

Economic regulation: A review of Gatwick Airport Limited's commitments framework

A consultation document

CAP 1387



Published by the Civil Aviation Authority, 2016

Civil Aviation Authority,
Aviation House,
Gatwick Airport South,
West Sussex,
RH6 0YR.

You can copy and use this text but please ensure you always use the most up to date version and use it in context so as not to be misleading, and credit the CAA.

First published March 2016

Enquiries regarding the content of this publication should be addressed to: economicregulation@caa.co.uk
Consumers and Markets Group, CAA, 4th Floor, CAA House, 45-59 Kingsway, London WC2B 6TE.

The latest version of this document is available in electronic format at www.caa.co.uk, where you may also register for e-mail notification of amendments

Contents

Contents	3
Executive summary	4
Purpose of this document	4
Proposed scope of our review	4
Next steps	6
Views invited	7
Chapter 1	8
Economic regulation of GAL	8
Our primary statutory duty	8
Summary of the Q6 review process	9
Overview of GAL's licence and commitments	10
Our reasons for preferring GAL's commitments to a RAB-based price cap	12
Monitoring the commitments	13
Chapter 2	15
Summary of recent developments	15
Traffic growth	15
Investment	17
Airport charges	19
Service quality	20
Chapter 3	23
Proposed scope of our mid-term review	23
GAL's service quality and airport resilience	24
GAL's investment performance	25
GAL's relationship with airlines and other stakeholders	27
Other issues within the proposed scope of the review	28
Issues not in the proposed scope of the review	28

Executive summary

Purpose of this document

1. In 2014 we changed the way that we regulate the charges and services Gatwick Airport Limited (GAL) offers to airlines – and ultimately passengers. Specifically, we moved from using a price cap calculated by us to a more deregulatory approach of relying on specific commitments given by GAL. They cover, among other things, the maximum level of airport charges that GAL can levy over the seven years from April 2014 to March 2021, and a system of rebates if GAL misses certain service quality targets.
2. We issued an economic licence for GAL, as we found that it met the requirements of the market power test in the Civil Aviation Act 2012 ('the Act'). GAL's commitments were backed by obligations included in this licence and hence enforceable by us. In addition to offering a suite of commitments applicable to all airlines, GAL also entered into a number of bilateral commercial contracts with individual airlines.
3. We said that we would carry out a 'short and focused' review of the new commitments framework in the second half of 2016, to consider whether it was operating in passengers' interests.
4. The purpose of this consultation document is to seek views from all interested parties on the proposed scope of our mid-term review before we formally launch it later this year.

Proposed scope of our review

5. The overarching aim of the review will be to identify any aspect of the new framework that is acting against the interests of passengers. The Act gives us a single primary duty to further the interests of users of air transport services.
6. In the short time since the new framework was introduced, traffic growth has been significantly stronger than expected and GAL has held its charges below what we calculated a 'fair price' to be in 2014. Passengers have suffered delays, however, as on-time performance at the airport has been relatively poor in each of the last two summers.

7. Poor on-time performance in recent summers, when combined with strong traffic growth, raises questions about future capacity requirements and also whether stakeholders are working together effectively to deliver a better service for passengers. With this in mind, we expect the main focus of the review to be on issues within GAL's commitments framework that could influence on-time performance:
 - GAL's service quality and airport resilience;
 - GAL's investment performance; and
 - GAL's relationship with airlines and other stakeholders.
8. We recognise that on-time performance may be influenced by the actions of others such as airlines, ground handlers and air navigation service providers. We will also want to take into account evidence of on-time performance this summer, or any other changes that affect the service provided to passengers.
9. In relation to GAL's service quality and airport resilience, the main issues that we expect to cover include:
 - how the current service quality targets and rebates were agreed, whether they appear to be working well, and any possible risk of distortions especially in relation to on-time performance;
 - how all parties are working within the new commitments framework to deliver an appropriate level of service quality and performance; and
 - how passengers' interests are taken into account.
10. When reviewing GAL's investment performance, we expect to consider questions such as:
 - how its investment programme has changed compared with the programme we considered during the last periodic review (Q6) and the main reasons for this;
 - whether there is any evidence that GAL's investment decisions have affected on-time performance (or are likely to do so in future); and
 - how passengers' interests are taken into account.
11. When addressing GAL's relationship with airlines and other stakeholders, we expect to consider questions such as:
 - whether airlines have sufficient opportunities for constructive dialogue with GAL, either individually or collectively;

- whether the overall framework is working in a way that encourages parties to work together to deliver a better service for passengers; and
 - whether sufficient attention is given to passengers' interests during discussions between GAL and airlines.
12. We also propose to briefly review certain other issues, such as how GAL's bilateral contracts are operating in practice and the level of airport charges.
13. This consultation takes place against the backdrop of the Government developing its response to the work of the Airports Commission on new runway capacity in the South-East of England. We have already published a number of documents on our proposed approach to the regulation of new runway capacity. These include a Policy Update in September 2015,¹ setting out our current thinking on a range of issues, and a further Policy Update in February 2016 specifically on the treatment of planning costs associated with new runway capacity.²
14. Our mid-term review will focus on how the new framework is operating at present, rather than its potential suitability for regulating charges and services if GAL is given permission to build a second runway. Neither does the review cover the airspace change process (including changes to flight paths for aircraft landing and taking off at Gatwick), which is a separate process that is not affected by the form of economic regulation applied at Gatwick.³

Next steps

15. We expect to issue the final scope of our review in July 2016. At present, we expect to start the review in September and reach conclusions by the end of the year.

¹ CAP 1332, Economic regulation of new runway capacity – update. Available at www.caa.co.uk/cap1332.

² CAP 1372, Recovery of costs associated with obtaining planning permission for new runway capacity: policy update. Available at www.caa.co.uk/cap1372.

³ For more information see <http://www.caa.co.uk/Commercial-industry/Airspace/Airspace-change/Airspace-Change/>.

Views invited

16. We would welcome views on the proposed scope of our review. Please email them to economicregulation@caa.co.uk by no later than **noon Friday 6 May 2016**. We cannot commit to take into account responses received after this date.
17. If you would like to discuss the issues raised in this document before the deadline please contact Stephen Gifford (stephen.gifford@caa.co.uk) or Stuart Holder (stuart.holder@caa.co.uk).
18. Responses will be made available on the CAA's website. Any material considered confidential should be clearly marked as such. Please note that we have powers and duties with respect to Section 59 of the Act and the Freedom of Information Act 2000.

