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Gatwick

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Q5-034-LGW01

Dear Iain

Development of airport competition in the South East: Beyond Q5

We met with you on recently (and with Harry Bush on 9 December) to discuss your preparations for Q6, and your competition analysis. We thought it would be helpful to follow up on those discussions and to provide our further thoughts on the CAA's work investigating alternative approaches to regulation.

The Airport Economic Regulation Bill

In terms of your preparations for Q6, we support the work to develop contingencies to allow the next price control review to be conducted under the proposed new regulatory framework, to be introduced by the Airport Economic Regulation Bill. The new regulatory framework would be much improved from the current framework, in particular, by

- i) putting a priority on the interests of passengers, through the promotion of competition;
- ii) removing the 'dual regulator' model;
- iii) introducing right of appeal for all affected parties to the Competition Appeal Tribunal on the tier status of an airport;
- iv) ensuring the CAA has regard to the financeability of any price control proposals
- v) introducing a more standard right of appeal to the CC on price control decisions;
and
- vi) promoting competition between the London airports.

An extension to Q5

We indicated that Gatwick considers it may be appropriate for the CAA to consider extending Q5 by 12 months. We agreed that we would commence discussions with our customers, via the JSG, on this matter and will report back to you in due course.

The development of competition guidelines

On the issue of what form of economic regulation, if any, is required at Gatwick beyond Q5, we have previously stated we very much welcome the CAA's development of competition guidelines and its review of different forms of regulation. Recent developments clearly call for such a review, in particular:

- With the break up of BAA through the sale of Gatwick to Global Infrastructure Partners (GIP) the airport ownership structure in the South East has fundamentally changed. Gatwick is no longer part of a group holding a near monopoly. It is now merely one of the set of three point-to-point lower-tier airports after Heathrow (Stansted and Luton being the other two). Gatwick is clearly no longer a "monopoly" (or part of a monopoly) of the type that justified the detailed price cap regulation applied to it in the past.
- The regulatory arrangements adopted in the past have not performed well. The Competition Commission's (CC) market investigation documented a range of performance failings, from poor relations between airports and airlines, problems with service quality, and a lack of incentive to deliver capacity. A lack of competitive pressure was part of the problem, but regulatory failure was also a key element. The CAA has been refreshingly frank in its recognition of the difficulties associated with the current approach to price regulation.

Beyond the current regulatory framework

In light of these developments we consider that the CAA now faces an important choice in relation to airports generally, but in particular in relation to the regulation of Gatwick. The choice faced by the CAA as we see it is between an approach where it continues to regulate Gatwick in the manner previously adopted, which would perpetuate a situation where regulatory decisions continue to dominate the incentives and actions of airports and airlines, with no expectation that the failings of the past will not continue. Alternatively, the CAA has an opportunity to allow the competition and market forces that now exist to take a much more central role, with regulatory interventions put in place being the minimum to protect the interests of current and future passengers through the promotion of competition.

The implications of such an approach can be seen across a wide range of sectors where regulators have taken a more deregulatory approach when competition has become established in a market. These include retail energy markets where price controls were removed soon after liberalisation of the market, retail voice telecommunications markets which have benefited from lighter regulation after effective wholesale regulation was put in place on BT and wholesale broadband markets where much of the country has been fully deregulated, allowing innovative tariffs and products to be offered to consumers, often as part of a bundle with other services. The

level of competition between airlines is also demonstrative that competition, rather than regulation, has delivered unanticipated benefits.

Attempting to retain the current regulatory framework in the medium term with a vague hope that competition may at some point emerge may give rise to other risks and problems which are also potentially very damaging. For example, consider the incentives to pursue highly risky and very large new investments such as a new runway. If demand for the runway fails to materialise, the regulator may leave the downside risk with the airport on the grounds that that is the outcome of market forces; but if the runway turns out to be a success, the airport risks the continuation of a price cap that limits the upside to its cost of capital. Asymmetric risks such as this could seriously undermine incentives to proceed with such projects, even where users value them highly. If the CAA continues to regulate on the traditional model, these will likely be the risks that are faced. In order to compensate for them, the CAA will need to make far stronger regulatory commitments regarding the future. While this might provide some mitigation of the risks faced, it will also place regulatory commitments even more centrally, with an associated negative effect on allowing market imperatives to become the chief driver of decisions.

