

***Extending the current price regulation at
Heathrow and Gatwick airports***

The CAA's Decision

March 2011

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Summary

The CAA has decided to extend the current price and service quality regulation at Heathrow and Gatwick by one year to March 2014.

This document sets out the CAA's reasons for this decision and the consequential changes to the technical terms of the price control conditions at these airports for 2013/14.

1. The current price control and associated arrangements ("Q5") in respect of 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. The CAA in February 2011 set out the reasons why an extension to Q5 of one year might be best calculated to further the interests of users and its other statutory duties.¹ This was principally, but not exclusively, related to how the CAA could best manage the uncertainty surrounding the timing (and content) of the Government's proposed legislation to reform airport economic regulation.
2. Following consideration of the responses to its consultation, the CAA has decided to exercise its power under section 40(7) of the Airports Act 1986 ("the Act") to extend the current price controls at Heathrow and Gatwick by one year. They will now expire on 31 March 2014, at the same time as the current arrangements for the other designated airport, Stansted.
3. In reaching its decision, the CAA has had regard to the fact that the majority of stakeholders who responded to its consultation supported this option. In particular many supported the CAA's initial view that:
 - an extension was the best option available to help manage the risks to the sector and users, of the transition between the current legislative framework and the Government's proposed reforms to airport economic regulation. There was widespread concern that it would not be in users' interests to start Q6 under one legislative framework and then switch to another framework part way through. This could also frustrate constructive engagement and discussions over capital investment; and
 - users' interests would be furthered by seeking to undertake Q6 under the proposed legislation, provided the Government could ensure its timetable for introducing legislation was aligned to the price control process. In this regard, the Secretary of State on 3 March 2011 confirmed in a written ministerial statement to Parliament that Government intends to introduce legislation to reform airport economic regulation "early in the next

¹ 'A consultation on extending by one year the current price regulation at Heathrow and Gatwick airports' (February 2011), available on the CAA website at <http://www.caa.co.uk/docs/5/ergdocs/Q6extension.pdf>

Parliamentary session”.² Legislation is always uncertain until it has completed the Parliamentary stages, so an extension cannot guarantee that Q6 will be implemented under the proposed legislation. However, without an extension, there is no chance of the CAA being able to use the proposed reforms to bring benefits to consumers in developing Q6.

4. The CAA has also considered the terms of the price controls that should apply in 2013/14. Under sections 40(6)-(8) of the Act, the terms of the price controls in the extended year must be the same as the last year of Q5, unless the CAA can agree modifications with the airport operator. Stakeholders generally welcomed the CAA’s suggestion of trying to keep any changes simple, maintaining the overall balance of the settlement, and encouraging negotiated settlements on certain issues such as renegotiating capital expenditure triggers.
5. The CAA applauds the considerable progress made during the consultation period between the airport operators and their airlines in seeking to agree on the terms for the price controls in 2013/14.
6. Heathrow has agreed with its airlines a cap for its capital programme in 2013/14 of £735 million (in 2007/8 prices). This comprises of some baseline capital expenditure from ongoing Q5 projects, some projects that are called “choices” for the airport and airlines, and a contribution to the development costs of Crossrail. Heathrow has said it will continue to work closely with its airlines to finalise the programme and the appropriate capital expenditure triggers that should apply in 2013/14, using existing governance and change control processes. Both sides have agreed that any failure to reach agreement by June 2012 will result in them seeking a binding determination from the CAA.
7. Gatwick has secured a more comprehensive negotiated settlement with airlines through its Joint Steering Group (JSG). It has agreed to alter its price cap in 2013/14 from the current RPI+2% to RPI-0.5%. This is in exchange for a new set of capital expenditure triggers to apply in 2013/14 that will be negotiated under an agreed process. Both sides have agreed that any failure to reach agreement by June 2012 will result in them seeking a binding determination from the CAA.
8. Given the CAA’s inability to impose changes to the price control terms in the extended year without the airport operator’s consent, it is content that the terms of the agreements at Heathrow and Gatwick furthers the CAA’s statutory duties as it represents an improved outcome for consumers. At Gatwick prices are likely to be lower in 2013/14 than would otherwise be the case. In addition, at both airports the agreements should encourage more alignment between the airport and its airlines over the nature of the capital programme in 2013/14. These agreements bode well for the development of Q6 in particular the

² CAA notes that this is subject to the Fixed-term Parliaments Bill but, for planning purposes, CAA is assuming that the next session will start in May 2012.

possibility of moving discussions to a more commercial footing at the airports within a broad incentive framework set by the regulator.

9. There are a number of other factors that relate to the price controls, which – based on the high degree of consensus among stakeholders – the CAA intends to simply roll on for a further year. These include the service quality rebate scheme and the conditions on charges for non-passenger flights. The CAA is also minded to roll on the Public Interest Conditions.³ The security cost pass-through (or “S” factor) term will be extended by a further year. At Heathrow, BAA has agreed with the view expressed by some stakeholders that the term ought to be increased to reflect inflation in the additional year. At Gatwick the term remains the same as in the last year of Q5 as it was not covered by the airport/airline negotiated settlement.
10. The CAA is keen to use the time available in 2011 to facilitate a strategic discussion with stakeholders on its next round of price control and service quality reviews including the objectives and process. To this end the CAA intends to organise two half day roundtable discussions with stakeholders in May and June 2011 to help develop its thinking prior to the launch in July 2011 of a “Setting the Scene for Q6” consultation. This will enable stakeholders to influence the objectives and scope of Q6 and see how various workstreams within the CAA will come together as part of the Q6 programme, such as the CAA’s competition assessments of the designated airports and its work considering alternative forms of regulation.

