

YOUR LONDON AIRPORT  
*Gatwick*

The CAA's May 2012 Policy Update  
Response from Gatwick Airport Ltd  
Promoting competition in the period beyond Q5



July 2012

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## Executive Summary

Since becoming an independent airport in 2009, Gatwick has increasingly been competing with other airports in the South East and more widely. This is apparent in the way we have introduced service innovations and improved levels of service generally, redirected capital expenditure to facilities most critical to passengers, and enhanced connectivity from the airport - all resulting in more passengers and airlines flying from Gatwick, many for the first time.

Ensuring that competition flourishes is vital to Gatwick's future. However, it is also the best way of stimulating all South East airports to provide passengers and airlines with the route choice and service that they need. This is the reason why BAA's dominant position in the South East is being broken up. It is therefore critical that the CAA's regulatory arrangements for the period after Q5 encourage competition to develop further and do not impede it. There is no case for continuing to regulate the airports as though BAA had not been broken up.

In a competitive market, both airlines and passengers have choice. Currently, more are exercising that choice in favour of Gatwick. Nevertheless, we understand that they will continue to do so only so long as the airport delivers. For passengers, many of whom on the CAA's own figures have used – or have considered using – another London airport in the past, that means continued good service, better facilities, shorter queues, and a sensitivity to the differing requirements of a diverse passenger base, including passengers with reduced mobility as well as business travellers. For airlines, it means a readiness to meet their commercial and operational needs and to provide the longer term security over charges and service that enables them to invest in the development of routes that meet their – and Gatwick's – passengers' needs.

In unregulated airport markets elsewhere, including across most of the UK, commercial arrangements between airports and airlines provide the security that both parties need to plan their businesses and to invest. In the South East, such arrangements have been displaced by regulation. For the period beyond Q5, Gatwick is keen to discuss with its airlines commercial, contractual arrangements which are tailored to their individual circumstances, recognising the differing demands they make of – and contributions they make to – the airport. Such arrangements will be able to recognise the many complex dimensions of the commercial interface between airlines and Gatwick in a way that the inevitably blunt instruments of regulation, suited more to constraining the natural monopoly power of utilities, are not.

Gatwick's vision is therefore of an airport operating within a competitive, commercially driven market where the airport succeeds only by meeting the needs of its customers; where airlines can gain both security and commercial advantage from contractual or default arrangements; and where passengers come to Gatwick because they want to. Gatwick recognises, however, that while the competitive drivers are in place following BAA's divestment of Gatwick, airline customers need time and space to adapt to these new circumstances and to enter into new commercial arrangements. There needs to be a transition from 25 years of regulation and the resulting behaviours and distortions.

The approach that Gatwick sets out in this document is intended to show how it will operate in a competitive market, as well as to provide assurance to both the CAA and our customers. This approach is consistent with the development of an increasingly competitive market and with Gatwick's evidence presented in November 2011 on substantial market power (SMP)

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and, in this response, on the risks of 'abuse' and the extent to which the costs of regulation are likely to outweigh the benefits.

Gatwick is therefore proposing that it will make transitional Commitments for the period following Q5 including a path for prices, and commitments on service levels and investment. These Commitments are intended to provide assurance to our customers about the behaviours that Gatwick airport will continue to demonstrate into the future, building on the progress made to date. We will engage with the CAA on these Commitments to show that alongside Competition law they provide sufficient protection to our customers. Such Commitments will not, however, represent the commercial deal facing our customers. While, for instance, we will commit to the passenger service standards the regulator has demanded in Q5, Gatwick will, as in the last few years, do better than this, both in the range of services it delivers and in their quality. Our ambition is to improve our service ranking amongst major European airports. Similarly, airlines will be able to negotiate underneath the price path set out in our Commitments and agree services geared more precisely to their circumstances.

We have not at this stage quantified these Commitments. We want to discuss with the CAA, airlines and passenger bodies the principle behind these new arrangements, to seek a consensus on this new way forward. To do otherwise would cut across the regulatory processes that the CAA has already initiated. However, we are keen to begin discussions so that some of the effort that will otherwise be expended on regulatory position-taking and process can more usefully be directed to future commercial arrangements that yield more benefits to all parties.

We are particularly looking to the CAA for a prompt and positive response. Our concept of Commitments chimes with a number of the ideas that the CAA has recently set out, and provides an opportunity to deliver on the Government's wider aim of cutting the burden and costs of regulation.

We believe it is important that the CAA's analysis pays more attention to both the development of competition and to the challenges facing Gatwick and its customers. The CC's break-up of BAA has created an opportunity for a more dynamic, competitive airport market in the South East which better serves passengers and airlines. The CC's ruling involved a significant break with the past but, if it is to deliver its potential, it also requires the CAA to break with its past and to recognise that competitive markets require a fundamentally different approach. Gatwick has shown through its innovation and conduct over the last few years, and now through its offer of Commitments to assist in the transition to this new market, that there is a different way of doing things. We hope that our customers and the CAA, as regulatory policy maker, will agree that regulation needs as significant a change as did the ownership by one company of London's three main airports.

## Introduction

This document is the response from Gatwick Airport Ltd (GAL) to the CAA's Policy Update<sup>1</sup> issued in May 2012. It will be followed in due course by further evidence relating to the issue of market power. GAL continues to believe that Gatwick Airport does not possess SMP, and intends continuing to press this point. However, while reserving our position on the SMP issue, GAL seeks in this response to focus on the question of whether and to what extent regulation is needed should Gatwick be judged to have SMP.

It does not, of course, automatically follow that SMP requires economic regulation. SMP exists elsewhere in the economy, without economic regulation, relying on the protection afforded by competition law. It is clear that such a position for the London and South East airports market is envisaged by the new legislation going through Parliament. That is why the requirement for a licence requires the passing of three tests, not simply one relating to SMP. The CAA, as it has acknowledged, has yet to address these issues in the depth required. GAL's views on the second and third tests are covered later in this document.

Another key feature of the new legislation also gives the CAA a duty to carry out its functions in a manner which will promote competition as the favoured means of protecting the interests of passengers (...“where appropriate, by carrying out the functions in a manner which it considers will promote competition in the provision of airport operation services”). Any new approach ought therefore to be developed with a view to promoting competition and the behaviours that might be expected in a competitive market from both the airport and its airline customers. This would also be consistent with the intent of the CC's break-up of BAA's ownership of the three main London airports.

There is no sense in the CAA's document that it has approached the issues in this way. Rather, the focus is primarily on regulatory mechanics without sufficient prior discussion of the long term vision that the CAA has for a competitive airports market; including how best to address the pressing need to make best use of capacity and the need to enhance the connectivity of London and the UK to the World. Nor is it clear what specific problems the CAA considers it needs to address at Gatwick Airport. It is particularly important that these issues should now be addressed because, in the UK, economic regulation has tended to be reserved for the natural monopoly elements of vital industries. In seeking to regulate the entirety of independently owned, competing firms the CAA will be an outlier in the UK regulatory spectrum, where moves to introduce competition involve a step away from, rather than towards, intrusive regulation. Overall, it is unclear that the benefit intended by the CC when breaking up BAA will be delivered under the CAA's proposals.

The way in which the CAA approaches the task given to it by Parliament is critical, embracing both economic regulation and the future development of the UK's aviation market. Gatwick believes that the evidence on SMP and its behaviours to date point clearly against continuation of intrusive economic regulation and towards recognising and encouraging the more competitive airport market that is now developing. The dynamics of competition will themselves ensure that GAL focuses on the needs of its customers, our airlines and passengers.

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<sup>1</sup> “Review of Price Regulation at Heathrow, Gatwick and Stansted Airports, Policy Update”, CAA, May 2012



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Gatwick believes that it can contribute both to furthering the debate on regulation, and to a practical solution, by setting out Commitments as to how it plans to behave beyond Q5 in terms of price, service, capital expenditure, innovation and in terms of the development of more commercial relationships with our airline customers. These Commitments, which are intended to aid the transition to a deregulated market, should provide assurance to Gatwick's airline customers and comfort to the CAA. They will also contribute to the already considerable evidence in relation to Gatwick's behaviours post break-up.

In this document, Gatwick identifies the scope of the Commitments it proposes. In some areas, such as passenger service quality, we also indicate the direction of travel in terms of the service improvements we wish to see. In the more commercially sensitive areas of price, airline service and capital expenditure, GAL is ready to discuss at an early stage with the CAA and airline partners the concepts and quantitative parameters it has in mind. However, we will be first looking first both to the CAA and the airlines for signals that they genuinely wish to explore this way forward. Otherwise, it is inevitable that the CAA-sponsored constructive engagement process, focused on traditional regulatory parameters, will inhibit consideration of GAL's proposed move towards a more commercial approach.

Within the Commitments, GAL intends to include a price path. We wish to make clear that any price path Commitment by GAL is intended to provide assurance only. It will represent an upper limit on the average price. We would envisage that this will not be the actual price that most of our airline customers will pay. This is because GAL believes that those actual prices, and the related services, are best negotiated between the airport and individual airlines.

We envisage that these Commitments would be transitional in nature. This will provide the space for Gatwick's airline customers to conclude longer term contracts with the airport, consistent with what happens in a competitive market, so that the prices and services they receive can be tailored to their specific circumstances. In this way, we can reflect the business commitments that each party gives the other, and the value that can be added by collaborative working between the airport and individual airlines.