Chapter 1

Economic regulation of GAL

Introduction

- 1.1 This chapter provides background to, and the outcomes from, the most recent regulatory settlement (Q6) at Gatwick. Specifically, this chapter describes:
- our primary statutory duty;
 - the process that led to our acceptance of the commitments;
 - GAL's licence and the commitments;
 - our main reasons for accepting the commitments rather than continuing to impose a formal price cap on GAL's charges; and
 - the current monitoring regime.
- 1.2 Further information on the Q6 settlement for GAL is available from our website.

Our primary statutory duty

- 1.3 The Act gives us a single primary duty to *further the interests of users of air transport services*. Under the Act, users of air transport services are defined as present and future passengers and those with a right in property carried by the service i.e. cargo owners.
- 1.4 The scope of our primary duty concerns the *range, availability, continuity, cost and quality of airport operation services*. We must carry out our functions, where appropriate, in a manner that will *promote competition in the provision of airport operation services*.
- 1.5 In discharging this primary duty, we must also have regard to a range of other matters.⁴ These include:
- the need to secure that GAL is able to finance its licensed activities;

⁴ See section 1(3) of the Act.

- to secure that all reasonable demands for airport operating services are met;
- to promote economy and efficiency in the provision of airport operating services;
- the need to secure that GAL is able to take measures to reduce, control or mitigate adverse environmental effects;
- any relevant guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and
- better regulation principles.

Summary of the Q6 review process

- 1.6 The Q6 review of GAL's charges started in 2011 with our initial 'setting the scene' consultation, and ended in 2014 with our final notice of the licence granted to GAL. The Q6 review was unusual, as it was carried out while the Civil Aviation Bill was passing through Parliament.
- 1.7 From an early stage in the review, we stated that we wished to explore the merits of some form of default regulatory settlement at Gatwick, which would provide greater scope for commercial agreements of service differentiation as compared with a traditional price cap underpinned by a regulatory asset base (RAB).⁵
- 1.8 In 2012, GAL put forward proposals for a framework based on airport commitments that would provide airlines with an agreed level of service at a capped average price, as an alternative to a RAB-based price cap. Initially, GAL's proposed cap was significantly higher than our own view of a fair price (based on our calculation of a traditional RAB-based price cap).
- 1.9 For the remainder of the Q6 review, therefore, we followed two parallel approaches. We continued to consider GAL's proposed commitments, which were revised several times before the end of the review, and we also continued to refine our own assessment of a fair price, using the same analysis and calculations that underpin a RAB-based price cap. This provided us with a suitable alternative if we could not accept GAL's final

⁵ See, for example, chapter 5 of '[Review of Price Regulation at Heathrow, Gatwick and Stansted Airports \("Q6"\): Policy Update](#)', May 2012 (archived).

commitments, and also established a strong basis for us to assess the reasonableness of the charges cap included in GAL's commitments.

- 1.10 By the end of the review, the cap included in GAL's commitments was close to our own view of a fair price.⁶ For the reasons summarised below, we decided to build our final proposals around the commitments offered by GAL. These commitments would be backed by a licence, to ensure that they were in fact honoured and to ensure we could continue to act where appropriate to protect passengers. We also made it clear that we would monitor how the new commitments and licensing regime was operating in practice. This is described in more detail below.
- 1.11 While we accepted GAL's commitments as the basis for regulating GAL in Q6, therefore, this was within an overall licence-based framework, and accompanied by a monitoring regime.

Overview of GAL's licence and commitments

- 1.12 We granted GAL's licence in February 2014. The commitments themselves also form part of GAL's Conditions of Use. The main provisions that make up the commitments include:⁷
- a price commitment – in summary this is based on price paths of the Retail Price Index (RPI) +0% for the blended price (which takes accounts of discounts agreed in bilateral contracts) and RPI+1% for the published price.⁸ GAL can trade-off under or over-recoveries in individual years, subject to any cumulative over-recovery of published prices not exceeding £10 million in any intermediate year (and zero by the end of the seven years), and the average published price not increasing by more than RPI+10% in any of the first six years;

⁶ At the time of CAA's final proposals, in October 2013, the cap in GAL's then proposed commitments was actually slightly lower than our assessment of the fair price. But this situation was reversed by the time of the notice granting the licence in February 2014.

⁷ Various administrative clauses also form part of the commitments, including applicability and enforceability; variation; and dispute resolution procedure.

⁸ In each case, the "price" refers to the average revenue per passenger from services and facilities connected with the landing, parking or taking off of aircraft and from selected ancillary services. There is also provision for a pass through of changes in security costs.

- a service standards commitment – similar to the service quality rebates included in GAL's Q5 price cap, there is a system of rebates payable if GAL misses certain service quality targets. The targets cover passenger satisfaction measures, security queues, passenger operational measures, airline operational measures and an aerodrome congestion term. GAL's performance is assessed monthly, and separately for each terminal. The maximum amount of revenue at risk is 6.75 per cent (South Terminal) or 7.25 per cent (North Terminal);⁹
- continuity of service plan, operational and financial resilience – an obligation to prepare and maintain plans on continuity of service and operational resilience. The continuity of service plan must be provided to us and amended in line with our reasonable requirements, and GAL must consult stakeholders (including us) annually on the operational resilience plan. It is required to have regard to any guidance that we issue on the operational resilience plan. In addition, GAL must provide an annual confirmation of adequate resources and obtain our approval before making certain changes to its finance documents;
- an investment and consultation commitment – GAL will maintain the airport to comply with safety/environmental requirements and develop the infrastructure to allow it to meet service quality standards. To achieve this, it will invest at least £700 million during the seven years of the commitments. It will also consult airlines on its investment programme; and
- a financial information commitment – GAL will ensure that it provides either statutory accounts or an equivalent audited statement so that airlines can understand whether charges are reasonable. Each year it will publish its assessment of the value of its asset base.

1.13 GAL's licence states that:

- the commitments are conditions of the licence (which means, among other things, that they are enforceable by us);
- however, any obligations placed on third parties in the commitments shall not be treated as conditions of the licence;

⁹ The Conditions of Use also detail Airline Service Standards for check-in queues and arrival bag performance. Airlines that do not meet these standards may have any service quality rebates they would otherwise have received reduced by up to 1.5 per cent of GAL's revenues. These airline standards are not treated as conditions of GAL's licence.

