

A further note on regulation of an increasingly competitive airport sector

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Background

1. Gatwick Airport Ltd (GAL) has asked me to advise on issues associated with regulation of the airport sector, particularly at Gatwick and taking account of the Commitments and Contracts that GAL has offered. In response to the CAA's consultation process following its Initial Proposals of April 2013, GAL submitted my initial paper "Regulation of an increasingly competitive airport sector", 26 May 2013.¹
2. GAL has now asked me to comment on the submissions of the airlines since that date. After summarising the main thrust of my previous paper, this paper considers the responses of the airlines, as expressed in their meeting with the Board of the CAA on 17 July 2013.

Summary of previous paper

3. My initial paper argued that, despite the CAA's new duty to promote competition, its consultation documents have barely considered how to do this. It also appears that the CAA has an unduly limited concept of competition, essentially meaning that price equals cost. Hence the CAA is led to think that promoting competition means keeping price equal to cost, which it considers is best achieved by means of a RAB-based price control or equivalent.
4. Competition is more realistically understood - not least by the Competition Commission (CC) in its market investigations including into the airport sector - as "a dynamic process of rivalry between firms seeking to win customers' business over time". The profit incentive in a competitive market leads airports and airlines to discover the prices, qualities of service, terms and conditions, duration of contract or rack-rate tariff, and other arrangements that best suit each individual user given the other competing offers available.
5. To promote competition means to encourage this rivalrous discovery process, not to second-guess the answers so that the process becomes redundant. Indeed, inappropriate regulatory restrictions may stifle the process and thereby restrict competition. In particular, maximum price caps and minimum quality of service conditions, which may seem in the short-term interest of airlines and passengers, may discourage potentially competing airports from exploring and offering alternative opportunities that could be in the longer term interests of these same airlines and passengers.

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http://www.gatwickairport.com/PublicationFiles/business_and_community/Regulation/Competition/LGW-BQ5-238-Regulationofanincreasinglycompetitiveairportsector-26May2013.pdf

6. The CAA has indicated its preference for GAL's Commitments in lieu of a RAB-based price control, but only on condition a) that the substance of the Commitments is modified to reflect the substance of the RAB-based price control, and b) that the Commitments are enshrined in a licence in order to ensure enforceability. My reservations in the initial paper were threefold. First, it is not clear that the CAA's additional demands are consistent with what a competitive market would provide and they may unduly constrain the development of competition, to the detriment of users of Gatwick airport. Second, there are alternative ways of enforcing the Commitments without a licence, for example via bilateral contracts with users or undertakings to the CAA. Third, the licensing of Gatwick would encourage the CAA (under pressure from other parties) to intervene more frequently, which again would not be conducive to the development of competition.
7. Given the potential drawbacks of licensing, and the CAA's proposal of monitoring at Stansted, I considered the possibility of regulation at Gatwick by means of monitoring plus Commitments from GAL, where these Commitments were not included as part of the licence. I concluded that this approach would reduce the burden of regulation, would overcome uncertainty about acceptable prices, would promote competition by encouraging negotiation between airports and airlines, would be more flexible than a licence condition, and would be a step closer to an unregulated competitive market. While not preventing the CAA from taking an active role and proposing a licence if it considered it necessary to do so at a later date, the approach would promote competition by reinforcing the expectation that issues and differences should be resolved by means of commercial negotiations and contracts rather than by regulatory intervention and a revised licence condition.
8. A regulatory body cannot hope to determine the most appropriate prices and services for each airline at each airport. The most effective way to promote competition is to give maximum opportunity for the airports and airlines to work out these details for themselves. Monitoring and Commitments can provide reassurance during this process.
9. It may at first seem difficult for a regulator to argue that licensing and price regulation are no longer appropriate. But maintaining the present approach to regulation will mean that debate on the merits of deregulation will continue to be based on hypothetical conjectures and fears, and will prevent the learning from experience that is necessary for improving the regulatory framework. With the most significant changes in airport sector and regulatory conditions for nearly three decades, a window of opportunity is open that will gradually close. If licensing and price regulation are not removed now, will they ever be?

Arguments of the airlines

10. In the absence of regulation, there is no doubt that Gatwick airport would continue to function and airlines would continue to fly there, some on the basis of a published tariff and others on the basis of negotiated contracts, all within the umbrella of the Commitments that GAL has offered. Broadly speaking, the question for the CAA to consider is whether the

Commitments offered by GAL are so unsatisfactory that the CAA is justified in stepping into the market, either to require GAL to be licensed in order to facilitate enforcement of a possibly more onerous set of Commitments than GAL has hitherto offered, or even to reimpose a conventional price control.