Such longer term contracts will benefit passengers by providing airlines with a firmer basis on which to invest and grow their routes and services at the airport – so addressing one of the principal passenger priorities identified by the CAA, and assisting in achieving Government objectives for improved connectivity and optimised use of existing airport capacity. Passengers will benefit from the Commitments on service quality and Gatwick's ambition to improve its service ranking relative to European competitors. Passengers are also protected, of course, by the choice that they now have in the London and South East market – choice which the CAA's own evidence shows they are both aware of and use. Gatwick will continue to publish service and other indicators to allow all stakeholders, including the CAA, to monitor its performance against its Commitments.

The approach that GAL sets out in this document is intended to show how it will operate in a competitive market, as well as to provide assurance to both the CAA and our customers. This approach is consistent with the development of an increasingly competitive market and with Gatwick's evidence presented in November 2011 on SMP and, in this response, on the risks of 'abuse' and the extent to which the costs of regulation are likely to outweigh the benefits.

GAL looks forward to discussing these issues and its proposed approach to the period beyond Q5. We will also continue to contribute constructively to the CAA's current

regulatory processes. However, GAL believes that the approach it has outlined can, if supported, provide a way forward around which all parties can coalesce. The evidence on market power, the need to encourage and sustain competition and the challenges facing Gatwick in improving our performance and connectivity, all suggest that a traditional RAB-based price control would clearly be disproportionate, potentially counterproductive, and substantially at odds with the intent of the new legislative framework.

### **Structure of this document**

This document is structured in five sections.

- First, we summarise our understanding of the direction in which the CAA's proposals are heading.
- Second, we address the strategic and competitive challenges that need to be considered in designing any system of regulation for Gatwick, and the risks that continued regulation will thwart the development of Gatwick's commercial ambitions and of a competitive market. In this section, we discuss the evidence of Gatwick's behaviour since its sale by BAA in supporting Gatwick's view that the tests required by legislation cannot be evidenced by the CAA to the level required to support the imposition of a licence.
- Third, we assess how far the benefits of regulation stack up against what are very significant potential costs. Both benefits and costs need to be calibrated against any risk of abuse.
- Fourth, we discuss the issues associated with setting a "conventional" price control for Gatwick, in particular, highlighting the significant increase in price that might result.
- The final section of this document outlines Gatwick's proposed Commitments for the period beyond Q5 and explains how these will promote the interests of its customers and assist in the development of a more commercially focussed airport market, consistent with the competitive thrust of the CC's break-up decision.

The questions on which the CAA has specifically sought responses are dealt with in an Annex to the extent that they are not covered in the main document. In Gatwick's view, many of these questions seek to engage with the details of regulatory mechanisms in advance of having defined adequately the strategic issues which they are meant to be addressing. It is these strategic issues that are the main focus of this document.

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### 1. The CAA's Policy Update

The CAA's January and February documents provide the CAA's initial views on market power at the currently designated airports. The CAA's initial view is that Heathrow, Gatwick and Stansted are all likely to have SMP. The CAA's initial view is that SMP is likely to be strongest at Heathrow, weakest at Stansted, with the degree of market power at Gatwick lying somewhere between those two. In the light of its initial view, the CAA has indicated that it is minded to use its impending powers under the Civil Aviation Bill to issue licences to each of the three airports.

On the assumption that a licence is likely to be deemed necessary by the CAA, a range of possible regulatory options is then proposed. Chapter 5 of the Policy Update identified the following alternative forms of price regulation that the CAA wishes to explore -

- Flexible RAB
- LRAIC based price caps
- Pegging tariffs to "comparator" airports
- Regulatory default settlement
- Ex post licence condition
- Airport / airline negotiations

The CAA does not consider that these options are mutually exclusive. Thus, airport/airline multi-lateral negotiations (constructive engagement) could be a means of developing each of these. The CAA has been clear that some form of constructive engagement is compatible with all forms of regulation. Indeed, the CAA explains that, in its view, multi-lateral engagement between Gatwick and its airline customers would be expected in a de-regulated environment. Gatwick has explained that in fact competitive markets do not generally feature forms of constructive engagement in the way proposed by the CAA. In addition, the current regulatory process is highly costly, bureaucratic and stretches over three years. This approach is impractical in a dynamic, competitive and unpredictable market environment.

Later in chapter 5 of the Policy Update, the CAA begins to flesh out some possible issues that are specific to the market situation seen at Gatwick. These issues include –

- The preference of the airlines (but not the airport) for a RAB-based single till option
- The current mix of airlines and passengers mitigating against a "one size fits all" approach
- A price control design that offers sufficient protection against market power, whilst encouraging commercially led service differentiation

The CAA identifies a default regulatory settlement as one way of meeting its policy objectives at Gatwick. The existing Q5 price cap is defined by the CAA as being a default price cap that airport and airlines can contract around. The CAA considers that this kind of price cap could be extended to ensure sufficient protection against SMP while encouraging greater flexibility, service differentiation and commercial deals.

The CAA explains that a default regulatory settlement could specify a maximum average price per passenger, with a minimum acceptable service quality being defined. The airport would then be free to earn more than this maximum to the extent that higher service quality was agreed. The CAA suggests that the minimum level of service proposition could be discussed during constructive engagement. The CAA explains that the default settlement should be a realistic option for airlines that choose not to negotiate bilateral contracts.



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While the principle of a default price arrangement has some merit it appears in the CAA's reasoning to derive more than Gatwick's market circumstances require from a traditional RAB based methodology. Some of the other, less intrusive, regulatory ideas also have a degree of merit. To the extent that the CAA decides to continue down a relatively conventional regulatory framework, there will be concepts here that could be useful evolutions to the framework. However, we do not believe that such a conventional approach is either required at Gatwick, or would be to the advantage of our customers. As we set out later, Commitments seem to us to offer a preferable way forward. Nevertheless, we acknowledge that the Commitments offered below could fit with some of the CAA's ideas.

In chapter 6, the CAA identifies a range of "regulatory incentives" that it is considering. These include relatively detailed opex and capex incentives, of the kind seen in the regulated monopolies in the UK. Gatwick considers that some of these incentive mechanisms might, in a conventional RAB-based world, have elements of merit and we discuss each of the proposals in the Annex. However, our general concern is that the level of regulatory oversight and intervention envisaged is more likely to stifle, rather than support, the continued development of competition. We note that the CAA seems to be considering applying these incentive mechanisms to Gatwick, although the discussion appears mainly to be in the context of Heathrow.

Most importantly, we feel that the CAA's Update gives little attention to the nature and purpose of regulation as opposed to the mechanics of regulation. It is for this reason that we do not believe that the options so far identified will address the key issues facing Gatwick and we believe that they are unnecessary anyway given the market and regulatory fundamentals discussed below.

## 2. Gatwick's views on the CAA's analysis

### 2.1 The three statutory tests

As set out in the draft Civil Aviation Bill, there are 3 tests that must be considered by the CAA before a licence is issued -

- Test A, "the relevant operator has, or is likely to acquire, substantial market power ..."
- Test B, "competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that substantial market power"
- Test C, "the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects".

The tests are important in two ways –

- First, it is for the CAA to prove the need for regulation. As outlined above, the thrust of the CAA's Policy Update document is that regulation should be assumed at the three currently regulated London airports. At one point, the document talks of Gatwick appearing 'to still hold SMP' despite the airport never previously having been considered as a stand-alone entity from this perspective whereas its market power, and the need for regulation, derived from BAA's joint ownership. Until, therefore, an evidenced case under all three tests has been made, we consider that the *ex ante* assumption should be that there should be no economic regulation.
- Second, even if SMP is found, the extent and nature of that market power should feed directly into the need for regulation (if any). A finding of SMP could as easily sit with no licence, a licence without price regulation or a licence with price regulation. The need for, and type of, licence and regulation should derive from the "harm" that is evidenced by the CAA, and a clear demonstration that competition law is insufficient to deal with it.

The CAA has undertaken some work on Test A. Gatwick continues to have reservations about the quality and balance of the CAA's analysis. There is, as yet, no detailed consideration of the second and third tests. The CAA has presented no substantive analysis of the risks of abuse of any SMP and there has been only limited analysis as to why competition law is deemed not to be sufficient to rely upon. There appears to have been no analysis as to whether the benefits of regulation outweigh the costs, not least because there has been no real analysis of the strategic issues facing Gatwick and its customers. There has been no consideration of the approach that is likely to be taken by Gatwick Airport without economic regulation. Without analysis in these key areas, it is not clear to Gatwick why the CAA is already proceeding to discuss detailed interventionist regulation at Gatwick on the basis of its "exploratory views".

In the remainder of this section, we review the three part test which the CAA has to conduct and the considerations that should inform its analysis.

## Test A

### **“the relevant operator has, or is likely to acquire, substantial market power”**

Gatwick is undertaking further work to add to the evidence that Gatwick does not, and should not be expected to have, significant market power. In summary, our view, evidenced in our November 2011 submission to the CAA<sup>2</sup> is that -

- Gatwick’s 25% market share falls well short of the level associated with dominance;
- Airlines and passengers can and do switch;
- Capacity is not a constraint on competition;
- Gatwick is operating competitively and innovating, in line with the CC and CAA’s expectations in mandating the break-up of BAA’s London airports;
- Airlines with a significant degree of buyer power account for the majority of Gatwick’s traffic;
- The competitive price level (the reference point for SMP analysis) is above the prevailing regulated price level at Gatwick, perhaps significantly so; and
- Regulation will hinder the development of competition and innovation

Each of these points is supported by detailed evidence provided in our November 2011 submission. We will continue to make the case that Gatwick airport does not have SMP.