- in complying with the commitments, GAL 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;
- GAL can only modify the commitments in accordance with specific provisions of the Conditions of Use – in summary the price path for the blended price and the service standards and rebates can be modified if this is agreed by airlines carrying at least 67 per cent of passengers or representing at least 50 per cent of airlines;
- if CAA modifies the licence,¹⁰ GAL will make any necessary consequential changes to its Conditions of Use; and
- GAL's automatic recovery of second runway costs will be limited to £10 million per year.¹¹

Our reasons for preferring GAL's commitments to a RAB-based price cap

1.14 Whereas our initial Q6 proposals for GAL were based on our own view of a fair price, our final proposals and the subsequent final decision were based on GAL's commitments, backed up by a licence and monitoring regime. As noted above, the cap included in GAL's commitments was close to our view of a fair price.

1.15 With the two frameworks offering a similar level of charges, our reasons for accepting GAL's commitments rather than implementing a RAB-based price cap were as follows:¹²

- the commitments would provide a better framework to diversify the service offering and incentivise volume growth, as they would encourage bilateral contracts that could be better tailored to the needs of individual airlines and their passengers;
- the commitments should promote competition by facilitating innovation and diversity of offer;

¹⁰ The process for this is set out in section 22 of the Act.

¹¹ Higher amounts can be recovered with the agreement of airlines or through a licence modification proposed by us.

¹² See CAP 1102, Economic regulation at Gatwick from April 2014: final proposals. Available at www.caa.co.uk/cap1102.

- the commitments would lock in lower future charges for longer (i.e. seven rather than five years), providing greater certainty to airlines and their passengers;
- the longer time period would provide GAL with greater incentives to reduce operating expenditure and outperform commercial revenue assumptions; and
- the commitments would facilitate efficient investment, as GAL would have flexibility to tailor investment to the needs of airlines.

Monitoring the commitments

1.16 We stated that we would implement a monitoring framework to review a number of areas. This would help ensure that GAL promotes passengers' interests and that any problems arising could be more easily addressed. We monitor a small number of areas on an ongoing basis. These include:

- the level of charges – rather than monitoring GAL's compliance with its commitments (RPI+1% and RPI+0% respectively for the published and blended prices), we said we would monitor prices against our fair price benchmark. Specifically, we will compare the outturn blended price with our view of a fair price (RPI-1.6%);
- service quality – if GAL misses a particular target for six months in a financial year then no further rebates are payable for that target during the rest of that year, thus reducing GAL's liability for repeated service failures. We said that we would undertake sufficient monitoring to enable us to identify an individual metric failing for more than six months;
- shadow RAB – we require GAL to calculate a shadow RAB, in case tighter regulation needs to be reintroduced;¹³ and

¹³ We also said, however, that there would be no presumption that GAL's shadow RAB number would be used as the basis for a future price cap.

- operational resilience – GAL is required to consult on and publish its operational resilience plan by 1 October 2014, and then to review the plan annually. We will continue to monitor GAL's commitment, as GAL has only committed to 'have regard to' any guidance issued by us. In the event of operational resilience problems that could have been avoided by GAL following our guidance, we will take this into account when determining the appropriate enforcement action.

1.17 GAL publishes an annual performance report. The first of these was published in July 2015. The public version of this report, which is available on GAL's website,¹⁴ includes information on traffic growth, airport charges (including a comparison with our fair price benchmark) and service quality. GAL has also published a report on traffic growth and service quality for the first half of 2015/16.¹⁵

¹⁴ Available at www.gatwickairport.com/globalassets/publicationfiles/business_and_community/regulation/economic_regulation/20150813-gal-performance-report-2014-15---public-version.pdf.

¹⁵ Available at www.gatwickairport.com/globalassets/publicationfiles/business_and_community/regulation/gal-performance-report-2015h1.pdf.

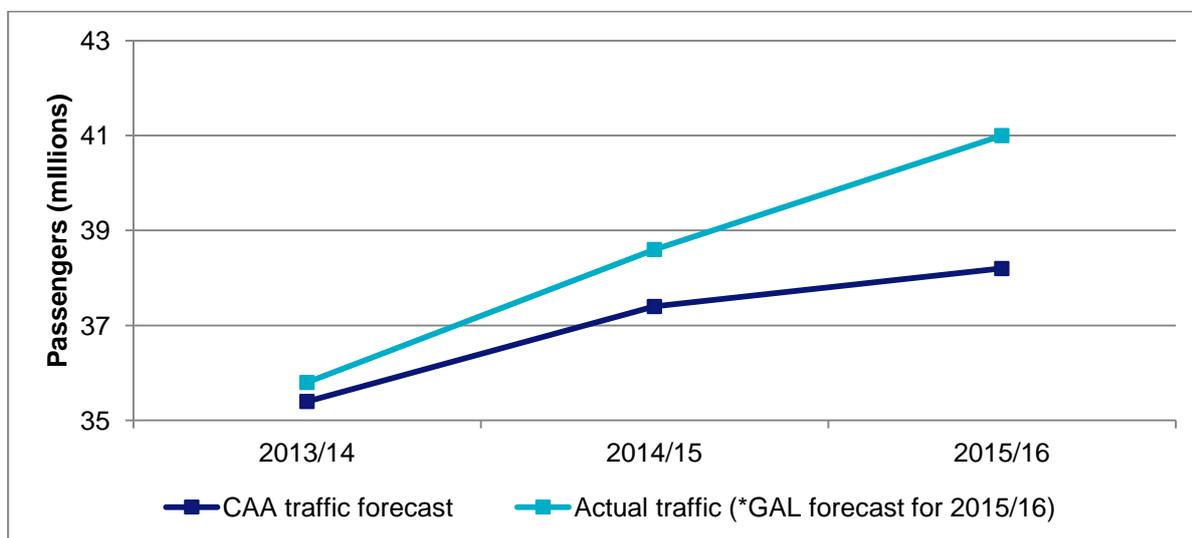
Chapter 2

Summary of recent developments

Traffic growth

- 2.1 The traffic forecasts underpinning our fair price calculations date from December 2013, and were therefore based on forecasts for the last few months of 2013/14 as well as the remainder of the price control period. We forecast relatively strong growth for 2013/14 and 2014/15, and more modest growth (between 1 and 2 per cent a year) for the rest of the period.
- 2.2 As shown in Figure 1, outturn passenger volumes have been substantially higher than our forecasts. GAL is expecting passenger traffic in 2015/16 to reach 41 million, which is higher than our forecast for the end of the commitments period (2020/21). GAL also expects strong growth to continue, and is predicting 42.5 million passengers in 2016/17.