11. In the light of the final Commitments offered by GAL, do the views of the airlines suggest that such intervention by the CAA is necessary and appropriate?
12. The airlines and the ACC, which is said to represent the majority of airlines at Gatwick, met with the Board of the CAA on 17 July 2013, the minutes of which meeting have been published on the CAA website. The ACC and some airlines have separately submitted formal responses to the CAA, but this meeting was the opportunity for the airlines to make or reinforce their main concerns about the nature of Q6 regulation.
13. The airlines present a mixed picture of GAL's performance and the nature of the airport/airline relationship. That is, they do not simply have a litany of complaints that they wish the CAA to remedy. On the contrary, although they have concerns about GAL, they also make a number of complimentary remarks about the airport. For example, "airlines considered that GAL provides a good level of service" (p 2), "since the change of ownership, GAL has been a good operator and had made significant improvements to the airport in many areas" (p 3), and "airlines considered that the relationship with GAL had improved over the last couple of years" (p 4).
14. Furthermore, "the airlines stated that they were interested in commitments in principle" (p 2) although they had certain significant concerns (discussed below). "On balance they were not convinced by GAL's proposal ... however, airlines confirmed that they have not fully digested Gatwick's revised commitments published on 25 June". (p 2)
15. This is not a picture of a market in a crisis with poor performance and relationships damaged beyond repair, a situation that can only be resolved by regulatory intervention. On the contrary, it is precisely the kind of relationship that one would expect in most competitive markets. The parties have different views about what they would like and what they consider appropriate for other parties to provide, they are never wholly satisfied, but nonetheless good service is provided and the parties have respect for each other.
16. What are the reservations that the airlines express? "They were interested in commitments in principle but had significant concerns over the level of price, the service quality that would be provided and the legal enforceability of the service commitments." (p 2) I take these in turn.

The level of price

17. GAL's initial Commitments in its January 2013 Business Plan proposed a price path increasing at RPI + 4% per year over seven years. In their June 2013 response to the CAA's Initial Proposals, the airlines calculated that RPI – 9% would be appropriate.² This is an entirely plausible start to any

² ACC response to CAA Initial Proposals, 5 June 2013

price control negotiations, or indeed to any commercial contractual negotiations on the subject of price.

18. However, the CAA indicated its own thinking and GAL's own position moved too. The CAA's initial proposals in April 2013 suggested that a fair price path would be RPI + 0% over the seven years of the GAL Commitment. In June 2013, GAL argued that the CAA's regulated comparison price was unrealistically low. Nonetheless, GAL modified its proposed Commitment to RPI + 2.5%. (For simplicity I do not discuss its proposed RPI+1.5% for a blended price including revenue from bilateral contracts.) In August 2013, in response to airlines claiming this price was too high, GAL's final proposed Commitment was for a price path increasing at RPI + 1.5%.
19. It is not surprising that the regulator's position on a fair price fell between the proposals of the airport and airlines. But now that the CAA has indicated its view that a fair price path would be RPI + 0%, and GAL has moved from RPI + 4% to RPI + 1.5%, it is questionable whether the airlines' argument for RPI – 9% retains credibility.
20. Experience with price controls set by all utility regulators, including the CAA, is that the positions of both regulator and regulated company move in the light of new information and argument provided during the course of the price control discussions. It would be very surprising if the CAA failed to take on board any of the arguments made by GAL with respect to the components of the price control.
21. Suppose, for the sake of argument, that the CAA modified its calculations to indicate that an increase of about RPI + 0.5% would be a fair price. The CAA would then be faced with the question whether it was justified in imposing regulation for the sake of a 1% per annum difference in the level of the price path. Over the seven year duration of the Commitment that difference would gradually increase from zero to 7%, with an average of about 3.5%. Can a regulator ever be confident that its own calculations and forecasts are correct to within about 3.5% over a period of seven years? Even if the CAA made no adjustment at all to its initial calculations, the difference would be only 1.5% per annum, an average of about 5% over the seven year period. The same point still applies.

The service quality provided

22. The second concern mentioned by the airlines was the service quality that would be provided under the Commitment. However, in the minutes of the meeting with the CAA it is very difficult to ascertain what that concern consisted of, and how GAL might better address it. The only explicit remark, by easyJet on behalf of airlines, was that “the service commitment was not adequate to protect passengers”. (p 4)
23. The CAA's concerns about service quality, apparently endorsed by the airlines, were more explicit. They related to the level of rebates and bonuses in the service quality scheme, and to the extent of protection against repeated failures to meet service quality targets. In response, GAL's revised Commitments reduced the bonuses and increased the rebates that were sources of concern, and, in the event of persistent failure, proposed to introduce an improvement plan in consultation with the CAA.