So, Gatwick airport is keen to engage the CAA and our customers in considering appropriate evolution of the current regulatory framework. It is clear from the CAA's publications to date that all options remain on the table, from enhanced price control regulation to full deregulation of an airport. We recognise that the issues faced by the CAA when considering Heathrow are likely to be substantially different from those at Gatwick and, in turn, Stansted. Nevertheless, we can envisage an evolution of the existing regulatory framework that more directly incentivised commercial relationships between airports and airlines.

Incentivising contract-based relationships

We envisage being given the opportunity to enter into contractual relationships with our main customers. In such a world, we would envisage that price regulation could be supplemented by such contracts between the airport operator and airlines, covering for example the following areas:

- Price
- Service quality commitments between airport and airline – across the entire range of services offered at the airport
- Differentiated service quality
- Transparency over costs
- Consultation over capital expenditure
- Capital expenditure commitments (and associated incentive mechanisms)
- Airline – airport incentive arrangements to drive revenue increases
- Airline – airport incentive arrangements to drive operating cost efficiencies, including for the airlines cost base
- Term, potentially being longer than the existing quinquennial price control period

We envisage that such a suite of contracts would then replace the need for the direct oversight of the relationship between airport and its airlines.

However, depending on the CAA's SMP finding, this might still leave the issue as to what level of protection might apply to airlines that did not want to enter into long term contracts with the airport.

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We could envisage a scenario in which contracts were then supplemented by a default set of terms, conditions and prices that would apply in those circumstances. In this outcome, the CAA would be promoting competition while retaining back stop protection for users.

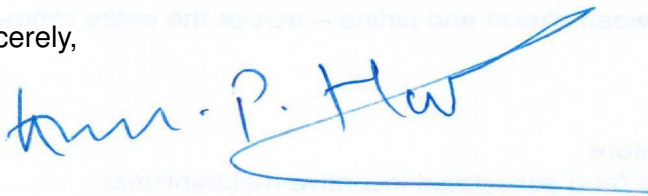
However, it would be fundamental to this approach that the CAA commits to engendering an environment that encourages market-based price setting, fully realising the scope for competitive forces to take effect, and which encourages normal commercial relations between airports and airlines. This would require – at some relatively early stage – a proposal by the CAA to allow such commercial negotiations and default arrangements to be developed by the airport and its customers.

It would also require some clarity from the CAA – in due course – as to how it would intend to implement any financeability obligations that it might have under the forthcoming legislation. Gatwick understands the central importance of the regulatory environment for debt investors. We will therefore continue to argue for a financing duty on the CAA to ensure investment can be financed efficiently. Maintenance of a solid investment grade rating is a fundamental part of the draft proposals from the DfT for new regulation for Tier 1 airports. Shareholders and management will aim to maintain such a rating and we support this being mirrored in any regulatory obligation to this extent.

The appropriate regulatory approach can only be determined by conclusions from a comprehensive and robust competition analysis. Therefore, we consider it important that – given the change of ownership of Gatwick (and hopefully Stansted) – the CAA conducts such a competition analysis, regardless of whether its review of price controls is to be conducted under the proposed AER or under the Airports Act 1986. We also consider that it would be highly preferable for the CAA's competition analysis to be sequential to, rather than parallel with, any regulatory proposals beyond Q5.

We propose making more detailed submissions to the CAA in due course on this option as well as providing a detailed critique of the current regulatory approach. We would of course be happy to meet with you to discuss its contents if that would be helpful.

Yours sincerely,



Kyran P Hanks

Strategy and Regulation Director