Figure 1: CAA traffic forecast vs actual traffic



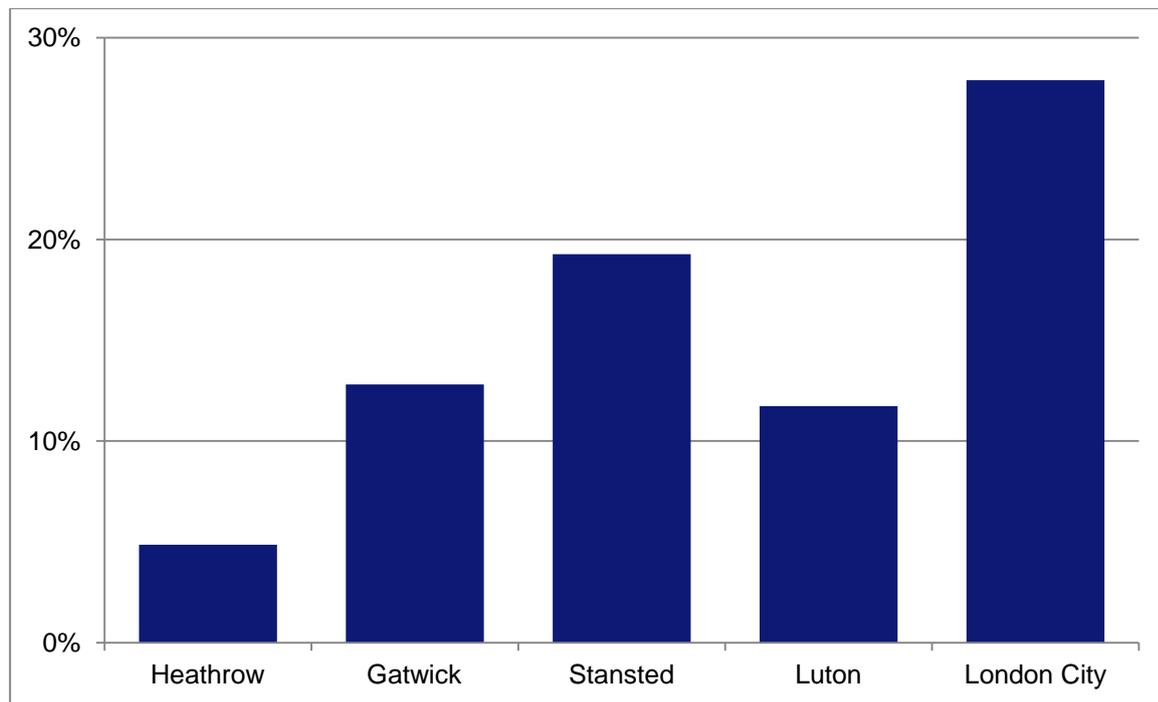
Source: CAA (CAP 1152), GAL forecasts and monthly traffic reports

- 2.3 Most other London airports have also experienced strong traffic growth, with the exception of Heathrow where growth is limited by capacity constraints. Growth at London City and Stansted airports has been particularly strong, though we note that this reflects a recovery following

slower traffic growth at these airports in the preceding period, and these airports also have fewer capacity constraints than Gatwick.

- 2.4 There has also been strong traffic growth at the largest airports in the rest of the UK. Manchester, Edinburgh, Birmingham and Glasgow airports have all seen passenger volumes increase by more than 10 per cent between 2012/13 and 2014/15.

Figure 2: Two year growth (2012/13 to 2014/15) in passenger numbers – London airports¹⁶

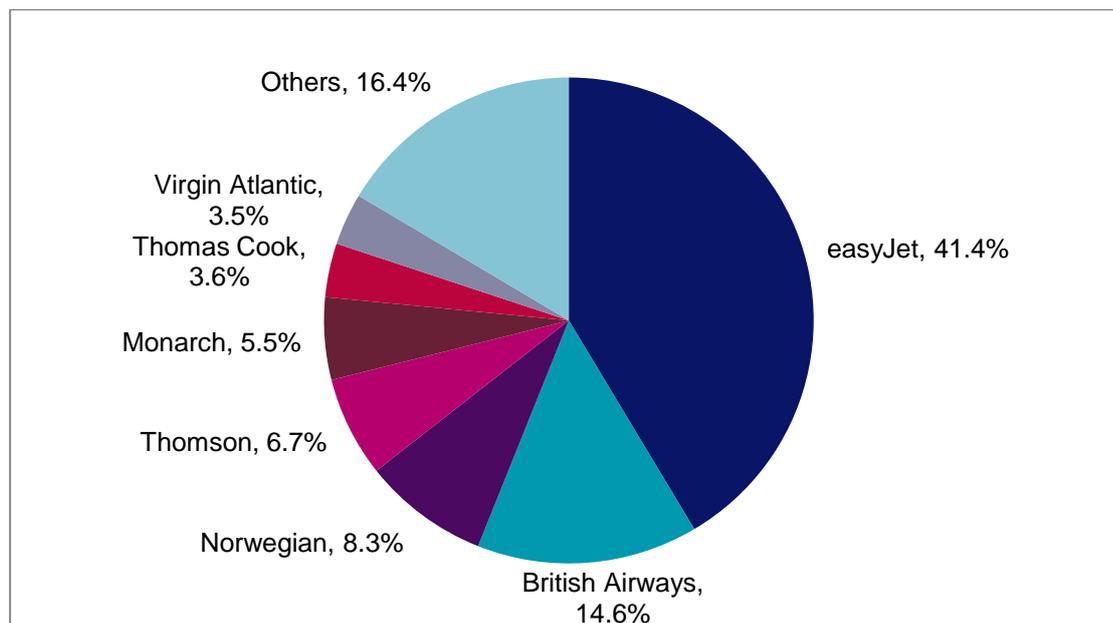


Source: CAA Statistics

- 2.5 While there have been some changes involving individual airlines, the composition of traffic at Gatwick has remained relatively stable. Short haul traffic accounts for around 85 per cent of passenger movements¹⁷ and two airlines, easyJet and British Airways, account for more than half of all passenger traffic.

¹⁶ This excludes Southend airport, which experienced even higher traffic growth from an initial base of 776,000 passengers in 2012/13.

¹⁷ This includes passengers who may be catching a short haul flight as the first leg of a long haul journey.