## Test B

### **“competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that substantial market power”**

The CAA says it has come to an initial view that competition law cannot be relied upon to address the risks of abuse of the SMP that it considers exists. We note that the CAA has yet to provide evidence in this area. Nevertheless, in its January and February documents, the CAA has in general terms identified the risks of abuse it is concerned about –

*“The CAA’s emerging views on market power, based on the balance of current evidence, means that there remains a significant risk that absent some form of safeguard from April 2014 the degree and nature of market power possessed by the airports may result in adverse outcomes (compared to what might be expected in a well-functioning market) for the users of airport services, including present and future passengers, cargo shippers and airlines. Potential areas where these adverse outcomes might manifest include service quality, investment decisions, consultation, innovation and prices charged.”<sup>3</sup>*

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<sup>2</sup> “Airport Competition: Competing to grow to become London’s airport of choice”, Gatwick Airport Ltd, November 2011 ([link to website](#))

<sup>3</sup> “Heathrow, Gatwick and Stansted – market power assessments, Summary of CAA’s initial views”, CAA, January 2012

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We address each of these areas, in summary, as evidence that the risks of abuse identified by the CAA, are not borne out by Gatwick's behaviour since the purchase of the airport or by Gatwick's stated intentions in relation to our approach in the future.

### *Service Quality*

Since the change in ownership, the service quality to our airlines and passengers has been transformed, and we plan to build on this by continually improving service and efficiency. We note that Gatwick is now meeting all of the regulatory service quality targets set by the CAA and has introduced a number of services which were not mandated by the regulator but have been designed to assist our more vulnerable passenger groups. We have also worked to improve service to passengers in areas not directly under the control of Gatwick as an airport operator, notably arrivals baggage and immigration queuing.

These initiatives have been designed to improve Gatwick's competitive position and the results are now apparent in the gradual rise of Gatwick's position in the independent ASQ rankings. Gatwick now rates 8<sup>th</sup> in terms of the major European airports. There has been a significant improvement in the ASQ score of Gatwick since Q4 2009, the date of purchase by GIP, when on the same basis, Gatwick was ranked 12<sup>th</sup>.

In summary, the CAA has indicated a general concern that service quality would fall if Gatwick were deregulated. Gatwick's performance, including in areas which are outside CAA regulation, provides no justification for that concern. Gatwick is prepared to provide further assurance on this area by proposing service commitments which are set out in the final section.

### *Level of investment*

Since the change in ownership, Gatwick has prioritised capital expenditure where it will most benefit passengers, and therefore improved the airport's competitive position. We have been able to progress most of the projects put forward by BAA for Q5, while also delivering additional investment in, for example, the £45m South Terminal security project and a new fleet of snow clearing equipment. These investments came out of savings in the BAA investment programme and were not contemplated in the Q5 regulatory settlement. It should also be noted that we took the decision to sacrifice retail income in order to deliver the South Terminal security project. We achieved these improvements despite and not because of the current regulatory system.

We are now proceeding to invest in A380 capability, despite lack of formal agreement from our existing airlines, and despite the incentive not to do so under the current regulatory environment. Our current capital expenditure programme to 2014 amounts to £1.2bn. The proposals in our business plan for the period 2014 to 2020 amount to a further £1.15bn<sup>4</sup>. The record of delivery since sale, the support of our airlines for the vast majority of the Q5 capital programme, and the scale of ambition

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<sup>4</sup> "Connecting London to the World, Initial Business Plan to 2020", Gatwick Airport Ltd, April 2012

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in the period beyond Q5, suggest that any CAA concern over our willingness to invest is not supported by evidence. As with prices and service quality, the Commitments provide assurance as to continued investment and appropriate consultation.

### *Consultation*

Prior to the change of ownership, GAL carried out consultation in accordance with Annex G. Since the change in ownership, GAL has striven to improve the level of engagement within consultation. For instance, we now consult on more individual projects and give more detailed information via business cases (on templates agreed with the airlines) than ever before. This detail has helped the Gatwick airlines put forward educated challenges which are either satisfactorily answered with further detail or help to improve the business cases and final solutions.

A further example of improvement under new ownership is our immediate remedial actions (in the few areas found) following the mid-quinquennial review, which was focused on GAL's performance prior to change of ownership. Examples of the changes include the appointment of independent consultants (Davis Langdon) for external benchmarking of our capital projects, and indeed the more extensive use of external benchmarking data by our internal cost consultants EC Harris prior to providing cost estimates.

This step change in information disclosure and consultation has been recognised by our airlines. We are confident that the requirements of Annex G – the CAA's own guidance for consultation – will have been met in full. All projects go through extensive and internal review, via a Tollgate process. The success of this consultation process is that the vast majority of the original Q5 project plan – as revised following sale – is supported by our airlines. We continue to strive to secure support for the A380 and the snow equipment. With respect to Q5+1, we are confident that we will secure airlines support to well over £200m of capital expenditure.

### *Innovation*

There is ample evidence that innovation has been increasing at Gatwick. This has been recognised by the Competition Commission as well as the Competition Appeal Tribunal. Examples that are visible to passengers include family security lanes, premium products, security queue times on screens in the departure halls, many online awards, new toilets and South Terminal security. There are many other examples of the application of advanced management techniques and innovation. A key example is the programme that seeks to expand peak capacity on the runway to 55 movements per hour, a runway that is already the most efficient single runway in the World. There is therefore no evidence that innovation is suffering as we seek to compete, nor a risk of innovation being restricted in the future. Indeed, Gatwick clearly sees innovation as an important way of developing a competitive edge in the market.

### *Prices*

The regulatory price cap has directly governed the level of prices in Q5. Evidence of abuse, or risk of abuse, is therefore difficult to bring to bear. Such evidence would have to be set against a view of the "competitive market level" faced by Gatwick. As

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the CAA's competition guidelines explain, any evidence as to the price level has to be made at the competitive price level, not the regulated price level. The issue for the CAA is not whether prices can rise from the regulated level, but whether they can rise from the competitive price level. Until the CAA has evidence as to what the competitive price level is, no conclusion can be drawn from projected levels of price rises against today's (regulated) price levels. In any event, any concern the CAA may have about Gatwick's future intentions with regard to prices is directly addressed by the Commitments proposed below.

### *Conclusion on evidence on Gatwick's behaviour*

The evidence from Gatwick's behaviour since break-up, reinforced by the Commitments to service and price that we are willing to give, suggest that the risks of abuse in this case fall far below those usually associated with a dominant position. Our behaviours to date and the Commitments we are proposing are consistent with development of a competitive proposition against other airports in the UK and overseas.

### *Can the CAA rely on Competition Law?*

The evidence above is also relevant to the question as to whether the CAA can rely on competition law. This evidence suggests that, even if CAA concluded that Gatwick held a position of SMP, the scale, scope and nature of that SMP is such that any behavioural risks can be dealt with by competition law. Only where such risks are particularly great, as is the case with natural monopolies, do public authorities usually resort to *ex ante* economic regulation as opposed to *ex post* competition law. We contend that there is nothing to suggest that Gatwick either possesses a degree of market power, or poses a risk of abuse, sufficient to merit anything but oversight through competition law.

The CAA appears to place reliance on the CC's opinion that economic regulation may be required as competition develops. However, that assessment is now five years old. Market circumstances have changed. There is now clear evidence of our competitive behaviours as was recently confirmed by the CAT and the CC. The capacity position is also very different. While the CAA draws attention to the changed position on new runways, it has not recognised the changed capacity picture following the recession and other factors identified in Gatwick's submission of November 2011. Most crucially, the CC's opinion was not calibrated against the tests that the CAA is required by law to follow.

Finally, the CAA's arguments do not take account of the changed institutional arrangements under the Bill currently proceeding through Parliament. The CAA will become a concurrent competition authority in respect of airports, and will be able therefore to focus its expert resource and organisation on ensuring that barriers to appropriate enforcement are overcome. Any doubt as to the interpretation and use of general competition law will be for the CAA, rather than other competition bodies, to assess. Instead, many of the arguments adduced by the CAA against reliance on competition law are tantamount to questioning the basis of competition law enforcement in the UK generally. These raise questions which ought to be dealt with by Parliament rather than by a single regulator in relation to a single business entity. The relevance of arguments adduced in the case of Stansted is anyway doubtful given that that airport was part of the BAA monopoly rather than, as in the case of



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Gatwick, a self-standing competitive entity. The balance of risk was therefore very different.

### Test C

#### **“the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects”**

If the CAA had substantiated SMP, and had concluded that competition law could not be relied upon to address perceived risks of abuse, the CAA would still have to demonstrate that the costs of regulation are outweighed by the benefits that it delivers. As with the second leg of the test, the CAA has yet to present any analysis on this part of the statutory test. Such analysis needs to include an assessment of the challenges facing Gatwick, and the aviation market more generally, and how far regulation can assist in meeting these challenges. Such assessment should include analysis of the interaction between regulation and the competitive airport market that is developing. The CAA has yet to engage in detail with these issues despite their importance to the balance of regulatory cost and benefit. GAL’s analysis of these issues is set out in the next section but, in summary, GAL would highlight the risks that regulation will -

- cut across the development of the competitive market to the detriment of both passengers and airlines;
- undermine the development of normal commercial relationships between Gatwick and its airlines;
- encourage undue emphasis on one-size-fits-all approaches to passenger service and fail, as regulation focuses on the airport alone, to address the end to end processes which involve many airport partners; and
- distort the incentives of the airport and airlines generally but with particular impact on capital investment.