³ As permitted by section 51(2) of the Airports Act 1986.

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1. Relevant Background⁴

Responses to the CAA's consultation

- 1.1 The CAA received 11 written responses to its consultation, which are available from the CAA's website.⁵ Responses were received from the following organisations:
- British Airways ("BA");
 - BAA (Heathrow);
 - bmi;
 - easyJet;
 - Gatwick Airport Consultative Committee (GATCOM);
 - Gatwick Airport Limited;
 - Heathrow Airline Operators Committee and London (Heathrow) Airline Consultative Committee (AOC/LACC);
 - IATA and BARUK;
 - NATS (En Route) plc ("NERL");
 - United/Continental; and
 - Virgin Atlantic.
- 1.2 On 15 February 2011, the CAA hosted a stakeholder roundtable to explain its thinking in its consultation document. The presentations made at this meeting by CAA, Department for Transport (DfT), BAA (Heathrow) and Gatwick are available from the CAA's website.⁶
- 1.3 The CAA has held meetings with individual airports and airlines and held roundtables with each airport and their major airlines together. The CAA also attended a British Air Transport Association ("BATA") roundtable and presented to the Air Transport Users Council ("AUC").
- 1.4 The CAA has also taken into account the commercial discussions between the airports and airlines on the terms for any extension. Some of these discussions continued after the close the consultation period.

Government progress on its proposed legislation

- 1.5 The Government is keen to ensure that the CAA's price control reviews can be undertaken under its proposed legislation. On 3 March 2011 the Secretary of

⁴ The consultation document set out relevant background related to a number of issues that is not repeated here

⁵ The responses are available at <http://www.caa.co.uk/default.aspx?catid=5&pagetype=90&pageid=12088>

⁶ The presentations are available at <http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=67>

State (SoS) laid a written ministerial statement in Parliament confirming the Government's intention to introduce legislation to implement reforms of airport economic regulation "early in the next Parliamentary session". Some secondary legislation may be necessary in the second half of 2013 to enable the new regime to come into force. Following his announcement, the SoS wrote to the CAA and confirmed that he is presently minded to exercise his power under section 40(9) of the Act to direct the CAA that there should be no mandatory reference to the Competition Commission, but in exercising this discretion he will need to take account of all relevant matters at the time.⁷ Having regard to this letter, the CAA considers this will provide for greater certainty over the process that will govern the development of Q6 especially once the proposed legislation enters Parliament. It will also help minimise the risks that could arise if stakeholders had to switch to a different regulatory frameworks part way through the price control review.

⁷ A copy of this letter can be obtained from the CAA's website at <http://www.caa.co.uk/docs/5/ergdocs/20110314HammondHuttonAviationBill.pdf>.

2. Assessment of CAA's options

The CAA's consultation

2.1 The CAA set out three broad options for how it could deal with the uncertainty surrounding the Government's legislative timetable for airport economic regulation reform. The pros and cons of these options are summarised in Table 1. Based on this analysis, the CAA's initial view was that the balance of argument in terms of how it furthered its statutory duties favoured an extension by one year to the price controls at Heathrow and Gatwick.

Table 1: Summary of CAA's options

<i>Option</i>	<i>Potential strengths</i>	<i>Potential weaknesses</i>
1. Undertake the price control reviews under the present legislation (Airports Act 1986) without an extension.	Known process, which would start in April 2011.	Risk and cost to stakeholders from undertaking nugatory work, especially in relation to constructive engagement. Risk of lost opportunities for stakeholders of having time at the start of Q6 to engage in a strategic level discussion on how a new regulatory framework can be best designed to enhance the interests of passengers.
2. Undertake the price control reviews under the Government proposed legislation without an extension.	The CAA could develop proposals in light of the provisions of the new legislation, which are aimed at enhancing the focus on the passenger.	Detail of the proposed Bill has not been published. CAA must ensure it can undertake its current responsibilities under the present Act should the proposed Bill fall or not become law in a timely way.
3. Extend the price controls by one year (2013/14).	Manages the uncertainty of the Government's legislative timetable better than the previous options and increases the chances that Q6 can secure the benefits of the new framework. Avoids need for stakeholders and the CAA to undertake work and detailed analysis either earlier than required (and on a different basis). Gives time for a strategic discussion about what economic regulation should be designed to achieve - in advance of launching into the detail of Q6.	The price formulae, established in March 2008, may no longer reflect the outcome that would be derived from the Q6 review. 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.