24. In its final Commitments, and in response to continued opposition by airlines to its proposals on bonuses, GAL eliminated the bonus element of the Commitments. GAL says “We are able to report also that all the metrics of the proposed service quality regime have now been agreed with our airlines, and we believe that we are now in full agreement on all aspects of the service quality regime.”³ GAL had also proposed “an increase in the penalties that would apply in the unlikely event that there were protracted failures in service”.
25. In their meeting with the CAA on 17 July, “airlines confirmed that they have not fully digested Gatwick’s revised commitments published on 25 June, on which the CAA issued a consultation letter on 12 July.” (p 2) It seems that GAL’s revised Commitments, and the further modifications in its final Commitments, have addressed the airlines’ concerns. If so, there seems no basis for the CAA to require any further changes in response to airline concerns about service quality under a Commitments approach.
26. There is perhaps one related item that needs to be considered here. The minutes of the July meeting contain some slightly confusing discussion of the implications of additional investment, particularly with reference to Pier 6 south. Initially, easyJet for the airlines says that “airlines considered that GAL provides a good level of service and that given the high levels of investment over Q5, there was little appetite for further improvements in Q6, if this meant increasing costs”. (p 2) It is further said that only one airline supports Pier 6 south, that “the airlines did not consider that Pier 6 was required to deliver 95% pier service”, that pier service could be improved by other measures, and that “airlines considered that the expenditure on Pier 6 south was not in the passenger interest and would prefer the risk of a small reduction in pier service (to ca 94% at the end of Q6) rather than sanctioning the expenditure”. (p 3) Then the airlines are said to be “concerned that under GAL’s capex commitment, GAL would not deliver Pier 6 south or other passenger improvements but would instead focus expenditure on projects that generated commercial returns”. (p 4)
27. The minutes of the CAA’s meeting with GAL on the same day contain GAL’s more detailed explanation as to why it considers that Pier 6 south is a worthwhile investment. I am not able to assess the merits of these arguments by the airlines and GAL. However, it seems to me that the airline views on this topic do not provide any further basis for concluding that GAL would reduce service quality. On the contrary, it seems that GAL is arguing for investment to improve service quality, and airlines are resisting this.

Legal enforceability of the service commitments

28. Although the airlines mentioned enforceability of commitments as a concern, the meeting notes make no further mention of it. At this point I have nothing to add to the points made in my initial paper. I argued there that enforcement would be possible via bilateral contracts with users

³ GAL, Covering letter to Final Contracts and Commitments proposal, 20 August 2013, p 2.

and/or by GAL undertakings given to the CAA, as agreed between BT and Ofcom to avoid the need for licensing in that sector.

The consequences of regulation

29. The minutes of the CAA's meeting with the airlines include sections entitled GAL's approach and Contracts and commitments. The introductory paragraphs read as follows.

Airlines considered that, since the change of ownership, GAL has been a good operator and had made significant improvements to the airport in many areas. However airlines felt that GAL did not communicate well with the airlines, airlines "did not feel like valued customers", consultation was better at other airports and GAL managed to the contract and regulatory requirements. Airlines did not see GAL behaving in a normal commercial manner, for example by asking what it can do to help, for example to deliver greater passenger growth. (p 3)

The ACC stated that GAL had spent more time talking to the CAA than the airlines on contracts and commitments. (p 4)

30. Take first the point about commercial behaviour. GAL's Business Plan emphasises its wish to help its airlines to deliver greater passenger growth.⁴ I am unable to comment on how far GAL has succeeded in this. However, I would comment that, at an airport operating below capacity, it would indeed be a normal commercial approach to seek to deliver greater passenger growth. But at an airport operating at or near capacity the commercial priority will also need to increase the value of the traffic using the airport, and hence asking what the airport can do to help airlines achieve this. Higher value traffic is a more economic use of scarce capacity. Thus, if some airlines perceive GAL as not doing enough to help them grow traffic, this does not necessarily indicate airport behaviour that is uncommercial or inconsistent with a competitive market, nor a lack of interest in its airline customers.
31. The airlines express concern that GAL seems to spend more time talking to the CAA as regulator instead of to its airline customers. I am not able to comment on the actual situation here. However, economic theory and supporting evidence suggest that such a pattern of attention is a predictable consequence of regulation.⁵
32. If regulation rather than customer relations is the prime determinant of the level of a company's revenue, and indeed of its quality of service and other elements of its cost, it makes absolute sense for such company to devote