Figure 3: Share of passenger traffic by airline, 2014/15

Source: CAA Statistics

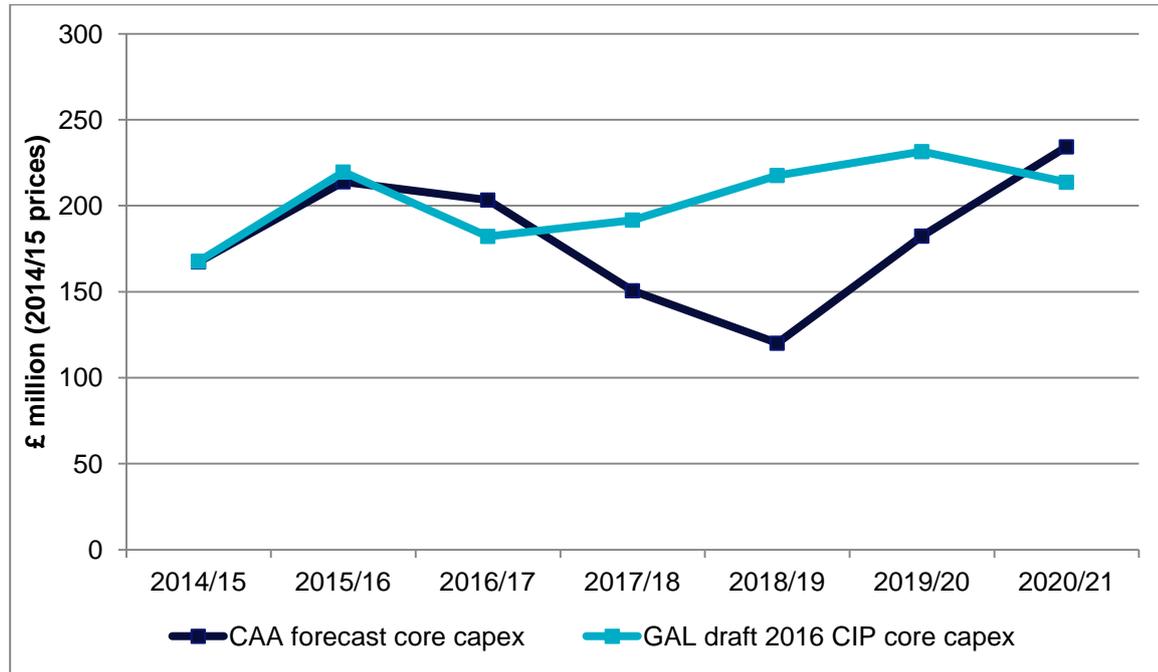
Investment

- 2.6 We based our calculation of a fair price benchmark around a capital expenditure (capex) forecast that showed GAL investing around £171 million a year¹⁸ over a five year period. In contrast, GAL's commitments include a minimum obligation to invest an average of £100 million a year over the seven year period of the commitments.
- 2.7 As shown in Figure 4, GAL's total capex was close to our forecast in 2014/15 and 2015/16, and therefore substantially higher than the annual average implied by GAL's minimum commitment.¹⁹

¹⁸ This is in 2014/15 prices. Our Q6 projection showed an average of £158 million in 2011/12 prices.

¹⁹ Figure 4 shows GAL's 'core' capex forecast. Its draft 2016 Capital Investment Programme also shows 'development' capex of between £33 million and £56 million a year between 2016/17 and 2018/19.

Figure 4: CAA forecast core capex vs GAL draft 2016 Capital Investment Programme core capex



Source: CAA (CAP 1152), GAL draft 2016 Capital Investment Programme

2.8 For the remainder of the period, the comparison between our original forecast and GAL's latest draft forecast reflects the combined impact of a number of different changes, including:

- the postponement of the Pier 6 Southern Extension project,²⁰ which accounted for £164 million of our five-year capex forecast. GAL has stated that the consolidation of easyJet's services in the North Terminal, which is planned for early next year, means that this capacity will not be required as early as previously thought. The core capex forecast in GAL's draft 2016 Capital Investment Programme now shows this expenditure occurring towards the end of the seven year period;

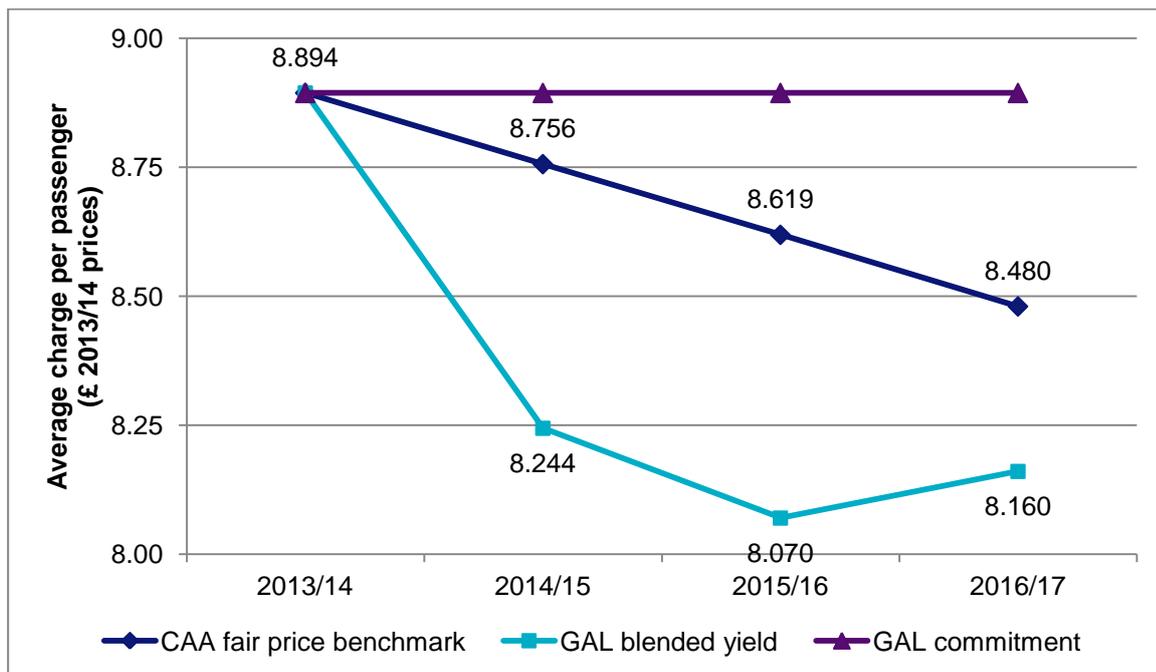
²⁰ This project is designed to provide additional stands in the North Terminal, so that GAL can continue to meet its target of 95 per cent pier service. We note that this project was not supported by some airlines, who questioned whether there might be alternative, lower cost solutions.