Summary of responses

- 2.2 The majority of respondents either supported or accepted that an extension was the best option available to the CAA. Most supported the balance of arguments set out in the CAA's consultation document.
- 2.3 Some additional reasons given by respondents to support this position included:
- capturing the benefits of the new legislation, including its greater emphasis on passengers⁸ and flexibility;
 - the potential for the extra time to help the CAA and the sector better understand the nature of the competitive dynamics at the designated airports especially in relation to the change of ownership at Gatwick and the potential change of ownership at Stansted; and
 - a concern about the preparedness of the sector to start Q6 in earnest in April 2011 and the limited time available to develop the CAA's initial proposals prior to the mandatory reference to the Competition Commission.
- 2.4 The CAA's initial view was that it should apply an extension at both airports, rather than extend at one and not the other. 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. The responses to the consultation broadly endorsed this position. NERL, however, noted that this would mean the CAA would need to undertake all three airport price control reviews at the same time, in addition to the CP4 review for NATS. This could stretch resources of the CAA and the sector.
- 2.5 Some stakeholders were keen to ensure that the CAA maintained at all times a credible fallback position of undertaking Q6 under the current legislation should the proposed Bill fall or not be introduced in a timely way.
- 2.6 Two respondents did not support an extension: IATA/BARUK and United/Continental. Both expressed concern at what they perceived as the unreasonably high present level of the price caps and the need to review these as soon as possible rather than continue price caps at these levels for an additional year.

The CAA's decision

- 2.7 Having regard to the responses to its consultation, the CAA confirms that it will exercise its power under section 40(7) of the Act to extend the current price controls at Heathrow and Gatwick by one year.
- 2.8 The CAA considers that this course of action is best calculated to further its current statutory duties under section 39 of the Act. In particular:

⁸ The AUC said that the CAA should encourage airports to improve services to passengers in advance of Q6 and an extension could help facilitate this.

- *furthering the reasonable interests of users* - an extension helps to align the price control review to the timing of the Government's proposed new legislation, which should create opportunities for the CAA to further users' interests in ways that are not available if it were to establish the new price controls under the present framework. In addition, disruptive change mid-way through a price control review could also impose additional costs on the sector, which would not be in users' interests. Although an extension does not guarantee minimising this uncertainty, it could help to manage the risks more effectively than without an extension.
- *promoting the efficient, economic and profitable operations of designated airports* - undertaking Q6 under the proposed legislation helps create the potential for more targeted and flexible regulation best suited to market and competitive conditions at each airport;
- *encouraging investment in new facilities in time to satisfy anticipated demands by users* - an extension helps encourage investment. 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; and
- *imposing the minimum restrictions that are consistent with the performance by the CAA of its economic regulation functions* - an extension does not impose any additional restrictions over and above the present settlements and the proposed legislation would better enable the CAA to develop tailored arrangements to reflect the particular circumstances of the airports.

2.9 Legislation is always uncertain until it has completed the Parliamentary stages. An extension does not guarantee Q6 can be implemented on the basis of the proposed legislation. However, without an extension, the CAA cannot implement Q6 using the reforms the Government has proposed. Should the Bill for whatever reason be delayed in its introduction into Parliament, the CAA must ensure that it can complete Q6 and satisfactorily discharge its duties under the current Act. If the Bill's introduction into Parliament is delayed to the extent that it is unlikely to be implemented within the assumed timetable, then the CAA would need to consider commencing Q6 in Spring 2012 under the current Act.

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3. Further issues relevant to an extension

The CAA's approach

- 3.1 There are a number of issues related to the technical operation of the price control conditions that need to be addressed in the context of an extension of one year. Under sections 40(6)-(8) of the Act, the CAA must apply the same terms of the price control in the extended period as applied in the final year of the previous period, unless it can agree modifications with the airport operator.
- 3.2 The CAA said in its February 2011 consultation that:
- it considered there was 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; and
 - in principle, there was a case for these issues to be dealt with in a manner that did not change the overall "balance" of the Q5 settlement.
- 3.3 The CAA encouraged the airport operators and airlines to seek to negotiate and agree any changes to the price control conditions that might apply in 2013/14, especially in relation to capital expenditure triggers for projects that had substantially altered in nature and scope.

Capital expenditure triggers

(a) *CAA's consultation*

- 3.4 In the consultation document the CAA's initial view was that the existing Q5 triggers were conditions that would be continued as part of the price control formulae unless the CAA obtained consent from the airport operator to an alternative set of arrangements. In relation to ongoing projects, the CAA said there was merit in continuing with the triggers for a further year. In relation to projects where the nature and scope had fundamentally changed in Q5, it considered 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.^{9,10}

(b) *Summary of responses*

- 3.5 All respondents agreed that there should be triggers that reflected the likely capital expenditure in 2013/14, that existing triggers for ongoing projects should be retained, and that the airports and airlines should work to establish new triggers to replace discontinued projects. Should agreement not be reached on new triggers, airlines generally favoured retaining the triggers for discontinued

⁹ 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).

¹⁰ The CAA said it would expect to take into account these new triggers as part of the overall Q6 review.

projects, whilst the airport operators generally favoured removing them. BAA suggested there could be a new input-based trigger on the amount of investment spent in the extended period. Some airlines thought that the 3-month period between expected delivery date and the trigger payments made no sense in the context of a one-year extension. Airlines at Heathrow were especially keen to ensure that any changes were considered using the existing agreed change control governance processes.