⁴ "We have included projects that will facilitate growth in airline traffic, helping our existing airlines to grow and also seeking to attract new long haul traffic. Many of the projects in our business plan accommodate the continued growth in short haul aircraft. However, we also need A380 capability, which will in fact be delivered in 2013. Much of the work in our asset stewardship programme is required to ensure the continued efficient operation of our airside assets, an area of key importance for our airlines. We also aspire to negotiate commercial arrangements with our airlines underpinning our intention to retain, and to grow, their businesses." (*GAL Business Plan*, ch 1, p 10)

⁵ E.g. Louis de Alessi, "An economic analysis of government ownership and regulation: theory and evidence from the electric power industry", *Public Choice*, 19, Autumn 1974.

more attention to the regulator than to its customers. This is unfortunate for the customers, but it is a direct consequence of regulation.

33. It seems that the airlines' own experience is consistent with this. They say that "consultation was better at other airports". They are not recorded as saying at which airports consultation was better. It would be surprising if it were at Stansted, where relations were so bad a few years ago that airlines and the airport were unable even to start constructive engagement in Q5, where the major airline there even now considers that Stansted's present engagement with airlines could not be any worse than before, and where the ACC can detect no difference in approach compared to before.⁶ It would be equally surprising if it were at Heathrow, where the airlines have been extremely disappointed by HAL's unilateral disengagement in the process.⁷ We are led to the conclusion that consultation is better at airports that are not regulated by the CAA. This is entirely to be expected.
34. One airline refers to trust. "Thomson considered that there was a fundamental lack of trust with GAL and this required efficient and effective regulation." (p 4) The reality is quite the opposite. If regulation is efficient and effective (from the point of view of the airlines) then there is no point in the development of trust. Neither airport nor airlines would find it worth investing time and resources to develop such trust. On the contrary, trust becomes worthwhile precisely in the absence of regulation. The way to develop such trust is to remove the regulation that reduces the value of trust.

Conclusions

35. In their most recent meeting with the CAA on 17 July 2013, airlines expressed three main concerns about GAL's proposed Contracts and Commitments approach. They are concerned about enforceability, but have not indicated any new thinking on that. They are concerned about service quality, but the modifications in GAL's subsequent final Commitments would seem address their concerns.
36. Perhaps most substantially, airlines are concerned about price. However, the CAA's own indicated fair price path is significantly above what the airlines argued for. Moreover, the price path in GAL's final Commitments is not significantly above the CAA's fair price path, and experience suggests that an economic regulator is likely to modify its initial proposals in response to arguments put forward by a regulated company. The remaining difference might be of the order of about 3.5% over a seven year period. Is it really justified to impose a price control in order to

⁶ "Ryanair stated that it was too early to say whether there was a material difference between MAG's engagement with airlines and those of its predecessor BAA/Ferrovial. Ryanair felt that it couldn't be any worse given that BAA Ferrovial had refused to engage with Stansted users." "The ACC's view was that, from an operational perspective, it did not feel it had much power in the recent negotiations ... As had previously been the case with Ferrovial/BAA, once Stansted decides to do something it simply goes ahead and does it, regardless of what feedback it receives from the ACC." (CAA Minutes from Board Stakeholder Session for Stansted held on 3 July 2013)

⁷ "Over the CAA's consultation period ... we had hoped to continue work with HAL towards an agreed and prioritised capital plan. ... We have been extremely disappointed by the unilateral disengagement by HAL on Q6 review matters at a critical stage in the process." (CAA, Response of the Airline Community to the CAA Q6 Initial Proposals for the regulation of Heathrow Airport, 8 July 2013, p 7)

reduce prices by an average of about 3.5%, particularly when doing so would restrict the incentives and operation of the competitive market?

37. Finally, the views expressed by the airlines suggest that continued regulation of GAL would have a detrimental effect on customer relationships. It would encourage GAL to pay more attention to what the CAA wants than what the airlines want, and it would encourage airlines to pressure the CAA to achieve their objectives by lobbying rather than by commercial behaviour.
38. The views expressed by airlines are thus not inconsistent with the final Contracts and Commitments proposed by GAL. Indeed, they provide reason to believe that such an approach would be preferable to that of continued regulation, even from the perspective of the airlines themselves.