- the accelerated implementation of a number of investment projects that will be brought forward in order to meet expected passenger growth.²¹

Airport charges

2.9 We said we would monitor GAL's blended price (which takes account of discounts agreed in bilateral contracts) against our fair price benchmark of RPI-1.6%.²² As shown in Figure 5, GAL's average charges for the first two years of the commitments period were around 6 per cent below our fair price benchmark, and its charges for 2016/17 are forecast to be around 4 per cent lower than our benchmark.

Figure 5: Real terms comparison of airport charges



Source: GAL Performance Monitoring Report 2014/15, Airport Charges – Tariff Decision 2016/17

²¹ These include the North Terminal International Departure Lounge expansion, the North Terminal short-stay car park, Border Force expansions in both terminals and additional pier served stands. See www.mediacentre.gatwickairport.com/press-releases/2016/16-02-10-gatwicks-increases-investment-programme-and-calls-for-consultants-to-deliver-second-runway.aspx.

²² GAL's commitment for the blended price is a price path of RPI+0% over seven years.

Service quality

2.10 GAL has met the majority of its Core Service Standards since April 2014. The main exceptions have been:

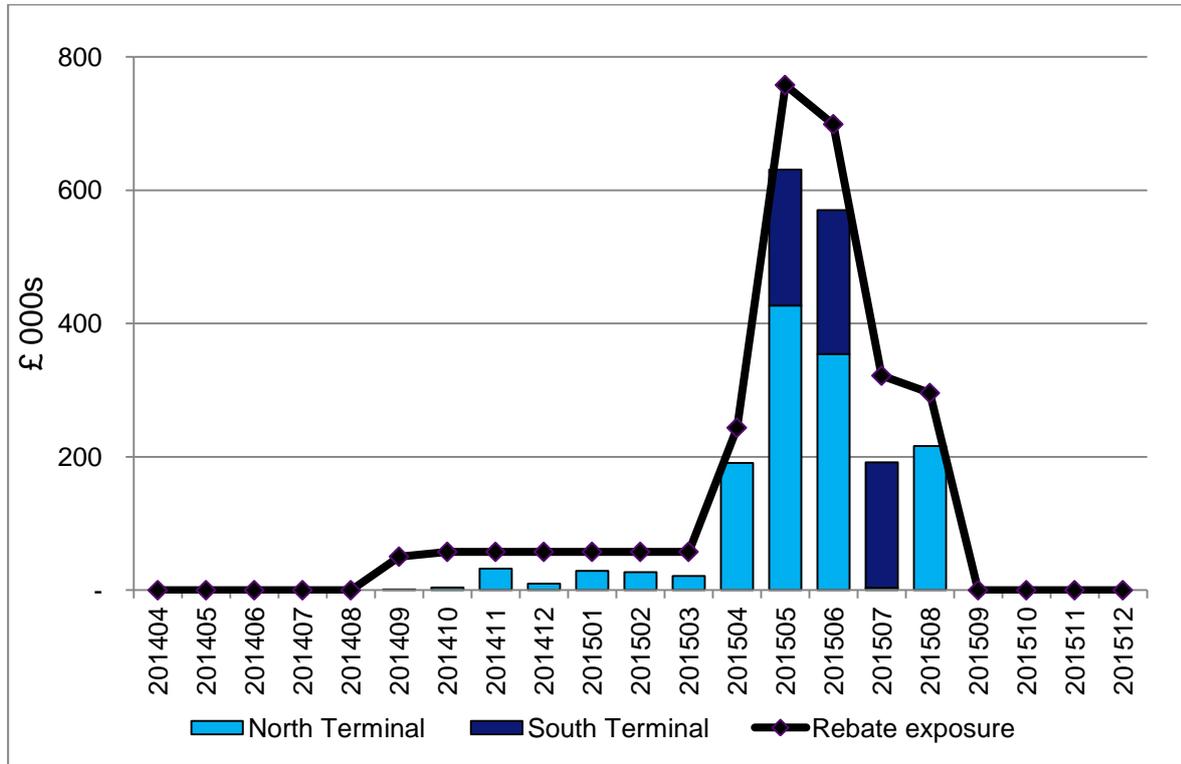
- failures to meet security queue time targets between May and August 2015, following the introduction and bedding in of a new security process and facilities;
- failures to meet certain airfield operational targets (availability of stands, jetties and fixed electrical ground power) between April and June 2015, as a result of delayed construction work;
- the cleanliness score for the North Terminal fell slightly below target between October 2014 and May 2015. This reflected the redeployment of cleaning staff to help with ground handling operations in summer 2014,²³ and the impact of construction works in the North Terminal; and
- three failures to meet the daily outbound baggage system target.

2.11 These have led to GAL paying rebates to airlines, as shown in Figure 6. In practice, GAL has paid less than the maximum amount payable for these failures (the 'rebate exposure' line in Figure 6), as the rebates can be reduced for individual airlines that fail to meet certain standards.²⁴

²³ The score is calculated as a 12-month moving average, therefore events in summer 2014 continued to affect GAL's compliance with the target in later months.

²⁴ Currently only arrivals bag performance, but this will also include check-in queue times in future.