(c) Commercial discussions at Heathrow

3.6 BAA and the airlines, through the AOC and LACC, have agreed a broad outline for the Heathrow capital expenditure programme in 2013/14. This is subject to an agreed cap of £735 million in 2007/8 prices.¹¹ They also agreed to the following subsequent to the close of the CAA consultation:

- the capital programme for 2013/14 is made up of “baseline” capital expenditure of £435 million related to projects that will have already started before 31 March 2013 and planned to extend into 2013/14. The remaining £300 million comprises £210 million allocated to what BAA calls “choices” projects, which are mutually agreed, and £90 million allocated to the first tranche payment for BAA’s contribution to Crossrail;
- BAA and the airlines will continue to discuss the degree to which the “choices” projects should be treated as “baseline” expenditure versus treated as expenditure under the “PSDH¹²” approach (see below). The parties aim to reach agreement by June 2012 or earlier if practicable. Should agreement not be reached by this date, both sides have agreed to refer the matter to CAA for a binding determination;
- projects excluded from the “baseline” expenditure, including the Crossrail payment, will be treated under the “PSDH” principles established for the Q5 review.¹³ Under the CAA’s “PSDH” approach, the airport operator is allowed a return on the forecast capital expenditure and an expectation that it will be ultimately included in the RAB once the asset comes into operation. However, the airport will only receive a return if the project is carried out and the money is actually spent. CAA reserves the right to claw back allowed returns at the end of the period (and not provide for such capital expenditure or interest in Q6) if BAA were to incur expenditure that was unnecessary at the time it was incurred. BAA must consult airlines effectively before the expenditure is incurred; and
- all the existing Q5 capital expenditure triggers will continue and the parties will use existing change control governance processes to renegotiate those they wish to change. They will seek to agree new

¹¹ All numbers shown here are based on BAA’s “P50 estimates”.

¹² Project for the Sustainable Development of Heathrow.

¹³ See paragraph 2.56-2.62 of Economic Regulation of Heathrow and Gatwick Airports 2008-13, CAA Decision, March 2008.

triggers that should apply to the capital programme in 2013/14. The parties aim to reach agreement by June 2012 or earlier if practicable.¹⁴ Should agreement not be reached by this date, both sides have agreed to refer the matter to CAA for a binding determination.

(d) Commercial discussions at Gatwick

3.7 Gatwick and its airlines, through its JSG, have agreed to the following subsequent to the close of the CAA consultation¹⁵:

- to alter the maximum price cap in 2013/14 from RPI+2% to RPI-0.5%;
- the existing capital expenditure triggers will cease to operate as at 31 March 2013. Gatwick will consult on and seek to agree revised triggers applicable for 2013/14 with respect to 60 per cent of the 2013/14 capital expenditure programme;
- any failure by Gatwick to agree triggers with its airlines by June 2012 (or earlier if practicable) would lead to the parties seeking a binding determination from the CAA¹⁶; and
- Gatwick's 2013/14 capital expenditure programme will be consulted on using the normal price control consultation processes.

(e) CAA decision

3.8 The CAA applauds the progress made at Heathrow and Gatwick by the parties in seeking to agree pragmatic negotiated settlements to the terms that should apply in the extended year. BAA and airlines were able to agree a process for developing the Heathrow capital plan and for negotiating capital expenditure triggers. Gatwick secured a more comprehensive agreement with the airlines, which included the price that will be charged in 2013/14 in addition to the process for deciding the capital programme and capital expenditure triggers.

3.9 Given the constraints on the CAA in altering the terms of the existing price control (this requires consent of the operator) and the objectives the CAA set to keep the package simple and maintain the balance of Q5, it considers that endorsing these agreements and making the technical adjustments necessary to the price controls is best calculated to further its current statutory duties under section 39 of the Act. At Gatwick, prices will be lower in 2013/14 than would otherwise be the case. In addition, at both airports, these settlements should encourage more alignment between the airport and the airlines over the nature of the capital programme in 2013/14.

¹⁴ In the event that both BAA and the airlines agree that additional time is needed beyond June 2012 in respect of how the "choices" element of expenditure is split between baseline or a PSDH approach or the appropriate triggers, then a joint letter will be written to the CAA stating the new date.

¹⁵ A joint letter from Gatwick and the ACC containing this agreement can be found on the CAA's website at <http://www.caa.co.uk/docs/5/ergdocs/20110321JSGAgreement.pdf>.

¹⁶ In the event that both Gatwick and the airlines agree that additional time is needed beyond June 2012, then a joint letter will be written to the CAA stating the new date.

- 3.10 The CAA hopes that in its development of Q6 it can build on its stakeholder engagement and the positive approach the parties took to negotiation of the terms in the extension year.
- 3.11 At Heathrow and Gatwick the CAA will apply the terms of the commercial agreement between the airport and airlines, therefore:
- at Heathrow all the existing Q5 triggers will 'roll on' into the extended year unless the airport and airlines come to a different agreement following the normal change control governance process. If the parties are not able to reach agreement the CAA will make a binding determination ; and
 - at Gatwick all triggers will terminate at the end of Q5 and be replaced with new triggers agreed by the parties. If the parties are not able to reach agreement the CAA will make a binding determination.
- 3.12 The CAA in making any binding determination on triggers or capital expenditure in the extension year will focus on the outcome that is best calculated to further its statutory duties. In doing so, it expects to take into account a full range of options from cancelling triggers, reallocating triggers, or rolling on triggers. It might also consider pragmatic approaches for the nature of the capital programme in 2013/14, such as a balance between input spend and output triggers. The CAA could take into account its view on the reasonableness of the positions reached by the parties and does not rule out determinations based on "pendulum" arbitration. Any CAA determination will be final and binding under the terms of the agreements reached between airports and airlines for the Q5 extension.