These points are addressed in more detail in the next section.

### **Conclusion on the statutory test necessary to issue a licence**

A full review by the CAA of the three part test will not, in Gatwick’s view, provide sufficient evidence to support a decision to continue regulating Gatwick airport. The CAA has yet to provide evidence sufficient to substantiate its initial finding on SMP and is even further from satisfying the second and third legs of the statutory test. We believe that the CAA should now undertake further work on the three part test in the context of the Commitments by Gatwick that directly address issues raised by Tests B and C. Moreover, we believe that the third leg of the test requires the CAA to consider how effective economic regulation will be in addressing the challenges facing Gatwick airport and the CAA in sustaining and encouraging the development of a competitive market. In the next section, we explain why it is important that the CAA’s proposals address these challenges directly.

## 2.2 Key strategic and commercial issues for Gatwick

### Introduction

In Gatwick's view, the starting point for construction of a regulatory framework – indeed, whether regulation is required at all – should be analysis of the issues which that framework is intended to deal with. This starts with the nature of any SMP finding and how that affects assessment of the risks of abuse. But it also needs to include assessment of the market generally and of the specific circumstances facing the regulated entity, recognising not least the significant differences between regulating competing airports as compared with regulating natural monopolies. Such analysis is crucial to consideration of the costs and benefits of regulation as, without it, neither cost nor benefit can be determined. Indeed, it is difficult to see how there can be any realistic debate about the nature of economic regulation without prior analysis and understanding of what harm regulation is seeking to address.

Other regulators facing similar challenges have usually conducted a good deal of prior work to understand the strategic context within which regulation will play out. Hence,

- Both Ofwat and Ofgem have reviewed their regulation of natural monopoly networks, recognising that regulation needs to be refreshed after a long time in operation;
- Ofgem also removed regulation where competition in the retail energy market was felt to be sufficient protection for customers;
- Ofcom has fundamentally changed the regulation of Royal Mail to recognise changing market circumstances; and
- Australian airports have now been through three reviews which initiated de-regulation and then confirmed it, leading to outcomes which have benefited airlines and passengers. We note that the London airports all serve the same market whereas the Australian airports tend to be hundreds of miles from each other.

In the CAA's case, such work would need to address -

- How best to sustain and promote the competition initiated by the CC's break-up of BAA, in line with the CAA's new statutory duties and the best interests of passengers;
- The strategic business challenges facing Gatwick; and
- Key passenger priorities

These issues are dealt with in turn below.

### Competition between the London airports

The recognised difficulties of implementing, and distortions created by, *ex ante* sectoral economic regulation, have generally limited its use to areas of dominance in areas of natural monopoly and essential public services. In particular, the greater the degree of competition and/or of market change, the less appropriate economic regulation is likely to be. A regulator, at some distance from such a market and using inevitably slow moving processes, is going to find it hard to keep up, and therefore risks compromising the development of the market and associated competition. For this reason, regulators have tended proactively to

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lift – or significantly modify – regulation in advance of competition developing fully for fear that the presence of regulation would inhibit the development of competition. It is doubtful, for example, whether the low cost airline revolution would have progressed as far and as quickly as it has had the airline sector still been regulated as it was in the 1980's. These are highly successful airlines, carrying many more passengers and delivering excellent value. Would the regulators of the 1980's have envisaged, allowed or incentivised this particular model?

Although the end result of competition is the consumer receiving the product or service desired at a reasonable price point, the competitive process involves more than this. It is also about discovery of more efficient ways of doing things and of what consumers want. This may often be through trial and error, success and failure. These are features of competition that economic regulation finds difficult to replicate. Economic regulation tends to be more focused on the setting of prices that do not involve excessive profits. Even for a natural monopoly, that focus inhibits innovation. It is likely to be all the more so where market forces and competition are in play.

The importance of this is underlined by the fact that under the Civil Aviation Bill, the CAA will have a duty ...*“in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services ... where appropriate, by carrying out the functions in a manner which it considers will promote competition in the provision of airport operation services”*. This puts the promotion of competition at the heart of its regulatory mission, given Parliament's preference for competition as a means of furthering passenger interests. This means considering not only how competition can be promoted, but also how regulatory measures may be designed better to promote competition; and testing whether any regulatory proposals may be likely to hinder the development of competition, or the behaviours that may be associated with it. This is something that other regulators (and, indeed, the CAA itself in the past in relation to Manchester and Stansted) have paid particular attention to.

Some of the risks to competition are risks which can apply to economic regulation generally. So, for example, tight price caps risk dampening the development of price signals that are crucial to the development of competition and may provide insufficient room for the development of the more differentiated pricing required to secure better use of scarce facilities and to differentiate service offerings. Similarly, regulation, which is an administrative process, is not well-suited to the more complex judgments and trade-offs which are the essence of markets. Nor are the inevitably lengthy timescales for regulatory processes likely to be consistent with those needed to innovate in competitive, fast moving markets.

In most previous cases where regulation has previously been involved in markets developing towards competition, it has been applied to only one firm, the incumbent. The situation in the London and South East airport market is considerably more complex, with the break-up of BAA's dominant ownership position introducing separately owned major airports in the South East for the first time. Faced with this new dynamic, the CAA appears to have ambitions to regulate three of the competing airports, with even greater potential for distortion. The way in which regulation fails to meet these competitive requirements is discussed in the next section.

In summary therefore, any proposal for regulation of the airport market has to take account not only of the issues that are generic to the interplay of regulation and the development of competitive markets, but also of airport-specific issues. There is as yet little indication that the CAA has analysed these issues or the cumulative difficulties that regulation, and in

particular some of the processes it has already set in train, will cause the development of competition. Nor does the CAA appear to have considered the particular strategic and business position of Gatwick airport at this juncture or how economic regulation might best take account of these requirements which, in turn, will have a significant influence on the way in which competition develops.

### **The business challenges facing Gatwick**

Gatwick is facing a number of challenges which, aside from the overriding issue of developing competition, would have required a radical rethinking of regulation. Airports are significantly fixed cost businesses. Simple regulatory mechanisms which encourage traffic and commercial revenue growth work with the grain of the natural commercial incentives of a fixed cost business. However, such mechanisms are less well suited to more complex conditions such as those that now obtain at Gatwick, where the key commercial challenges are -

#### *Competition*

We see competition from Heathrow, Luton and Stansted as well as more distant airports as being one of the key challenges facing Gatwick. The ongoing massive investment in Heathrow's facilities means that we will need to continue to invest and upgrade service if we are to build on recent successes in attracting long haul airlines. In contrast, the lack of investment at Stansted obscures the fact that Stansted could grow significantly, to around 35mppa, with relatively little investment. We note with interest the recently announced expansion plans at Luton. All of these airports create significant competitive challenges for Gatwick.

Looking beyond the South East market, we see major competitive dynamics, particularly in the low cost sector. easyJet's announcement that it was closing its base in Madrid reinforces the message that low cost airlines are readily and easily able to change aircraft allocations across the whole of Europe, a fact that is amply supported by a review of actions undertaken by easyJet, Ryanair and others.

#### *Encouraging efficient use of the runway*

As the busiest single runway international airport in the world, Gatwick is already the most efficient user of runway capacity in the world. Nevertheless, there is still room to grow throughput on the runway. Current forecasts indicate that we could provide up to 40mppa by 2020, and perhaps more thereafter. This will require more effective incentives on our airlines to encourage best use of the runway. We will be looking for larger planes, with higher load factors, operating outside of our traditional peak periods. While a standard regulatory framework rewards additional throughput for a short regulatory period, it does not adequately recognise the increasing effort to secure gains that are ever more marginal to the airport but important to airlines and public policy. Nor does it encompass the partnership working that is necessary to secure such gains and risks allowing insufficient space for the degree of incentivisation that will encourage best use of the airport's facilities.

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### *Better targeting of commercial incentives*

The single till nature of the price cap means that we cannot distinguish between those airlines that bring higher commercial revenues to the airport or help us to make better use of the infrastructure. We see a wide range of commercial performance from our various airlines. Allowing airlines that provide higher commercial income and/or lower costs to the airport to benefit from that higher contribution would ensure that airport charges better reflected the overall economic contribution of different airlines to the airport, while also providing higher-powered incentives overall to increase commercial income.

### *The end to end passenger experience*

Gatwick's commitment to improve the passenger experience can be seen in the improving scores for passenger experience we reported above. We are now meeting all our regulatory service targets. However, much of the passenger journey through the airport is in the hands of others, and we can see considerable room for improvement in this, involving the full range of airport partners. We are beginning to increase collaboration with our partners so that we can ensure a focus on the passengers' overall experience at the airport. However, regulation is at best irrelevant to this, in that it focuses on the airport alone, and at worst detrimental to the extent that it mitigates against contracting which is likely to be the main way of bringing all elements of airline performance within a single commercial arrangement.