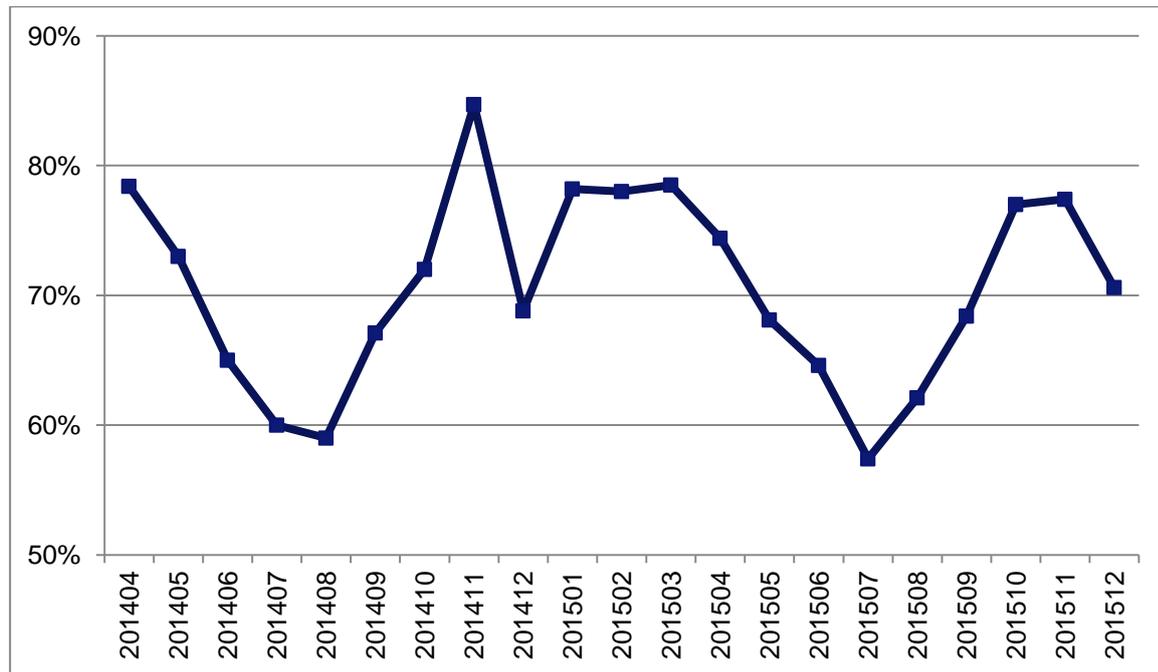
Figure 6: Service quality rebates



Source: GAL monthly performance reports

2.12 On-time performance is not included in the Core Service Standards. One reason for this is that it is affected by a number of different parties, including the airport operator, airlines, ground handlers and air traffic control. On-time performance at Gatwick has declined since 2012 and now lags behind that of other UK airports. Performance has dipped markedly in each of the last two summers, with more than 40 per cent of flights departing more than 15 minutes late in the worst months.

Figure 7: Departure punctuality (% of flights departing Gatwick within 16 minutes of scheduled time)



Source: GAL Monthly Performance Reports

- 2.13 Poor on-time performance in summer 2014 and 2015 was due in part to a combination of air traffic control delays and staffing problems experienced by certain ground handlers.²⁵ GAL also argues that ambitious airline schedules and turnaround times are further significant contributors to poor performance, whereas airlines disagree with this and argue instead that insufficient pier infrastructure and airfield congestion have also contributed.

²⁵ Swissport for British Airways in 2014, and Menzies Aviation for easyJet in 2015.

Chapter 3

Proposed scope of our mid-term review

Introduction

- 3.1 When granting the licence to GAL,²⁶ we said that we expected to ask stakeholders for their views and undertake a 'short and focused' assessment of the performance of the commitments. We clarified that we did not expect to carry out "a further building block" review in 2016, and would continue to compare GAL's charges with the fair price benchmark we established in 2014.
- 3.2 The review therefore represents an early 'health check' on a new regulatory framework, rather than a reopening of the conclusions we reached during the Q6 review. Our main aim is to identify any aspect of the new framework that is acting against the interests of passengers.
- 3.3 As described in chapter 2, traffic is ahead of forecast and charges are below those estimated at the last periodic review. Passengers have suffered delays, however, as on-time performance at the airport has been poor in each of the last two summers. At least some of this was due to events outside of GAL's control. Nevertheless, an important question for us to consider is whether the new regulatory framework has contributed to this poor performance or made it more difficult for GAL and airlines to work together to deliver a better service for passengers.
- 3.4 We also said that we expected GAL's capital plan to be a key component of the review, noting that GAL had not provided a commitment to deliver specific outputs beyond a certain minimum spend, and so could fail to deliver outputs that are in passengers' interests.
- 3.5 A further important issue is the current state of relationships between GAL and airlines. We said that if GAL can develop good relationships with airlines and the flexibilities within the regime are operating in passengers' interests, then there could be scope for a scaling back in our monitoring of the commitments over time.

²⁶ CAP 1152, Economic regulation at Gatwick from April 2014: Notice granting the licence. Available at www.caa.co.uk/cap1152.

- 3.6 We therefore expect the main focus of the review to be on these three issues: service quality and airport resilience, investment, and GAL's relationship with airlines and other stakeholders.

GAL's service quality and airport resilience

- 3.7 GAL's commitments include a system of service quality rebates if it misses certain targets (Core Service Standards), similar to those that applied while GAL was subject to a RAB-based price cap.²⁷
- 3.8 We are currently carrying out an audit of service quality regulation at both Heathrow and Gatwick airports. This is focused on the measurement and reporting of service standards and the accuracy and reliability of rebate calculations, rather than the actual level of performance or the effectiveness of the Core Service Standards and associated rebates.
- 3.9 The Core Service Standards cover many aspects of service quality that are important to passengers, but inevitably they focus on standards that are mainly under the control of GAL. On-time performance is important for passengers, but it can be significantly affected by the actions of other parties (including airlines, ground handlers and air traffic control) and is therefore not included in the Core Service Standards. This means that GAL does not face an explicit financial incentive to improve punctuality.
- 3.10 As a result, there could be a risk that on-time performance (and other aspects of service quality that are important to passengers, but not covered by the Core Service Standards) will be neglected. However, the flexibility provided by the commitments framework could also make it easier for GAL and airlines to work together to address any emerging or potential problems and to deliver a better service for passengers.
- 3.11 We hope on-time performance this summer will be better than in the previous two summers. However, one possible concern is that, while problems with ground handling or air traffic control may be the initial cause of some delays, the pressures created by strong recent traffic growth and a number of specific infrastructure constraints could magnify the effects of any disruption that does occur.

²⁷ The rebates are set out in Schedule 3 of GAL's Conditions of Use. Two differences from its previous system of service quality regulation are that GAL no longer receives bonuses for performance above the target standard, and any rebates payable may be reduced for airlines that do not meet certain Airline Service Standards for check-in queue times and arrivals bag performance.

- 3.12 Separate from this review, we are carrying out a wider analysis of the impact of congestion on punctuality (and how this affects passengers) at major UK airports. This will include an assessment of where passengers' interests lie in balancing capacity and on-time performance, and consideration of any appropriate policy recommendations.
- 3.13 For the mid-term review, our focus will be on how the commitments framework affects service quality and airport resilience. The main issues that we would expect to cover include:
- how the current service quality targets and rebates were agreed, whether they appear to be working well, and any possible risk of distortions especially in relation to on-time performance;
 - how all parties are working within the new framework to deliver an appropriate level of service quality and performance; and
 - how passengers' interests are taken into account.