Correction for over- or under-recovery

(a) CAA's consultation

- 3.13 The price control formulae include a term that adjusts for any difference between actual prices charged and the maximum prices charged (calculated with a two year lag). Following the precedent of previous extensions, the CAA proposed 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.

(b) Summary of responses

- 3.14 All stakeholders that expressed a view on this subject supported retaining the correction factor as an integral part of the current price control arrangements.

(c) CAA decision

- 3.15 The CAA confirms that it will make the technical adjustments necessary to apply the correction factor in 2013/14 at Heathrow and Gatwick.

Security pass-through term (“S-factor”)**(a) CAA’s consultation**

3.16 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 £16.5 million for Heathrow and £7 million at Gatwick. These adjustments have an effect on the allowed charges in the year after the changes take place. The CAA proposed to retain the 90 per cent pass-through for additional security costs in the extension year with the same thresholds.

(b) Summary of responses

3.17 All stakeholders that expressed a view on this subject supported the CAA’s position to retain a 90 per cent pass-through but some airlines argued that the thresholds should be increased, with either RPI inflation or pro-rating for a sixth year. Some other stakeholders suggested the formula should be unchanged and simply extended into 2013/14.

(c) CAA decision

3.18 BAA, in light of stakeholder feedback, has agreed to modify its condition to up rate the current value of its S-factor threshold (£16.5 million) for a measure of inflation. Given current RPI inflation is about 5 per cent, BAA has agreed to change the S-factor threshold for 2013/14 to £17.3 million.¹⁷

3.19 An adjustment to the S-factor was not a feature of Gatwick’s negotiated settlement with airlines and, therefore, Gatwick has not agreed to up rate its S-factor. The threshold that applies in the last year of Q5 will also apply to the extension year (£7 million).

3.20 The CAA confirms that for both airports it will retain the 90 per cent pass-through.

Service Quality Schemes**(a) CAA’s consultation**

3.21 These schemes are separate from the price control and could be rolled forward in their current form or amended.¹⁸ The CAA said in its consultation document that although there could be merit in proposing amendments to some of the detail of the present schemes, such as the range of measures, it was minded to avoid changing the sums of money at stake for either penalties or bonuses in the extension year.

¹⁷ Although this relates to current rather than forecast inflation, it is known and therefore can be used to produce a firm number for 2013/14 to minimise uncertainty and disproportionate complexity.

¹⁸ The payment of bonuses is in the price control, but the standards and rebates are in separate statements

(b) Summary of responses

3.22 Some stakeholders considered that changes were necessary to the schemes. None of the respondents suggested radical changes should occur before the Q6 review, but BAA, BA and Heathrow AOC/LACC mentioned that they had discussed changes to the detail of some of the service quality measures, and re-allocating money whilst keeping the amounts at risk at the same overall level. Stakeholders were keen to pursue changes to quality of service measures as part of the Q6 programme.

(c) CAA decision

3.23 The CAA confirms that it will retain the bonuses in the price controls and currently expects to make the technical adjustments necessary to extend the present Service Quality Rebate scheme at Heathrow and Gatwick in 2013/14. The CAA expects service quality and enhancing the passenger experience will be key themes for its Q6 review.

Conditions on non-passenger flights**(a) CAA's consultation**

3.24 The conditions on airport charges for non-passenger flights state that charges for such flights should be no higher than those for equivalent passenger flights and expires on 31 March 2013. The CAA proposed to extend the conditions for a further year.

(b) Summary of responses

3.25 No stakeholders commented on this issue.

(c) CAA decision

3.26 In the absence of any representations to the CAA's proposals, it is extending the conditions on charges for non-passenger flights at Heathrow and Gatwick by one year.

Public interest conditions**(a) CAA's consultation**

3.27 The Public Interest Conditions were established following findings by the Competition Commission and expire on 31 March 2013. In addition to service quality discussed above in section 3.21 to 3.23, these conditions relate to requirements such as cost transparency, the provision of information desks, and requirements around use of employment agencies. The CAA proposed to extend these conditions for a further year.¹⁹

¹⁹ As permitted by section 51(2) of the Airports Act 1986.

(b) Summary of responses

3.28 All stakeholders that expressed a view on this subject supported the CAA's position to roll on the existing Public Interest Conditions for a further year.

(c) CAA decision

3.29 The CAA is minded to make the technical changes necessary to extend the Public Interest Conditions for 2013/14 given the widespread stakeholder support for this position. 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 confirm its position with a statement on its website after considering all representations received by 7 April 2011.²⁰

“True-up” and reconciliation mechanisms**(a) CAA's consultation**

3.30 The CAA noted that if reviewing the arrangements in place at Heathrow and Gatwick by March 2013 would cause the CAA to come to materially different conclusions than continuing the current price caps, then it was possible that either the airport operator, or the airlines, could lose out in the year of the extension. The CAA said that it 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. However, the CAA noted that such counterfactuals were inherently difficult to assess, could be partial to one party, and potentially have perverse incentives. The CAA had not considered such a mechanism necessary in its past price control extensions, partly because of the difficulties of carrying out such an assessment.

