

**A consultation on extending by one year the current price  
regulation at Heathrow and Gatwick airports**

February 2011

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## Summary

**This document seeks views from all stakeholders by 7 March 2011 on whether the CAA should extend by one year the current price regulation that applies to Heathrow and Gatwick airports.**

1. The current price control and associated arrangements ("Q5") for both Heathrow and Gatwick airports are due to expire at the end of March 2013. The CAA's process to review what should happen thereafter ("Q6") should begin around April 2011.
2. The CAA's economic regulation of airports aims to secure its statutory duties, including demonstrably furthering the interests of passengers and other users. Effective competition is generally the best way to achieve this. Where the prospect of effective competition cannot be relied upon, the CAA currently regulates the maximum price the airport can charge airlines in addition to some requirements on minimum service quality standards.
3. The CAA is keen to develop future arrangements in line with the Government's proposals for its reform of economic regulation. Under these proposals, the CAA would have a new primary duty focused on the interests of passengers. It would also oversee a licensing regime for airport operators, and have concurrent competition and enforcement powers with the Office of Fair Trading. These reforms would enable the CAA to develop a more passenger focused, flexible and tailored set of arrangements for each airport that continues to require regulation.
4. The legislative programme has not yet been settled and the detail of the new regime will be subject to the Parliamentary process. This prevents the CAA from launching Q6 in April 2011 as if the new arrangements were certain. Equally, there are risks and costs that could be borne by stakeholders from the CAA launching Q6 in April 2011 under the present legislation and then switching at mid-point to a different procedure and legal framework. There is also a potential risk of a lost opportunity for stakeholders to engage with the CAA about how it can make best use of its new powers to establish a modern passenger-focused set of arrangements.
5. The CAA considers that the balance of risk and opportunity for users' interests could favour it extending by one year the present arrangements at Heathrow and Gatwick. Under current legislation the CAA has the power to do this, following consultation, so long as the terms of the price control remain unchanged. This would imply that maximum prices in 2013/14 would increase from the levels in 2012/13 in real terms by 7.5% at Heathrow and 2% at Gatwick. Any changes to these maximum limits require the consent of the airport operator.
6. The CAA will decide in March 2011 on whether to extend the present controls for one year. In addition to feedback from this consultation, the CAA will take into account the Government's plans insofar as they are known at that time.

7. Legislation is always uncertain until it has completed the Parliamentary stages. As such the CAA cannot guarantee that a 12-month extension will deliver Q6 under the new regime. There is no statutory basis for a longer extension to Q5. However, if the CAA does not extend Q5, then it is quite likely Q6 would need to start very shortly after this consultation so the CAA has sufficient time to complete the price review under the present Airports Act 1986. This could then risk losing the opportunities provided by the proposed legislation to further users' interests in ways that are constrained by the current legislation.

# 1 Relevant background

## a) Current price controls

- 1.1 The prices Heathrow Airport Limited (“Heathrow”) can charge airlines are capped over the period 2008/9 to 2012/13 by the change in the retail price index (RPI) plus 7.5% per year. Over the same period, the prices Gatwick Airport Limited (“Gatwick”) can charge are capped at RPI plus 2% per year. For each airport operator the CAA has also introduced measures to regulate minimum levels of service quality and various other mechanisms such as those to ensure capital investment is effectively delivered.
- 1.2 The current five-year regulatory period - called “Q5” - for regulatory arrangements will expire at the end of March 2013<sup>1</sup>. To review these arrangements properly in line with its previous processes, the CAA would shortly need to launch in April 2011 its “Q6” programme<sup>2</sup>. The key milestones for this process based on the last review would see the CAA launch its expectations for Constructive Engagement around April 2011 prior to developing and publishing its initial proposals around November 2011. After assessing feedback, it would then submit a mandatory reference to the Competition Commission around March 2012. After receiving the Competition Commission’s report around October 2012, the CAA would then publish its final proposals around December 2012 for implementation in April 2013.