### *Delivering efficiency*

New ownership has delivered a step change in the efficiency of Gatwick, both in terms of operating and capital expenditure. However, in common with most other regulated industries that have been subject to several turns of the regulatory handle, we are sceptical that there are further major advances in efficiency that can be achieved by the airport alone. The opportunities now lie more at the interface with other parties at the airport, with scope for process efficiencies through working with airlines and others to improve efficiency overall.

### *Product differentiation*

Gatwick is competing, for instance in securing based aircraft, with airports throughout the UK and Europe. In London and the South East, passengers and airlines have a number of choices. However, we have two main competitors. At one end, we compete with Heathrow, seeking to offer the full service experience demanded by many passengers. This full service experience will be enhanced at Heathrow when it opens its new 30mppa Terminal 2. On the other hand, we foresee major competition from Stansted, particularly as it moves into separate ownership. Our response to this multi-layered competitive dynamic is to seek to differentiate what we offer to cater for the great variety of airlines we now serve and for the differing requirements of their passengers. The airport's ambition to grow its long haul business is absolutely dependent on this.

### *Connectivity*

The period of separate ownership has already shown that Gatwick has an increasingly important part to play in providing enhanced connectivity of London to



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the World. We have recently introduced a number of Asian routes, and we see this push to the East as being a major part of our development as London's airport of choice. Continuing this route expansion requires offering prospective new airline customers a lot more than the one size fits all price and service resulting from regulation.

In short, as the airport continues to grow, its commercial revenues mature and efficiency gains become more difficult to come by, regulatory mechanisms suitable for less mature businesses will no longer suffice. There needs to be both more room and more incentive for the commercial arrangements that can realise the next layer of business improvement. Increasingly, that can only come from working more closely with partners who are also incentivised to deliver; from greater differentiation of pricing so that partners which deliver traffic and revenues for the airport are rewarded accordingly; and differentiation of service so that the airport is incentivised to deliver by benefiting from the value it adds to customers' experience at the airport.

### **Passenger priorities**

We are pleased that the CAA has undertaken research to understand passengers' priorities. Gatwick is very supportive of the CAA's duties being changed so that passengers' interests are at the heart of the CAA's regulatory policy functions. The CAA's Policy Update explains passengers' priorities to be (in order of priority) -

- Availability of flight and route
- Cost and convenience of getting to the airport
- Cheapest flight available
- Airport facilities

As part of its consideration of the appropriate regulatory framework, if any, for Gatwick, it will be important that the CAA considers how best to address the full range of passengers' priorities. There are some comments to make at this stage.

First, it is noticeable that the CAA – having identified that the passengers' top priority is availability of flight and route – does not set its regulatory proposals in that context. Gatwick has been very successful in attracting new long haul routes to London. This year, we have added connectivity to China, Hong Kong, South Korea and Vietnam. Competition between Gatwick and the other London airports has been a key factor, driven by our relentless focus on delivering improved service quality and facilities at Gatwick. In this way, we helping to provide the connectivity that London clearly needs. The CAA's developing thinking should directly address how this success can be maintained. In the longer term, this could be through the provision of extra runway capacity in the South East. In the interim, the CAA's proposals need to permit the airport to maximise the contribution it can make to extending London's connectivity. As yet, the CAA's analysis does not address this issue, which is closely linked to what has been identified as passengers' top priority.

Similarly, the CAA appears to be giving little thought to the second or third priorities of passengers, i.e. the cost and convenience of getting to the airport and cheapest flight available. Given the surface access challenges which passengers face at Gatwick, and the



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fact that airlines say they are reluctant to switch services away from Gatwick because of the higher yields available to them, it is surprising that the CAA does not address the second and third passenger priorities.

Instead, the CAA focuses almost all its attention on the passengers' fourth priority, airport facilities. Yet, Gatwick already has a direct and intense focus on the interests of passengers. This is reflected in its performance to date and the proposals in its business plan for investment in passenger facilities. The initiatives it has taken and plans build on the work it has done to understand passengers' views better. In addition, we commissioned YouGov to ask passengers what was important to passengers at an airport. This work should supplement the CAA's own work in this area. The YouGov work is summarised in the business plan published in April 2012. Overall, our passengers wanted a superior airport ambience, a reduction in time spent queuing at key passenger touch points and a welcoming environment.

### **Conclusion**

The challenges facing Gatwick now are significantly different from what they were only a few years ago. Gatwick needs to continue developing its competitive proposition for a market where airlines and passengers have choices. Any proposal for regulation of the airport market therefore needs to take account not only of the issues that are generic to the interplay of regulation and developing competitive markets, but also of airport-specific issues. We have identified above some of the ways in which regulation looks unlikely to assist in meeting specific challenges. We now turn to Gatwick's analysis of whether economic regulation generally is likely to be fit for purpose in the circumstances we face.

### 3. Can economic regulation meet these challenges?

In the unregulated part of the industry in the UK and elsewhere, airports and airlines look to reduce the uncertainties to which their businesses are subject. Airports wish to reduce uncertainty around traffic volumes which, given the fixed nature of airport costs, are a major determinant of profitability. For their part, airlines wishing to invest in developing routes from an airport look for security around airport charges and elements of service which are critical to their operations, for instance, turnaround times in the case of LCCs. The way both parties achieve their aims is through contracting, often for fairly long periods. However, the presence of economic regulation impedes such developments, for a number of reasons:

- the existence of a regulatory process and the prospect of potential regulatory outcomes can mean that contractual discussions do not get off the ground. First, the energies of both parties are diverted into the traditional territory of RAB-based price caps. This is the more so now that the CAA has both widened the remit of CE compared with Q5 and insisted that the discussions are conducted so as to enable a RAB-based price cap to be arrived at, even though this may not be the regulatory outcome required. This is simply displacing activity that would in a commercial environment be directed more fruitfully to contracting discussions, enabling the airport, airline by airline, to meet the needs of its customers better. Second, the prospect of a regulator-determined price cap significantly lessens, to the point of almost extinguishing, the incentive for airlines to engage in contract negotiations with the airport. If the regulator is ultimately to determine pricing, investment and service, why should airlines engage with the airport? The security that airlines in commercial environments seek through contracting is effectively provided by the regulator, once again displacing commercial activity.
- the CAA has set out in its document guidance on how commercial agreements might be incorporated into what it terms a 'default price cap'. Some of this is uncontroversial, for instance the need for consistency with the requirements of the Airport Charges Regulations. However, other parts of the guidance could cut across the development of contracting. For example, while the CAA suggests that contracts can span regulatory periods, there is no assurance that the regulator will honour them. Indeed the statement that the risks of inconsistency with future regulation lie with the parties, clearly cuts across contract development. Why would airports and airlines invest in contracting which subsequent regulatory decisions may undermine to either or both their detriments? So while the CAA has welcomed the concept of contracting, it has failed to analyse sufficiently what this might imply for its own approach and, in seeking to preserve its own regulatory freedom of manoeuvre, risks creating obstacles which could effectively preclude the development of contracting.
- Regulation which is intended to protect consumers from abuse of monopoly is not best fitted to more targeted requirements. In particular:
  - fixed and relatively short regulatory periods limit the incentives to seek out efficiency and commercial revenue gains, the more so where they are likely to be smaller than in the past. Regulatory tweaks, such as rolling incentive mechanisms, can in principle assist but only at significant cost in terms of complexity and potential uncertainty about what will in the event be counted and what excluded. Longer regulatory periods could assist but only if there was no question of the gains being revisited mid-term. Other regulators experimenting

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with longer regulatory periods have tended to opt for mid-term reviews, which can undermine the incentives that longer periods are intended to create.

- there are no mechanisms which give real encouragement to a partnership approach to realising either operating cost or commercial revenue gains. This is in part because regulation tends to share any gains around, rather than attributing them, in a more commercial way, to those airlines which have done most to help create the value for which they should be rewarded. It is also because regulation which is regulation of the airport discourages win/win discussions as opposed to arguments where parties seek to gain at the expense of each other.
- RAB-based regulation focuses attention on inputs rather than outputs. Airlines become focused on second-guessing the airport operator, as evidenced by the current CE requests for security rostering schedules and job descriptions. This goes way beyond how a commercial business should expect to relate to its customers; and it deflects all parties from what in a commercial environment would really concern them, namely price and service. Yet, the CAA's current interpretation of the 'strategic issues' within the CE mandate appears to be encouraging airlines further in the direction of detailed second-guessing rather than genuine commercial interaction.
- while the airport has freedom, in principle, to price-differentiate according to use of its facilities (for instance, peak vs off-peak runway use), and is seeking to use these pricing mechanisms, the CAA's approach is distinctly ambivalent. It is notable that the Stansted 'finding' of possible market power in the peak was accompanied by apparent CAA approval of Stansted's lack of peak/off peak pricing, with the implication that that might be regarded as evidence of abuse rather than as a legitimate response to differing demands for the runway .

While adjustments to regulation can seek to deal with some of the issues raised above they are likely to do so only by adding greater complexity or uncertainty. In addition, there are some issues, such as the encouragement of partnership working, which are not the task of regulation. We believe that the current stage of development of Gatwick raises real questions around the suitability of regulation and poses a real risk of costs outweighing the benefits that such enhancements are intended to solve. Indeed, the CAA's main focus on the regulation of services from airport facilities is at odds with its own findings on passenger priorities which identify that passengers' most important priorities lie elsewhere.