(b) Summary of responses

3.31 Respondents generally recognised this was a very difficult issue for the CAA to determine. Some stakeholders supported the principle of an equitable and simple true-up if a workable solution could be found that did not have perverse incentives or serious drawbacks. Many respondents recognised both the technical and conceptual limitations that could arise from applying a true-up mechanism. BAA thought there should be true-up at Heathrow based on it being assured that it would earn its cost of capital in the extended year. easyJet noted the lack of a workable method for true-up and said it might be focused on reconciliations around capital expenditure. BA did not support a true-up mechanism as it did not think a mechanism could be developed in the time available to meet the objectives the CAA had set. BA was concerned that the BAA proposal would effectively insulate the airport operator from any risk in the extended year, which should result in the cost of capital being reduced.

²⁰ 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. The consultation period therefore ends on 7 April 2011.

(c) CAA decision

- 3.32 The CAA has decided not to implement a true-up mechanism as it has not been able to overcome some of the conceptual and technical drawbacks identified by some stakeholders in its discussions during the consultation period.
- 3.33 The CAA notes that a true-up based only on the airport operator's cost of capital could introduce bias in favour of the airport because it could reduce its risk profile established for Q5 in the extended year. It may also introduce perverse incentives to avoid making operational cost savings that would result in returns in excess of the cost of capital. On the other hand, a more comprehensive 'sum of parts' true-up mechanism could be disproportionate and require a shadow price control review. Other options put forward in discussions with the CAA based on simple averaging of the Q5 and Q6 "X" factors risk may introduce an arbitrary bias in the distribution of risk.
- 3.34 The CAA notes BAA's concern that the risks it faces as a business must be balanced with the potential rewards/returns it can earn. The CAA notes BAA's concern that it has not been able to earn its expected cost of capital during the price control period. The CAA also notes modelling undertaken by BA, which suggests that although BAA has suggested a plausible scenario for 2013/14, there are other equally plausible scenarios for 2013/14 that could result in BAA meeting its cost of capital or exceeding it (depending on projections for traffic and operational expenditure, etc). The CAA considers that the balance between risk and reward is a key issue to be considered early in the scene setting for Q6 rather than in the context of a true-up for an extension to Q5 given the complexities and potential unintended consequences that such a mechanism could introduce.

Amendments to the price control conditions

- 3.35 Revised price control conditions that will apply in 2013/14 for Heathrow and Gatwick are set out in Annexes 1 and 2 incorporating the technical changes set out in this document.

4. Next steps

- 4.1 The present price and service quality controls at Heathrow and Gatwick will now expire on 31 March 2014. This is the same date as the present arrangements expire for the other designated airport, Stansted. The CAA's Q6 review will therefore consider all three airports at the same time.
- 4.2 The CAA intends to develop its Q6 proposals against the background of the Government's proposed legislative reforms for airport economic regulation. However, as some stakeholders pointed out, it must always have a credible fall back strategy to undertake the reviews under the present Act.
- 4.3 The CAA is keen to set the scene for Q6 by undertaking a competition assessment for each of the designated airports. This is because the CAA is keen to further the interests of consumers, where possible through relying on effective competition. The CAA has recently consulted on its draft guidelines²¹ on how it expects to undertake its competition assessments to inform Q6 and will issue the final guidelines in April 2011.
- 4.4 Where effective competition cannot be relied upon and regulation is necessary, the CAA is keen to work with stakeholders to develop a proportionate and effective set of arrangements. This includes considering the most appropriate form of regulation at airports that have significant market power. The CAA has been in discussions over the past year with stakeholders on a range of potential alternative forms of regulation. A stock take on our current thinking on the pros and cons of various options and requesting stakeholders' views on the proposed way forward is available on our website alongside this document.²² The CAA intends to integrate this workstream within the Q6 work programme.
- 4.5 Against this background, the CAA's current high-level timetable is set out below. This is subject to many caveats and uncertainties especially over the assumptions on Parliamentary processes. However, the CAA considers it in stakeholders' interests to give an indication of the interaction between our planning assumptions for the new legislation and the Q6 timetable.

²¹ Available on the CAA website at:
<http://www.caa.co.uk/docs/5/ergdocs/draftcompetitionguidelines.pdf> .

²² Available on the CAA website at:
<http://www.caa.co.uk/docs/5/ergdocs/AltRegulationWayForward> .

DATE	MILESTONE (INDICATIVE)
March 2011	CAA publishes Decision Statement on extension to Q5 and stock take of work on alternative forms of regulation
April 2011	CAA publishes Decision Statement on Public Interest conditions CAA publishes Final Competition Guidelines for airports
May/June 2011	CAA hosts sector roundtables to discuss “agenda” for Q6 and help it develop its July 2011 consultation document*
July 2011	CAA issues “Setting the Scene for Q6” consultation document
Remainder 2011	CAA undertakes initial competition assessments at the airports CAA develops, with the sector, the approach, process and high-level objectives for the Q6 programme. It also encourages airports and their airlines to discuss and seek consensus on the key issues that need be addressed for Q6
By March 2012	SoS decides whether to remove the mandatory Competition Commission (CC) reference If the CC is not removed by this date, the CAA still has two years remaining to complete Q6 under the Act
April 2012 onwards	If the CC is removed CAA would commence formal constructive engagement under proposed legislation around the same time the Bill is introduced into Parliament (assumption is May 2012)
April 2013	Assumption for Royal Assent
July 2013	CAA would publish its initial Q6 proposals followed by a 3-month consultation**
Second half of 2013	Any secondary legislation needed to make the new regime fully enabled would be completed
January 2014	CAA would publish its formal proposal for the licences to introduce Q6
April 2014	Q6 effective – subject to appeals

* The Department for Transport is considering the best way of consulting on the draft legislation before it is introduced into Parliament and it will provide briefing on this at the May/June 2011 roundtable events.