## b) The Government’s proposed reform of economic regulation

- 1.3 The Government confirmed in July 2010 that it intended to bring forward legislation to reform the legal framework governing the CAA’s economic regulation of airports<sup>3</sup>. Among the main features are likely to be a new primary duty for the CAA focused on the interests of passengers; a licensing regime for airport operators backed up by proportionate sanctions; and the ability to enforce concurrent powers with the Office of Fair Trading under general competition law.
- 1.4 These reforms should enable the CAA to develop a more modern, passenger focused, and tailored set of regulatory arrangements for the airports that remain subject to economic regulation.
- 1.5 The difficulty for the CAA’s forthcoming price control reviews is that the Government has not yet fixed when its proposed legislation will be introduced into Parliament. This means that the timetable for its eventual implementation is currently highly uncertain. Should the Government introduce its legislation into Parliament in its second session, from April 2012,

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<sup>1</sup> The current price control for Stansted expires a year later in March 2014.

<sup>2</sup> Given the CAA’s statutory requirements in the Airport Acts 1986, price control reviews typically take two years to complete.

<sup>3</sup> See Written Ministerial Statement on Economic Regulation of Airports - <http://www.dft.gov.uk/press/speechesstatements/statements/hammond20100721>.

and then given the expected Parliamentary and implementation processes that would need to follow, there would be insufficient time for the CAA to complete Q6 for Heathrow and Gatwick under the new legislation unless there was an extension of one year<sup>4</sup>. Even with a 2012 introduction, the timetable for Q6 may need to be reviewed depending on progress of the legislation through Parliament.

- 1.6 Should the Government for whatever reason not implement its proposals early enough for Q6, the CAA needs to ensure that it leaves itself sufficient time that it could still satisfactorily discharge its duties under the current Airports Act 1986.

c) Price control extensions

- 1.7 The CAA has used its power to extend price controls<sup>5</sup> by one year on three occasions. Two of these occasions related to uncertainty over Government policy.
- In May 1999, the CAA extended the price controls at Heathrow, Gatwick and Stansted airports so they expired on 31 March 2003. This was done to allow the CAA to take account of the Government's planning decision on the proposed Heathrow Terminal 5, which was then expected during 2001.
  - In November 2005, the CAA extended the price control at Manchester Airport so it expired on 31 March 2009. This was done to stagger the Manchester and BAA London airport reviews to allow for a more efficient use of CAA and airline resources given the greater focus on airline participation through Constructive Engagement.
  - In March 2007, the CAA extended the price control at Stansted so that it ended on 31 March 2009. This was done to allow time for the Government to conclude its review of the airport's designation status.
- 1.8 Before deciding to extend a price control, the CAA is required<sup>6</sup> to consult the airport operator, although in practice it will want to seek the views of all interested parties. Where the CAA decides to extend a price control it is required<sup>7</sup> to apply the same control in the additional period as was applied in the preceding year, unless a modification is agreed with the airport operator. The CAA views this as meaning that the same price formula should apply in the extension year as the last year of Q5.

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<sup>4</sup> This assumes the Secretary of State decides to use his power under section 40(9) of the Airports Act 1986 to remove the CAA's mandatory reference to the Competition Commission. This provides time for a thorough review and prevents a situation where the appeal body under new arrangements could be called upon to review its own previous work.

<sup>5</sup> Under section 40(7) of the Airports Act 1986.

<sup>6</sup> Under section 40(7) of the Airports Act 1986.

<sup>7</sup> Under section 40(8) of the Airports Act 1986.

## 2 Assessment of the CAA's options

- 2.1 The principal options available to the CAA in light of the legislative and regulatory uncertainty and their relative merits are set out below.

### a) Undertake the price control reviews under the existing legislation

- 2.2 Without an extension, the CAA would need to start the process of Constructive Engagement in April 2011 in order to develop and prepare initial proposals for around November 2011. This normally requires the airport operators to prepare an initial business plan around April 2011.
- 2.3 The process under the proposed legislation is somewhat different. It would start with a thorough assessment of the market power of the airport and discussion with the sector about the most appropriate form of regulation to drive value for passengers where the prospect of effective competition cannot be relied upon.
- 2.4 There is thus a risk to stakeholders that they could incur the costs and frustration of nugatory work if the CAA were to launch the process under the existing legislation and then change course mid-way through. Work would need to be done earlier than might otherwise be the case, especially around Constructive Engagement, and before the framework for regulation was known.
- 2.5 There is also a potential risk of a lost opportunity for stakeholders of having time at the start of the review process to engage in a strategic level discussion and more detailed engagement about how the new regulatory framework can be best designed to enhance the interests of passengers. This includes how licence conditions can better encourage passenger focused efficient investment and operations. It also includes whether the duration of the next controls should be shorter or longer than the statutory five-year period under the Airports Act 1986.