In particular, it is surprising, given the priority Government and many stakeholders attach to connectivity of London and the South East, that the CAA does not focus more on the issue of routes where Gatwick, competing with Heathrow, has made significant progress in the last year in broadening its portfolio of long haul routes particularly. Contracting would provide a firmer base for airline investment in such routes. More generally, the CAA rightly acknowledges the complexity of regulating for passenger outcomes but does not consider how far it really needs to regulate or whether developing competition between airports will be better able to deal with such complexity than regulators.

Whether approached from the direction of encouraging competition or dealing with the more complex, nuanced business drivers of a relatively mature airport business with a diverse customer base, the traditional approach to regulation looks likely to be found wanting in ways which need to be properly reflected in the assessment of costs and benefits required

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by the new legislation. It is striking that despite the importance of these points – underlined by the statutory duty that the CAA will have in respect of competition – the CAA's document does not pause to consider them. There is no discussion of how regulation might best encourage competition, despite the seismic change to the market wrought by break-up. There is very little consideration of how far traditional and relatively blunt regulatory approaches are likely to add value in circumstances where gains are likely to be more difficult to come by and require a more tailored, commercially focussed approach to working with partners. The CAA is in principle welcoming of commercial contracts but, again, does not consider whether the forms of regulation it has put on the table are consistent with such contracting or may be a barrier to them.

In summary, the CAA's approach appears to take an enhanced form of regulation as its starting point rather than first seeking to assess the issues to which economic regulation should be addressed. In Gatwick's view, that risks a solution that is inconsistent with

- the emergence of competition in London and the South East
- the evidence as to the improvement in service quality
- the need to drive greater airport – airline co-operation
- driving more capacity into the South East airport system
- the CAA's duties with respect to passengers.

In the next section, we address some of the issues that the CAA will need to address if it proceeds to calculate, and / or set, a traditional RAB-based price control.

#### 4. Setting a conventional RAB-based price control

In this section, we consider some of the issues that the CAA will need to address if it proceeds with a traditional RAB-based price control calculation. The CAA has been clear that – whatever the outcome is for Gatwick under the new framework for economic regulation – it expects to undertake a RAB-based single till price control calculation. The CAA notes that the airlines currently view this as their preferred option at Gatwick, but that this approach is not supported by the airport.

The CAA also explains that even if a price cap is not set by reference to the RAB, the conventional calculation can expect to be carried out, since the output of this calculation will provide a useful reference point for alternatives. In that light, we have considered some of the challenges that the CAA will face in making a RAB-based price calculation.

##### *Competition*

The break-up of BAA has introduced a significantly greater degree of competition into the South East market. In Gatwick's view, that is sufficient to indicate that Gatwick does not possess SMP, and even the CAA's analysis shows growing competitive pressures. These will need to be factored into RAB-based price calculations which are more usually constructed for monopoly concerns. Competition will increase the degree of uncertainty around a calculation which has already proved problematic in the recent past. The CAA's own analysis shows none of the three designated airports have earned their allowed returns since 2003. That indicates the difficulty of RAB-based calculations in this sector, a difficulty that the additional uncertainties generated by competition will only increase. There are a number of specific factors which highlight this increased uncertainty -

- First, it seems that all options for capacity development are now under consideration. While this consideration is likely to be a lengthy process, we note that mixed mode at Heathrow could be introduced relatively quickly. Given the mobility of the long haul airlines, this is a very significant competitive risk which impacts Gatwick more than any other competing airport. This risk is not currently directly factored into our business plan either in terms of traffic forecast or cost of capital.
- Second, the sale of Stansted, highly likely in the period of Gatwick's business plan forecasts, will introduce a significant, but as yet unknown, level of risk. Even if retained by BAA, its commercial strategy is likely to change given the continuing decline in traffic. We therefore see more risk (in terms of potential lost passengers) from a more aggressively commercial Stansted. It has significant available capacity and there is a history of airlines moving between the two airports. This risk is not currently directly factored into our business plan either in terms of the traffic forecast or the cost of capital.
- Third, while we have been relatively successful in attracting traffic and providing enhanced service levels at Gatwick, we expect other airports to react and compete more actively. Indeed, we are already seeing this.

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So, while airport competition is beneficial for passengers and airlines, it increases the challenge that a conventional RAB-based priced control will face in capturing these risks. Such risks need to be factored in some way into traffic projections and the cost of capital calculation. Properly reflecting the existence of these risks can only put upwards pressure on any price resulting from a conventional RAB-based price control.

### *Passenger priorities*

We have set out in the business plan our proposals for £1.15bn of capital expenditure in the period 2014 to 2020. Early constructive engagement discussions have revealed a degree of recognition by airlines that our proposed capital programme is worthy of progress to the next level of review although airlines have made some high level points about affordability.

We have discussed our proposals with passenger groups. While their views are inevitably less detailed than those of airlines, the message has been clear. Investment, particularly in areas of direct impact on the passenger experience, should be accelerated. This is of particular interest to us given the increased competition we now face for passengers. We are therefore commissioning more work from YouGov (and others) to understand more fully the priorities of passengers, including whether they would be prepared to pay more to fund the improvements they support.

There are several projects in our proposals which, if we were not subject to the regulatory process, we would be seeking to accelerate. Investment in the immigration halls would be one project that would seem to be an immediate priority, rather than for the period beyond Q5. Similarly, giving North Terminal airlines the same level of service that South Terminal airlines currently receive with respect to security screening would be another project that should not have to wait.

There are also lines in our operating costs projections that could be increased to improve the prospects of maintaining and improving the service quality offered by Gatwick.

In summary, we see a number of reasons why investment in the passenger-facing investment should be accelerated. This accelerated pace of investment would seem also to accord with the CAA's new duties to promote the interest of passengers. Nevertheless, an accelerated rate of investment would provide further upward pressure on the price that might result from a conventional RAB-based price control, as such capital expenditure would feed through into any opening RAB calculation.

### *Traffic*

We are about to commence our latest forecast of traffic growth for the period 2014 to 2020. The traffic forecasts underpinning the business plan were undertaken at the start of 2012. Since this time, general economic factors have deteriorated, pointing to a decrease in traffic forecasts. It may be, of course, that Gatwick's recent successes in attracting new carriers, as well as strong growth by our existing carriers, will to some extent mitigate this. However, there is clearly a risk that traffic growth will be lower than previously forecast. We also note that, to date, our traffic forecasts have not taken into account the competitive challenges that we may face from mixed



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mode at Heathrow and/or a sale of Stansted. As these situations evolve they could have a significant impact on our forecasts.

Any such reduction in traffic forecasts could then have a knock on effect in delaying the need for capacity-related investment. However, since most of the investment in the business plan is for compliance, maintenance or service improvement, we consider it unlikely that a reduction in forecast traffic would lead to a significant reduction in capital expenditure. Much of the investment is in effect making up for the deficiencies of the past and preparing Gatwick for its increasingly competitive future. The combination of falling traffic with increased passenger service quality aspirations, is unlikely to be offset by lower capital expenditure, and is therefore likely to put upward pressure on prices in a RAB based price calculation.

### *Cost of capital*

We have not at this stage carried out detailed cost of capital work. It is our intention that, should the CAA continue to undertake a conventional RAB-based price calculation, to make a detailed submission as part of the January 2013 regulatory submission. We note, however, that the CAA's May 2012 Policy Update begins to float some ideas that it considers may be worthy of consideration.

### **Split cost of capital**

We do not consider that the concept of a split cost of capital has any relevance at Gatwick. As the CAA itself, the CC in 2009, and Professor Dieter Helm all accept, the concept of a split cost of capital requires that the RAB is almost risk-free. It is clear that this is not the case for airports, in particular Gatwick and Stansted.

### **Skewness of returns**

Heathrow has commissioned work as to whether the form of price control creates a degree of skewness in returns. The skewed returns arise at Heathrow because an airport operating at capacity is more likely to under-perform than over-perform in terms of traffic. The CAA highlights several areas of consideration for further work.

The sources of skewed returns at Gatwick are different, but in combination these sources create a greater degree of negative skew in Gatwick's range of expected returns compared to Heathrow. Specifically, Gatwick's traffic numbers have been significantly lower than forecast at the start of either Q4 or Q5. Additionally, negative shocks to traffic are demonstrably larger than positive shocks. Moreover, skewness in returns is not solely created by skewness in volumes. The increasingly competitive environment means greater uncertainty over whether Gatwick will be able consistently to price at the level of a RAB-based yield cap. This uncertainty is much less of a consideration at Heathrow. The profile of expected returns at Gatwick is therefore more skewed towards the downside compared to Heathrow.

Negative skew in returns appears to us as an increasingly important feature of the market in which Gatwick operates, and a factor that would need to be included in the calculation of the cost of capital under a RAB-based price control.

### **Indexation of the cost of debt**

There has been some move towards indexed debt being issued by regulated companies. Some regulators have sought to introduce a degree of indexation into the debt calculation for the purposes of the cost of capital calculation. We have not considered the application of this approach to any calculation of a cost of capital for Gatwick.

### **Traffic risk sharing mechanisms**

The CAA suggests that a traffic risk sharing mechanism could reduce the airports' risks and therefore the cost of capital. For a monopoly-type company such as the National Grid or NATS, this may be an appropriate consideration. However, the essence of this proposal is that it requires the price to go up as volumes fall. This is not consistent with the pricing dynamic in a competitive market. It would put prices up at just the time when airlines will want prices constrained. We do not see this proposal as consistent with the development of competition.