** As part of its Q6 programme, the CAA is likely to publish consultations in advance of this, including on issues relevant to the appropriate form of regulation at each airport with significant market power and updates on the competition assessments.

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ANNEX 1: MODIFIED PRICE CONTROL CONDITION FOR HEATHROW

CONDITIONS AS TO AIRPORT CHARGES IMPOSED IN RELATION TO HEATHROW AIRPORT IN ACCORDANCE WITH SECTION 40(4) OF THE AIRPORTS ACT 1986

HEATHROW CONDITION 1

In the first sentence of paragraph 2 replace:

“On each occasion on which the airport operator fixes the amounts to be levied by it by way of airport charges in respect of relevant air services in each of the four relevant years beginning with 1 April 2009....”

with

“On each occasion on which the airport operator fixes the amounts to be levied by it by way of airport charges in respect of relevant air services in each of the five relevant years beginning with 1 April 2009....”

In the definition of the security terms S_{t-1} , with effect from 1 April 2013, replace:

“ S_{t-1} is the allowable security cost per passenger using Heathrow airport in relevant year t-1 (whether of a positive or a negative value) to be applied....”

with

“For 2008/9, 2009/10, 2010/11, 2011/12 and 2012/13, S_{t-1} is the allowable security cost per passenger using Heathrow airport in relevant year t-1 (whether of a positive or a negative value) to be applied....”

After paragraph 4 add a new paragraph 4a

“4a For 2013/14, S_{t-1} is the allowable security cost per passenger using Heathrow airport in relevant year t-1 (whether of a positive or a negative value) to be applied in relevant year t calculated in accordance with the following formulae expressed in £;

for each relevant year t-1

If

Expected Cumulative Costs $_{t-1} \geq \text{£}17.3$ million; and

Expected Cumulative Costs $_{t-2} \geq \text{£}16.5$ million

then

$$S_{t-1} = 0.9C_{t-1}$$

or if

Expected Cumulative Costs_{t-1} > £17.3 million; and

Expected Cumulative Costs_{t-2} < £16.5 million

then

$$S_{t-1} = 0.9 \frac{\text{Expected Cumulated Cost}_{t-1} - \text{£17.3million}}{(7 - t^*)Q_{t-1}}$$

or if

Expected Cumulative Costs_{t-1} < £17.3 million; and

Expected Cumulative Costs_{t-2} > £16.5 million

then

$$S_{t-1} = -0.9 \frac{\text{Expected Cumulated Cost}_{t-2} - \text{£17.3million}}{(7 - t^*)Q_{t-1}}$$

Where:

$t^*_{2008/9} = 1$; $t^*_{2009/10} = 2$; $t^*_{2010/11} = 3$; $t^*_{2011/12} = 4$; $t^*_{2012/13} = 5$ and

$t^*_{2013/14} = 6$

otherwise

$$S_{t-1} = 0$$

and where the expected cumulative cost of annualised claims shall be calculated
as follows:

Year (t-1)	2008/9	2009/10	2010/11	2011/12	2012/13
A. Effect of claims relating to 2008/9	$6 \times C_{2008/9} \times Q_{2008/9}$	$6 \times C_{2008/9} \times Q_{2008/9}$	$6 \times C_{2008/9} \times Q_{2008/9}$	$6 \times C_{2008/9} \times Q_{2008/9}$	$6 \times C_{2008/9} \times Q_{2008/9}$
B. Effect of claims relating to 2009/10		$5 \times C_{2009/10} \times Q_{2009/10}$	$5 \times C_{2009/10} \times Q_{2009/10}$	$5 \times C_{2009/10} \times Q_{2009/10}$	$5 \times C_{2009/10} \times Q_{2009/10}$
C. Effect of claims relating to 2010/11			$4 \times C_{2010/11} \times Q_{2010/11}$	$4 \times C_{2010/11} \times Q_{2010/11}$	$4 \times C_{2010/11} \times Q_{2010/11}$
D. Effect of claims relating to 2011/12				$3 \times C_{2011/12} \times Q_{2011/12}$	$3 \times C_{2011/12} \times Q_{2011/12}$
E. Effect of claims relating to 2012/13					$2 \times C_{2012/13} \times Q_{2012/13}$
Expected Cumulative Cost Sum rows A to E					

Where:

C_{t-1} is the total qualifying security claims per passenger using Heathrow airport in relevant year t-1 (whether of a positive or a negative value) expressed in £; and

Q and Q_{t-1} = passengers using Heathrow airport in the relevant year."

HEATHROW CONDITION 2

Replace in the first sentence of the condition:

"In each of the five consecutive years beginning on 1 April 2008....."

with

"In each of the six consecutive years beginning on 1 April 2008....."

