year to another.

Opening RAB t	=		For the financial year 2014/15, this figure will be set according to the following formula: £ 2,471.402 million x RPI Growth from 2011/12
		+	Actual Capex 2013/14 x RPI Growth from 2013/14
		-	£189.215 million x RPI Growth from 2011/12
		-	(Actual proceeds from Disposals 2013/14) x RPI Growth from 2013/14)
	=		For the remaining financial years, this figure will be set according to the following formula: Closing RAB t-1 x Annual RPI Growth t

Closing RAB t	=		Opening RAB t
		+	(Total Actual Capex t x Within Year RPI Growth t)[165]
		-	(Proceeds from Disposals t)
		-	(CAA's Assumed Depreciation t x RPI Growth from 20011/12)

Assumed Depreciation t in 2011/12 prices	=	For each financial year this figure will be fixed at the following values:	
		Financial year 2014/15:	£149.795 million
		Financial year 2015/16:	£156.459 million
		Financial year 2016/17:	£153.593 million
		Financial year 2017/18:	£142.077 million
		Financial year 2018/19:	£151.243 million
		Financial year 2019/20:	£153.505 million

165 Accrued capex with no adjustment for movements in working capital.

Financial year 2020/21: £153.923 million

APPENDIX K

Glossary

Abbreviations	
1982 Act	Civil Aviation Act 1982
1996 Act	Housing Grants Construction and Regeneration Act 1996
AA86	Airports Act 1986
ACAS	Advisory, Conciliation and Arbitration Service
ACC	Airline Consultative Committee
ACL	Airport Coordination Limited
ACRs	Airport Charges Regulations
ACTM	Airport Commerce and Talent Management
AGRs	Airports (Groundhandling) Regulations 1997
AMD	archway metal detectors
ANS	air navigation services
AOC	Airline Operators Committee
ASA	Alan Stratford and Associates
ASQ	Airport Service Quality
ATCO	air traffic control officer
ATMs	air transport movements
ATRS	Air Transport Research Society
BAA	BAA plc
BA	British Airways
BIS	Department for Business, Innovation and Skills
BoE	Bank of England
capex	capital expenditure
CAT	Competition Appeal Tribunal
CC	Competition Commission
CE	Constructive Engagement
CEPA	Cambridge Economic Policy Associates

Abbreviations	
CF	Consensus Forecasts
CIP	capital investment programme
CL	Compass Lexicon
CMA	Competition and Markets Authority
COPI	construction price inflation
COU	Conditions of Use
CSP	continuity of service plan
DB	defined benefit
DC	defined contribution
DDA	Disabled Discrimination Act
DfT	Department for Transport
DL	Davis Langdon
DNOs	distribution network operators
EBITDA	earnings before interest, taxes, depreciation and amortization
EE	Europe Economics
EU	European Union
EU261	Regulation (EC) 261/2004
FE	First Economics
FEGP	fixed electrical ground power
FFO	funds from operations
FP	final proposals
FTE	Full Time Equivalent
FTI	FTI Consulting LLP
FV	final view
GAD	Government Actuary's Department
GAL	Gatwick Airport Limited
GATCOM	Gatwick Airport Consultative Committee
Gatwick	Gatwick airport
GDP	Gross Domestic Product
HAL	Heathrow Airport Limited
HBS	hold baggage screening

Abbreviations	
IAG	International Airline Group
IAPA	International Airline Passengers Association
IATA	International Air Transport Association
IBP	initial business plan
ICR	adjusted interest cover
IDL	International Departures Lounge
IDS	IDS Thomson Reuters
IP	initial proposals
JSG	Joint Steering Group
LCCs	low cost carriers
LECG	LECG Corporation
LF	Leigh Fisher
LGW	London Gatwick Airport
Licensee	Gatwick Airport Limited
LRAIC	long-run average incremental costs
LRIC	long-run incremental costs
M&G	meet and greet
MDI	Managing Director's Instructions
MEAV	modern equivalent asset value
MPD	market power determination
MPT	market power test
NATS	NATS Holdings
NERL	NATS (En Route) plc
NIE	Northern Ireland Electricity Limited
NPV	net present value
NT	North Terminal
OBR	Office of Budget Responsibility
OFT	Office for Fair Trading
ONS	Office of National Statistics
opex	operating expenditure
ORCs	other regulated charges

Abbreviations	
ORR	Office of Rail Regulation
PAG	Passenger Advisory Group
pax	passenger
PMICR	post-maintenance interest cover ratio
PPP	Purchasing Power Parity
PRMs	passengers with reduced mobility
PSL	pier service level
Q5/Q5+1	the fifth quinquennium
Q6	the sixth quinquennium
QSM	quality of service measure
RAB	regulatory asset base
RAR	regulatory asset ratio
RBB	RBB Economics
RBP	revised business plan
RPI	retail price index
S&P	Standard & Poor’s
SDG	Steer Davies Gleave
SERAS	South East Regional Air Services
SLG	SLG Economics
SMP	substantial market power
SQR	Service Quality Rebate
ST	South Terminal
STAL	Stansted Airport Limited
TDA	Tobacco Display Act
TFP	Total Factor Productivity
the Act	Civil Aviation Act 2012
the airlines	the airlines operating at Gatwick airport
URS	URS Infrastructure & Environment UK Limited
Virgin	Virgin Atlantic Airways
WACC	weighted average cost of capital
WDF	World Duty Free

Abbreviations	
WICS	Water Industry Commission for Scotland