### **Increased risks**

The CAA has not highlighted the increased risks facing Gatwick in the future. We have highlighted a number of these including competition, accelerated investment, traffic forecasts as well as methodological issues associated with the cost of capital. In the initial business plan, we also discuss the fact that shocks to our traffic seem ever more common. As such, any cost of capital calculation would need to account for this increased level of risk and volatility. Taken in the round these all represent upward pressure on price relative to both current levels and the business plan. Some of these risks if not dealt with elsewhere in the pricing calculation need to be reflected in a cost of capital, if set in the conventional way, some way above the 6.5% pre-tax real figure used by the CAA when setting the price control for Gatwick which was part of the BAA group. The fact that Gatwick is now a stand-alone business subject to competition, and the amplified systematic risk that is likely to imply, would seem suggest greater risk (and therefore cost of capital), than when the airport was part of the BAA group.

Each of the issues raised in this section seems to point to upwards pressure on the price resulting from a conventional RAB-based price control.

It is striking that the CAA directly addresses the affordability for Stansted airlines of the prices resulting from a RAB-based price control. The CAA questions whether the Stansted airlines would be able to accept a RAB-based price control equivalent to RPI+7. It is for this reason that the CAA is seeking to develop an alternative that is not RAB-based, as an option for the period beyond Q5.

We consider that similar considerations apply at Gatwick. We already have a proposed business plan which results in a price path of RPI+5.5 between 2014 and 2020. The factors highlighted above represent upward pressures that could push Gatwick's prices, calculated under a conventional RAB-based methodology, some way beyond the RPI+7 calculated by the CAA for Stansted. Of course, the question of affordability for Stansted airlines could be even more acute than for Gatwick airlines, which enjoy higher yields than at Stansted, but such prices would nonetheless be a significant issue for Gatwick's airlines.

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More fundamentally, we do not see price increases of this magnitude as consistent with our vision to compete to grow to become London's airport of choice. This highlights the importance of Gatwick being able to develop with its airlines commercial arrangements that both incentivise and unlock value that can assist in offsetting the upward pressures on price that are clearly present.

Therefore, in the next and final section, we set out Gatwick's proposals for Commitments that, in parallel with bilateral contracts with a number of our airlines, can more effectively deliver the efficiencies and commercial revenues that will promote the interest of passengers, at a price that is likely to be more acceptable than that resulting from a conventional RAB-based price control.

## 5. Gatwick's proposed way forward

### 5.1 Principles to promote competition, not regulation

The need to sustain and develop competition, and for a more nuanced approach to developing Gatwick's business, both suggest that economic regulation is likely to be found wanting. As identified above, it is very difficult to amend regulation intended to protect against abuse of monopoly to do a very different job, that is the promotion of competition. Nor, in the presence of evolving competition, is it really necessary. Rather it is important to be clear about the characteristics that any arrangements beyond Q5 will need to exhibit. We believe that mere evolution of the regulatory framework is unlikely to deliver the degree of speed and targeting necessary to address the challenges facing Gatwick and its airlines.

We have therefore been developing an alternative to traditional economic regulation at Gatwick. In developing such a structure, we have been mindful of the following principles -

- consistency with the development of competition – there must be no barriers in the way of market forces developing further, continuing the fundamental changes created by the Competition Commission;
- facilitation of the behaviours seen in a competitive market, namely contracting, price and service differentiation;
- passenger protection provided mainly through the choice offered by competition, rather than regulation;
- rewards to airports for innovation and service rather than concentrated on the building of facilities;
- targeting and retention of rewards for out-performance to the party that has delivered it, be that airline or airport, or both; and
- co-operation in operating procedures to ensure that the overall airport experience is enhanced, including areas not subject to CAA oversight.

In this light, we see the way forward in three parts

- First, contracts should be at the heart of the airline – airport relationship
- Second, protection must be offered to non-contracted airlines, which we achieve through Gatwick's Commitments
- Third, the CAA enables a framework that allows contracts and Commitments.

We address each in turn below.

## 5.2 Contracts

Since the sale of the airport, Gatwick has consistently argued that normal commercial relationships between an airport and its customers should be seen as the default arrangement by which price and service quality is set at the airport. In some cases, this could take the form of formal contractual arrangements between the airport and an airline; in some cases, there could be more informal non-contractual arrangements in place; finally, there will be standard terms and conditions available to all airlines that choose to operate from the airport in that way.

It is in the nature of contractual discussions that they will be tailored to the specific circumstances of each airline. One airline may require full service, with CIP lounge access direct to a pier-served aircraft. Another airline may want a commitment to fast turn-around times, with rapid access to the runway, to facilitate a multi-rotation daily operation. Some airlines may want marketing support in order to come to the airport. Others may want long term price certainty in order to commit to remain at the airport.

The airport may also have differing requests of differing airlines. We may, for example, wish to increase overall retail income by jointly marketing to passengers as they come through the airport. Alternatively, we may wish to work with an individual airline to improve check-in performance, thereby reducing the airline's costs while also improving the passenger experience and the airport's utilisation of space. We may want to have discussions over terminal occupancy as we seek to maximise the usage of our terminals.

The degree of sophistication that can be offered by a series of bilateral contractual arrangements is, we believe, beyond the ambit of a standard "one size fits all" regulatory framework. As mentioned above however, not all airlines will want, or need, a bilateral arrangement with the airport. The CAA will want to be assured that these airlines are nevertheless protected from any degree of market power that the CAA considers to exist. We therefore propose to offer Commitments that we believe should meet a number of requirements. An overview of the scope of these Commitments is set out in the following section.

## 5.3 Proposed Commitments

Gatwick's proposed Commitments will support the development of Gatwick's competitive proposition by providing airlines and passengers with a multi-year view on what they can expect from the airport. This will assist with airline planning and underpin passenger expectations of the improving service that we are already delivering. Commitments are clearly consistent with the pattern of behaviour demonstrated since the change of ownership and provide prospective comfort to the CAA about Gatwick's future intentions. Any assessment of risk of abuse of SMP can now take account not only of what has happened to date but also what will happen over the next few years. Finally, the proposed Commitments assist in further developing competition – and competitive behaviours – in the market. They provide a transition which will enable airport-airline contracting to get under way while providing the CAA with assurance regarding the position of airlines unable or unwilling to contract.

Gatwick's Commitments should therefore remove the need for a licence as currently contemplated by the CAA. This is because, should the CAA find SMP (the first part of the 3 part test), any potential for abuse identified (the second part of the 3 part test) should be

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addressed by the Commitments, the offer of which is also relevant to consideration of the balance of costs and benefits of regulation in the third test.

The coverage of the Commitments set out below is designed to provide assurance. It does not reflect the complexity and coverage of the commercial arrangements that we envisage developing between the airport and individual airlines. Rather, the Commitments provide both an umbrella under which such negotiations can take place and a back stop for those airlines for which the contracting route may be unnecessary or unwanted. As indicated above, the service Commitments to passengers would likely be exceeded as Gatwick continues to innovate to improve its service offering. The key Commitments are:

### *Price Commitment*

We would propose a price path which would limit the average aeronautical yield, calculated on the basis of airport charges revenue per passenger, over the duration of the Commitment Period. This would consist of an initial proposed price and then an RPI+X Commitment for the remainder of the Commitment Period.

### *Service Quality Commitment*

Core Service Standards would include the existing SQR metrics. We would propose the immediate introduction of a service metric associated with outbound baggage, since this is currently excluded from the scheme. We would propose that the standards at the end of Q5 would be those applying in the Commitment Period. A reasonable system of penalties and bonuses should also apply. The Core Service Standards could be varied from time to time as agreed.

In addition, we would be proposing airport wide standards, covering the performance of all stakeholders at the airport, with performance published. This would continue the improvement generated by the publication of UKBF and arrivals baggage performance. Any performance incentives for individual airlines would be contained within any bilateral contracts entered into. Areas beyond the airport's direct influence to be covered would include

- Immigration
- Arrivals baggage
- Check-in
- On-time performance
- PRM performance.

In addition, Gatwick would publish its quarterly ASQ performance, with the stated aim of achieving upper quartile performance in the relevant ASQ comparator set.

### *Consultation Commitment*

Gatwick would consult with its airlines on all major capital expenditure programmes. We would publish and consult on a Masterplan. We would publish and consult annually on a rolling five year capital expenditure programme. As part of the annual consultation on airport charges, we would of course satisfy the requirements of the Airport Charges Regulations, as apply to all airports over 5mppa in Europe. Gatwick's financial accounts are published (in accordance with the UK listing requirement) and would be provided to the CAA giving transparency over the



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financial performance, investment and asset base of the airport. There would be no requirement on the CAA to approve a Regulatory Asset Base.

### *Investment Commitment*

Gatwick would commit to the capital expenditure necessary to maintain the Service Quality Commitment. However, we would not be proposing an explicit level of capital expenditure to achieve this Service Quality Commitment. Any incentives as to delivery associated with a particular capital project would be agreed, as appropriate, when that particular project came through the normal consultation process. To be clear however, our current business plan for the period to 2020 remains as published in April 2012.