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ANNEX 2: MODIFIED PRICE CONTROL CONDITION FOR GATWICK

CONDITIONS AS TO AIRPORT CHARGES IMPOSED IN RELATION TO GATWICK AIRPORT IN ACCORDANCE WITH SECTION 40(4) OF THE AIRPORTS ACT 1986

GATWICK CONDITION 1

In the first sentence of paragraph 2 replace:

“On each occasion on which the airport operator fixes the amounts to be levied by it by way of airport charges in respect of relevant air services in each of the four relevant years beginning with 1 April 2009.....”

with

“On each occasion on which the airport operator fixes the amounts to be levied by it by way of airport charges in respect of relevant air services in each of the five relevant years beginning with 1 April 2009.....”

In paragraph 2, with effect from 1 April 2013 and for 2013/14, replace

“X=2.0”

with

“X=-0.5”

In the definition of the security terms S_{t-1} , with effect from 1 April 2013, replace:

“ S_{t-1} is the allowable security cost per passenger using Gatwick airport in relevant year t-1 (whether of a positive or a negative value) to be applied.....”

with

“For 2008/9, 2009/10, 2010/11, 2011/12 and 2012/13, S_{t-1} is the allowable security cost per passenger using Gatwick airport in relevant year t-1 (whether of a positive or a negative value) to be applied.....”

After paragraph 4 add a new paragraph 4a

4a. “For 2013/14, S_{t-1} is the allowable security cost per passenger using Gatwick airport in relevant year t-1 (whether of a positive or a negative value) to be applied in relevant year t calculated in accordance with the following formulae expressed in £;

for each relevant year t-1

If

Expected Cumulative Costs_{t-1} ≥ £7 million; and
Expected Cumulative Costs_{t-2} ≥ £7 million

then

$$S_{t-1} = 0.9C_{t-1}$$

or if

Expected Cumulative Costs_{t-1} > £7 million; and
Expected Cumulative Costs_{t-2} < £7 million

then

$$S_{t-1} = 0.9 \frac{\text{Expected Cumulated Cost}_{t-1} - \text{£7 million}}{(7 - t^*)Q_{t-1}}$$

or if

Expected Cumulative Costs_{t-1} < £7 million; and
Expected Cumulative Costs_{t-2} > £7 million

then

$$S_{t-1} = -0.9 \frac{\text{Expected Cumulated Cost}_{t-2} - \text{£7 million}}{(7 - t^*)Q_{t-1}}$$

Where

$t^*_{2008/9} = 1$; $t^*_{2009/10} = 2$; $t^*_{2010/11} = 3$; $t^*_{2011/12} = 4$; $t^*_{2012/13} = 5$ and

$t^*_{2013/14} = 6$

otherwise

$$S_{t-1} = 0$$

and where the expected cumulative cost of annualised claims shall be calculated as follows:

Year (t-1)	2008/9	2009/10	2010/11	2011/12	2012/13
A. Effect of claims relating to 2008/9	$6 \times C_{2008/9} \times Q_{2008/9}$	$6 \times C_{2008/9} \times Q_{2008/9}$	$6 \times C_{2008/9} \times Q_{2008/9}$	$6 \times C_{2008/9} \times Q_{2008/9}$	$6 \times C_{2008/9} \times Q_{2008/9}$
B. Effect of claims relating to 2009/10		$5 \times C_{2009/10} \times Q_{2009/10}$	$5 \times C_{2009/10} \times Q_{2009/10}$	$5 \times C_{2009/10} \times Q_{2009/10}$	$5 \times C_{2009/10} \times Q_{2009/10}$
C. Effect of claims relating to 2010/11			$4 \times C_{2010/11} \times Q_{2010/11}$	$4 \times C_{2010/11} \times Q_{2010/11}$	$4 \times C_{2010/11} \times Q_{2010/11}$
D. Effect of claims relating to 2011/12				$3 \times C_{2011/12} \times Q_{2011/12}$	$3 \times C_{2011/12} \times Q_{2011/12}$
E. Effect of claims relating to 2012/13					$2 \times C_{2012/13} \times Q_{2012/13}$
Expected Cumulative Cost Sum rows A to E					

Where:

C_{t-1} is the total qualifying security claims per passenger using Gatwick airport in relevant year t-1 (whether of a positive or a negative value) expressed in £; and

Q and Q_{t-1} = passengers using Gatwick airport in the relevant year.”

In Table 1 delete the following Rows 4 and 5 with effect from 1 April 2013:

Pier 7	January 2012	£1.01 million
South Terminal Baggage	January 2013	£0.53 million

and replace with new trigger(s) to be agreed by the airport operator and the airlines (represented by the ACC). In the event that new triggers covering 60 per cent of the forecast 2013/14 capital expenditure cannot be agreed and submitted to the CAA by June 2012²³ - or earlier if practicable - along with the trigger definitions, Gatwick has provided the CAA with formal agreement (as required by the 40(6) Airports Act 1986) to amend Table 1 and replace Row 4 and 5 with appropriate triggers and accompanying trigger definitions to encourage the timely delivery of projects which the airport operator and airlines have agreed are to be carried out during 2013/14.

²³ In the event that both the ACC and Gatwick Airport agree that additional time is needed beyond June 2012 then a joint letter will be written to the CAA stating the new date.

GATWICK CONDITION 2

Replace in the first sentence of the condition:

“In each of the five consecutive years beginning on 1 April 2008.....”

with

“In each of the six consecutive years beginning on 1 April 2008.....”