### b) Undertake the price control reviews under the Government's proposals

- 2.6 The difficulty for the CAA in launching its process assuming the Government's proposals will be implemented is that neither the detail of the proposed Bill has been published nor has its timing to Parliament been confirmed. Given the CAA cannot obviate its responsibilities under the present Act, this uncertainty in the meantime presents major risks to the process.

### c) Extend the current price controls

- 2.7 The potential advantages of this option are that an extension:
- Helps to deal with uncertainty of the Government's legislative timetable and increases the chances that the next price control review can secure the benefits of the new framework; and

- Avoids the need for stakeholders and the CAA to undertake work and detailed analysis either earlier than required or at risk of having to be repeated at a later date.
  - Regardless of the Government's progress with its legislative timetable, some stakeholders might consider there is merit in there being time for the CAA to lead a strategic discussion about what economic regulation should be designed to achieve - in advance of launching into the detail of Q6.
- 2.8 One potential disadvantage of an extension is that it could delay the introduction of new price and service quality regulation if the Government secures a first Parliamentary session slot for the Bill<sup>8</sup>. Before the CAA needs to make a decision in March 2011, it would hope the Government would provide clarity on its intentions. A further potential disadvantage is that the price formulae, established in March 2008, may no longer reflect the outcome that would be derived from the Q6 review (but on this, see section 3(d)).
- 2.9 The CAA cannot guarantee that a 12-month extension will deliver Q6 under the new regime because legislation is always uncertain until it has completed the Parliamentary stages. However without the extension it would not be possible to complete Q6 under the new regime if the legislation is not introduced into Parliament until the second session.

d) CAA's assessment and proposal

- 2.10 Based on the analysis above, the CAA has considered whether an extension would be best calculated to further its present statutory duties including whether it would further the interests of airport users<sup>9</sup>.
- 2.11 Regulatory certainty is beneficial to airport operators and users alike as they need to understand and manage the impact on their business from changes to the legislative framework. For example, such uncertainty has the potential to undermine the process of constructive engagement on the outcomes stakeholders want to achieve, including in relation to capital planning and investment. This could undermine the CAA's ability to pursue its duties in relation to users' interests and encouraging investment. Disruptive change mid-way through a price control review could also impose additional costs on the sector, which would not be in users' interests.
- 2.12 In addition, an extension is more likely to align the price control review to the timing for the Government's proposed new legislation, which should create opportunities for the CAA to further users' interests in ways that are not available to it if it establishes the price controls under the present framework.

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<sup>8</sup> Without an extension, it would be challenging to implement an alternative set of price and service quality regulations under the new legislation and would, in any event, rely on the Secretary of State deciding to use his power to remove the CAA's mandatory reference to the Competition Commission.

<sup>9</sup> Under section 39 of the Airports Acts 1986.

- 2.13 Although an extension is not a guarantee of minimising this uncertainty, it could help to manage the risks more effectively than would be the case without an extension.
- 2.14 The CAA's initial view, subject to feedback to this consultation, is that the balance of argument favours an extension by one year to the price controls at Heathrow and Gatwick. The CAA will make a decision on this matter in March 2011, pending feedback to this consultation, and in light of the Government's plans known at that time.

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### **3 Further issues relevant to considering an extension**

- 3.1 If the CAA decides to extend the present arrangements by one year, there are a number of related issues that need to be addressed. The CAA considers there is merit in keeping the terms of any extension as simple as possible to enable it to work effectively with stakeholders on a more fundamental review of the arrangements under the Government's proposed legislation.

#### a) Separate treatment of Heathrow and Gatwick

- 3.2 The CAA wishes to understand whether there are any compelling reasons for treating the two airports differently, which could lead to an extension for one but not the other. This might occur, for example, if one or other of the airports would not be able to encourage investment and further the reasonable interests of passengers; and whether it might take longer to undertake the assessment of competition and appropriate forms of regulation at one of the airports.
- 3.3 The CAA's initial view is that it should apply an extension to both airports. This would mean that the CAA would review the price controls for all three designated airports together, including Stansted, as they will each expire in March 2014.