GAL's investment performance

- 3.14 For our ongoing regulation of GAL during the course of Q6, the treatment of capex represents one of the most significant departures from our previous approach of RAB-based price caps. GAL's price cap for the previous price control period (Q5) included triggers that would reduce the cap if GAL missed delivery milestones for 10 specific investment projects it was expected to carry out during Q5. Heathrow Airport Limited's price cap also included similar triggers, and this approach has been retained for its current price cap. In addition, for Heathrow Airport Limited's current price cap we introduced separate categories of 'core' and 'development' capex, with transitions from development to core categories overseen by a Capital Portfolio Board.
- 3.15 In contrast, neither GAL's price commitments nor our view of a fair price are directly affected by whether or not GAL delivers the specific investment programme that underpinned our fair price calculation. Instead, GAL's obligations in relation to investment during Q6 are a general commitment to maintain and develop the airport, a specific commitment to invest at least £700 million during the seven year term, and a commitment to consult airlines and the Gatwick Passenger Advisory Group.

- 3.16 Our calculation of a fair price benchmark was based on an assumed investment programme of £855 million over five years.²⁸ Under the commitments framework, however, GAL has flexibility to tailor its actual investment programme to the needs of airlines and their passengers, and to respond to changes in market conditions.
- 3.17 As shown in chapter 2, outturn capex was close to our forecast for 2014/15 and 2015/16, and substantially higher than the annual average implied by GAL's minimum commitment. GAL's latest draft forecasts then show capex being below our forecast for 2016/17, but above our forecasts for the next three years. This reflects the combined impacts of, among other things, some rephasing of major projects (including the Pier 6 Southern Extension), some increases in the cost of committed projects, and some investment projects being brought forward.
- 3.18 While we would not expect to hold GAL to the specific investment programme that underpinned our fair price calculation, we would be concerned if changes to the programme had a material adverse effect on passengers' interests, for example because potentially beneficial projects had been postponed or cancelled without a good reason.
- 3.19 Equally, we would expect GAL to be proactive in making changes to its investment programme where these are necessary to maintain service quality and performance standards when market conditions change, or where there are new opportunities to improve services for passengers. Higher than expected traffic volumes, for example, could mean that some investment projects need to be brought forward as capacity constraints will start to affect operational performance earlier than previously expected.
- 3.20 When reviewing GAL's investment performance, therefore, we expect to consider questions such as:
- how its investment programme has changed compared with the programme we considered during the last periodic review (Q6) and the main reasons for this;
 - whether there is any evidence that GAL's investment decisions have affected on-time performance (or are likely to do so in future); and
 - how passengers' interests are taken into account.

²⁸ This is in 2014/15 prices. Our Q6 projection showed a total of £791 million in 2011/12 prices.

GAL's relationship with airlines and other stakeholders

- 3.21 There are several consultations with airlines that GAL is required to carry out under its commitments and/or its Conditions of Use. These include consultations on GAL's investment programme,²⁹ an annual consultation with all interested parties (including us) on GAL's operational resilience plan, and consultation with airlines at least annually (and in advance of any change) on GAL's charges.³⁰
- 3.22 Over and above these formal requirements, we would also expect GAL to consult airlines, passengers' representatives and other stakeholders on a wide range of issues concerning the current and future operation of the airport.
- 3.23 One potential advantage of a framework of bilateral contracts, rather than a settlement imposed by a regulator, is that this could lead to a mature and constructive relationship between GAL and its airline customers. Where such relationships exist, we would expect to see all parties working together in a flexible and co-operative way to deliver a high quality service to passengers.
- 3.24 In relation to GAL's relationship with airlines and other stakeholders, we expect the mid-term review to consider questions such as:
- whether airlines have sufficient opportunities for constructive dialogue with GAL, either individually or collectively;
 - whether the overall framework is working in a way that encourages parties to work together to deliver a better service for passengers; and
 - whether sufficient attention is given to passengers' interests during discussions between GAL and airlines.

²⁹ These include consultation with the Airport Consultative Committee and the Gatwick Passenger Advisory Group in advance of GAL publishing its rolling five year Capital Investment Programme, and consultation with airlines on individual major development projects

³⁰ This requirement to consult on charges arises from The Airport Charges Regulations 2011 rather than any specific provision of GAL's licence, Conditions of Use or its commitments.

Other issues within the proposed scope of the review

- 3.25 **Bilateral contracts** – As described in chapter 1, one of our reasons for accepting GAL's proposed commitments (rather than implementing a formal price cap) was that the commitments would encourage bilateral contracts, which in turn could allow service quality, capital investment, operational practice, volume commitments and price to be better tailored to the needs of individual airlines and their passengers. GAL has now entered into contracts with airlines covering over 80 per cent of passengers.³¹ As part of our review we propose to carry out a brief overview of these contracts to assess whether the aspiration we had in accepting the commitments framework has been achieved in practice.
- 3.26 **Level of airport charges** – GAL's calculations show that its blended price has been below our fair price benchmark, which suggests that the level of airport charges does not necessarily need to be the main focus of the mid-term review. Nevertheless, we believe the review should address some issues in relation to charges, such as:
- validating GAL's calculation of the comparison between its blended price and our fair price benchmark; and
 - discussing with GAL its current expectations of charges in future years, the factors that could lead it to revise this view, and the possible arguments for providing airlines with a forward view of expected charges for the remainder of the commitments period.

Issues not in the proposed scope of the review

- 3.27 In keeping with our commitment for a short and focused review that does not resemble a reopening of the 2014 settlement, we need to prioritise the issues we cover. There are a number of issues that we could consider, but have decided not to pursue unless stakeholders provide evidence to the contrary. These include:

³¹ See www.caa.co.uk/WorkArea/DownloadAsset.aspx?id=4294974422 (page 6).

- our monitoring framework, for example whether there are changes to the information that we monitor or that GAL and other parties publish, and how we should monitor GAL's performance during the remainder of the commitments period;
- operating expenditure and commercial revenues, and how GAL is responding to the stronger incentives associated with a longer regulatory period; and
- wider airport developments at Gatwick, such as the process for making decisions about the number and timing of take-off and landing slots each season, or the drawing up of future plans for the development of the airport.

3.28 Alongside any views on additional issues that stakeholders consider should be included in the mid-term review, we will wish to understand why the issue is important, how passengers are likely to be affected, and the specific way that the commitments framework may not be operating in passengers' interests.