#### b) Correction for over- or under-recovery

- 3.4 This price control formulae include a term that enables the airport operator to recover the difference between actual prices charged and the maximum prices charged (calculated with a two year lag).
- 3.5 Following the precedent of previous extensions, the CAA proposes to retain the term during the one-year extension so that maximum prices in 2013/14 are adjusted for any under/over recovery from 2011/12.

#### c) Consequential Changes

- 3.6 An extension to the price control will require a number of consequential amendments listed in Appendix 1. These include the Service Quality Regime (SQR), capital expenditure triggers, and the security cost pass-through term.
- 3.7 The CAA recognises that stakeholders may wish to understand how it might treat these issues in order to inform their views on the desirability of an extension to the main price formulae.
- 3.8 In principle, there is a case for these issues to be dealt with in a manner that does not change the overall "balance" of the Q5 settlement. More specifically:
- The Service Quality Regime (SQR) - these schemes are separate from the price control and could be rolled forward in their current form or amended. Although there could be merit in the CAA proposing amendments to some of the detail of the present schemes, such as

the range of measures, it is minded to avoid changing the sums of money at stake for either penalties or bonuses in the extension year. The issue of service quality will be a major focus of the Q6 review process.

- Capital expenditure triggers - the existing triggers are conditions that would be continued as part of the price control formula<sup>10</sup> unless the CAA agrees with the airport operator an alternative set of arrangements. In relation to ongoing projects, the CAA considers there is merit in continuing with the triggers for a further year. In relation to projects where the nature and scope has fundamentally changed in Q5, there may be merit in the CAA removing these triggers, especially if the airport operator and airlines can reach agreement on more suitable triggers tailored to the expected capital programmes in 2013/14.<sup>11,12</sup>
- Security cost pass-through (the “S” term) – the price control formulae allow for an adjustment to allowed charges of 90 per cent of an increase (or decrease) in costs directly due to changed security requirements, subject to a minimum threshold of additional costs for Q5 as a whole of £14 million for Heathrow and £6 million at Gatwick. These adjustments have an effect on the allowed charges in the year after the changes take place. The CAA proposes to retain the 90 per cent pass-through for additional security costs in the extension year with the same thresholds.<sup>13</sup>

3.9 There are also a number of Public Interest Conditions that relate to the price controls. These were established following reports by the Competition Commission and expire on 31 March 2013. In addition to the SQR discussed in 3.8, these conditions relate to requirements such as cost transparency, the provision of information desks, and regulations around use of employment agencies. The CAA proposes to extend these conditions for a further year.<sup>14</sup> However, as the procedure for consulting stakeholders on these conditions is somewhat different to the consultation procedures for main price control terms, the CAA expects to reach a decision on this issue in April 2011 rather than March 2011.<sup>15</sup>

<sup>10</sup> Section 40(7) of the Airports Act 1986.

<sup>11</sup> All triggers would continue to apply until the end of the normal Q5 period and any cancelled projects would not count towards the Q6 opening Regulatory Asset Base (RAB).

<sup>12</sup> The CAA would expect to take into account these new triggers as part of the overall Q6 review.

<sup>13</sup> The CAA intends to make appropriate technical adjustments to the “S” term in the formulae so it applies for the sixth year.

<sup>14</sup> As permitted section 51(2) of the Airports Act 1986.

<sup>15</sup> Under Regulation 16 of the Civil Aviation Authority (Economic Regulation of Airports) Regulations 1986, the CAA is required to allow the airport operator two months to comment on a proposed extension to the period of a Public Interest Condition.

d) Ex-post reconciliation or "true-up" mechanisms

- 3.10 If reviewing the arrangements in place at Heathrow and Gatwick by March 2013 would cause the CAA to come to materially different conclusions on the levels of the price caps, then it is possible that either the airport operator, or the airlines, could lose out in the year of the extension. This could happen for example, if the CAA were to follow its previous approaches of rebasing traffic forecasts and looking afresh at operational efficiency, capital expenditure and the cost of capital.
- 3.11 We could attempt to ensure that no party would be systematically worse off from an extension with a form of reconciliation to the counterfactual of implementing Q6 in April 2013. Such counterfactuals are inherently difficult to assess and can be partial to one party if only one element of the control is taken into account rather than the entire package.
- 3.12 There are a number of possible approaches with varying degrees of complexity and conceptual and practical issues:
- we could base the relevant counterfactual for 2013/14 on an estimate of what the CAA would have assumed *ex ante* had it undertaken a price review. However, there may be challenges in defining this counterfactual, which could lead to regulatory uncertainty and confusion. It would also put the CAA in a position of using out of date information when it comes to setting any alternative price limits. A 'shadow' review for 2013/14 could also be very resource intensive for all parties; or
  - we could try to ensure *ex post* there is a reconciliation, or "true-up", for any material difference between the new price limits for Q6 and the price limits that applied in the extension year. Such a mechanism would, however, pose some risks. It could give rise to perverse expenditure incentives for the airports in 2013/14 if these costs can then be recovered over the course of the next control period.
- 3.13 The CAA has not considered such a mechanism necessary in its past price control extensions, partly because of the difficulties of carrying out such an assessment. However, it does see merit in trying to ensure that an extension does not systematically favour one side if an equitable, simple and non-distortionary mechanism can be developed. Therefore, before coming to a firm view on whether there should be a reconciliation, the CAA would welcome stakeholders' views, both on the principle and the appropriate mechanism.

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## 4 Views invited

- 4.1 The CAA welcomes views on the proposals above. Any comments should be sent, if possible by e-mail to [Airportsreview@caa.co.uk](mailto:Airportsreview@caa.co.uk) by no later than **7 March 2011**<sup>16</sup>. Alternatively, comments may be posted to:

Susie Talbot  
Economic Regulation Group  
CAA  
CAA House  
45-59 Kingsway  
London WC2B 6TE

- 4.2 If you would like to discuss your response prior to submission, please call Ken Cheong on 0207 453 6270 or email [ken.cheong@caa.co.uk](mailto:ken.cheong@caa.co.uk).
- 4.3 The CAA will hold a roundtable meeting with interested parties during the consultation period on the morning of 15 February 2011 in London to explain its proposals and gain feedback. Please let Barbara Perata-Smith know if you would like to attend ([Barbara.PerataSmith@caa.co.uk](mailto:Barbara.PerataSmith@caa.co.uk)).
- 4.4 The CAA will acknowledge all formal responses. It expects to make these available on its website for other interested parties to read as soon as practicable after the deadline has expired.
- 4.5 Any material regarded as confidential should be clearly marked as so and included in a separate annex. This will not be published, subject to the criteria that the CAA has established for treating information as confidential<sup>17</sup>.

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<sup>16</sup> The CAA also encourages stakeholders by this date to provide comments on the proposal to extend the Public Interest Conditions by one year. However, given the requirements noted in paragraph 3.9, the CAA would welcome any further comments up until the 7 April 2011 on this particular issue.

<sup>17</sup> Economic Regulation of Designated Airports (Heathrow, Gatwick, Stansted and Manchester) from 2008, CAA Process for the Reviews, October 2005, paragraphs 3.28 to 3.30.

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## Appendix 1 - Extension of Q5 Consequential Amendments

An extension to the price control will require a number of consequential amendments. These are listed below. The CAA's intention is to use this document to consult stakeholders on how it should deal with all these elements.

ISSUE	ELEMENT	IMPLICATIONS FROM AN EXTENSION
<b>Price Control - Passenger</b>	Basic control formulae	End date 31 March 2014, rather than 31 March 2013.
	"S" [security] Element	CAA will need to consider whether the cumulative threshold should change for a six-year period.
	Capital investment triggers	These expire in March 2013 so consideration necessary of whether any or all need extending for a further year.
	Service Quality Regime (SQR) bonuses	These expire in March 2013 so consideration necessary of whether any or all need extending for a further year.
<b>Price Control – Cargo</b>	Basic control	End date 31 March 2014, rather than 31 March 2013
<b>Public Interest – Heathrow/Gatwick</b>	SQR rebates	These expire in March 2013 so consideration necessary of whether any or all need extending for a further year.
		CAA will need to consider the implications for the detailed SQR specification of a six-year period.
<b>Public Interest – Heathrow/Gatwick</b>	Cost information for specified activities	These expire in March 2013 so consideration necessary of whether any or all need extending for a further year.
<b>Public Interest – Heathrow</b>	Employment agency	These expire in March 2013 so consideration necessary of whether any or all need extending for a further year.
<b>Public Interest – Heathrow</b>	Information desks	These expire in March 2013 so consideration necessary of whether any or all need extending for a further year.