### *Duration of Commitment Period*

Gatwick would propose that the Commitments are for a period of three years – ie to April 2017, though this period could be extended with the agreement of our airlines. That should give sufficient time both for the conclusion of longer term contracts with airlines and for the CAA to assess further how competition is evolving, given that in 2017, it would then be over 7 years since Gatwick had been in separate ownership. We would also expect Stansted to have been in separate ownership for some years by then, giving further evidence for the CAA, as to the level of competition.

### *Expiry of Commitment Period*

Prior to the expiry of the Commitment Period, several options might apply. One of these, in line with other industries in transition to competition, is that the CAA may choose to carry out a market review. The outcome of such a review could be to conclude that Commitments were no longer necessary; to request or require an acceptable extension of the Commitments, or a reversion to a more formal regulatory framework. Gatwick's view is that no further Commitments would be necessary. Clearly, Gatwick would be keen to ensure that any market review found that competition, not regulation, remained the best way to promote the interests of passengers. It is important to recognise also that it would be open to the CAA to conduct such a review at an earlier stage should there be sufficient evidence that the market and / or the Commitments were not working as anticipated.

### *Dispute resolution*

In line with normal contractual arrangements, it would seem sensible that a form of dispute resolution was agreed. We would not suggest that this was the CAA since this would seem to cut across the CAA's intervention powers.

### *The CAA's intervention powers*

In relation to our proposed Commitments, the CAA would take the role of standard competition regulator, a position that would be consistent with the concurrent Competition Act powers it will be given under the Civil Aviation Bill. As with other sectors, this provides a powerful level of intervention should Gatwick not abide by its Commitments or if the airport was acting anti-competitively in an area not covered by the Commitments.

The CAA has been concerned that standard competition law does not provide a swift enough response to any complaints with respect to abuse of a dominant position. Gatwick is not sure how much weight can be accorded this to argument since it would apply in principle to all sectors. However, as the body with concurrent Competition Act powers, it is the CAA that would have control over the timetable of any Competition Act investigations.

#### **5.4 The CAA's approach**

In relation to the way forward proposed by Gatwick, the CAA's approach is critical in a number of respects.

##### ***Contracts***

The CAA has already set out some initial guidance, much of which we support. This guidance will need to be developed further in parallel with the development of contracts and Commitments. An urgent priority in this area is providing more definition of the circumstances in which the CAA might seek to override or constrain commercial contracts via a price control review or changes in its regulatory approach. If this risk remains open ended, it will make it impossible for Gatwick and its airlines to make real progress with contracts.

Another area of maybe greater definition that will be required soon is in establishing a deeper understating of how the general principles in the Airport Charges Regulations should be applied to the contracts and Commitments framework we propose.

##### ***Commitments***

The CAA will need to consider the proposed arrangements and safeguards for those airlines which would not be subject to contracts or other commercial agreements.

##### ***The Contracts/Commitments Framework Generally***

The CAA will need to consider how this framework, as it develops, plays into its assessments under the three part test for licensing. We accept fully that, in the end, the CAA will need to reach its own formal conclusions on this. However, given that the development of contracts and Commitments is likely to be an evolutionary process over the next 12 to 18 months, regular information dialogue between the CAA, Gatwick and the airlines can be of great assistance to all involved.

The proposal of Commitments by Gatwick should be seen as a firm assurance as to the behaviour of Gatwick in the period beyond Q5. However, the CAA also has a role to play. Clearly, the CAA has to be supportive that Commitments are an appropriate response to any degree of market power that it may find when it concludes its market power assessments in late 2013.

CAA might signify its approval by concluding that, on the basis of the evidence, including Gatwick's offer of Commitments, the three part test had not been met in full, and that the conditions for the issuing of an economic licence had not been met. In this scenario, the CAA would be able to make clear that Gatwick's failure to abide by the Commitments would constitute a material change in circumstances. This would then enable the CAA to conduct a market power investigation under the auspices of the Civil Aviation Act.

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Gatwick would be prepared to engage with the airlines and the CAA on the question of enforceability of the Commitments and, for example, consider whether the Conditions of Use might be an appropriate vehicle.

Finally, the CAA has an important role in bringing clarity to the way forward on regulation of Gatwick. At present we have a lot of “moving parts”:

- An emerging new statutory framework;
- A wide-ranging set of ideas from the CAA; plus
- Views from the airlines and from Gatwick, the latter now including proposals for Commitments.

There is a risk that if too many issues are left for discussion until the later stages of the whole process, it will be impossible for everyone concerned to assess the issues properly. The CAA can assist greatly by reaching conclusions or giving guidance as soon as possible on those issues where there is sufficient evidence to support that.

### **5.5 Next steps**

We look forward to discussing with the CAA, our airlines and passenger bodies, the content of this document and in particular the concept of Commitments. We have yet to set out here our thinking on the quantities to be attached to some of them, particularly the price path. That is because development of these specifics need to proceed in parallel with the CAA’s regulatory process, and also because we think that the sensible approach is for us to obtain other parties’ views on the concepts first. We are therefore looking to engage soon with the CAA on our proposal and also with airline partners. The airport would be willing to move at sufficient speed in discussion with the CAA and airlines to ensure that our progress on contracts and the Commitments can be taken into account as the CAA reaches conclusions on the way forward for Gatwick. We also need to consider how constructive engagement, and the CAA’s workstreams on regulation, fit with the Commitments.

Commitments such as those that we are proposing have precedents in other industries as they moved to a more competitive environment. Gas storage, telecoms and the postal delivery services have all used forms of commitments as a way of ensuring a transition to competition.

The regulatory system has been in operation over the past 25 years. However, since separate ownership is now a reality, the future must look different to the past. In that light, we are therefore proposing a series of Commitments as a transition to a fully competitive environment. Our proposal would ensure that airlines choosing not to have bilateral contractual arrangements would be protected from any vestigial degree of market power that the CAA might believe to exist, either now, or in the future.

We recognise that the timetable of the Civil Aviation Bill, the CAA’s SMP analysis and the CAA’s preparations for a price control beyond the end of Q5, create challenges for the CAA. Nevertheless, the proposal for Commitments appears to Gatwick to have several strong merits. First, we can continue the move to a competitive airport environment. Second, the Commitments would directly address any concerns that the CAA may have with respect to price and service quality. That is, the Commitments would directly address any harm identified by the CAA as part of its market analysis. Third, the airport and airlines would be

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free to seek bilateral contracts which would, in our view, more directly improve the passenger experience than the current, or any revised, regulatory framework.

### **5.6 Conclusion**

We believe that our proposal of Commitments should be seen for the bold step that it is. Gatwick, now in separate ownership, is demonstrating the benefit of competition in London and the South East. The nature of regulation, if any, must take account of this fundamental change in the airports market.

We will continue to challenge the CAA's view of the degree of market power held by Gatwick. However, market power is only one part of the test that the CAA is required to carry out and we believe that it is also important to consider how Gatwick can be expected to behave in the period beyond Q5. That is also the issue of most relevance to airlines and passengers. We hope that that our offer of Commitments will be seen to provide re-assurance as to how we can be expected to act in this new world.

We look forward to discussing the Commitments with the CAA, as we proceed to start bilateral discussions with our airlines.

## Annex

### CAA May 2012 Policy Update

#### GAL response

This annex provides our current view on the questions from and content of the CAA's May 2012 Policy Update, given the stage reached so far in the regulatory review. These comments are provided to engage in the CAA's process. However, no comment in this annex should be interpreted as contradicting the main body of the response or our core statements on SMP, the other two regulatory tests and the Commitments.

#### Chapter 2:

##### **Question 1: How should the CAA approach developing a strategy for airport licensing?**

**Overall:** We support the CAA's focus on the Better Regulation principles in implementing the new licence regime enabled by the new Civil Aviation Bill. In particular, we encourage the CAA to consider the proportionality of any form of regulation under a new regime and, in particular, to consider whether traditional forms of regulation are at all appropriate in the new world of separate ownership and competition between the London airports.

The CAA discusses its primary duty to focus economic regulation on the interests of present and future users – without mentioning the second half of the primary duty, which is to do this where appropriate in a manner which will promote competition. This is an important part of the new statutory architecture, as it sets the boundary for regulation and requires the CAA to consider actively how best to develop competition to control operator behaviour and how far any regulatory proposals are consistent with the development of competition.

It is important also that the CAA's strategy takes full account of the challenges facing Gatwick and of the evidence relating to its current and prospective behaviours.

#### **Specific comments:**

2.3/2.6 – **CAA timetable:** We encourage the CAA to conduct any review work under the new legislative regime as soon as possible, so that benefits to users can be realised sooner rather than later. This would also prevent the delay of necessary studies and CAA decisions on matters such as market power, which could result in a lack of proper consideration ahead of the end of the regulatory review.

#### 2.17/Figure 2.7 – **CAA's approach to licences:**

- **Better Regulation:** We encourage the CAA to think thoroughly about the implications of applying the Better Regulation principles. In particular, we encourage the CAA to consider the proportionality of forms of regulation under any new regime, as it is established – and, in particular, to consider whether traditional forms of regulation are appropriate in the new world of separate ownership and competition

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between the London airports. We also note that the CAA will gain concurrent competition powers and that regulation should only be applied in areas where these powers are demonstrably insufficient;

- **Tailored licence conditions:** We believe that licence conditions, if applied, should be tailored to the specific characteristics of the airport, rather than a 'one size fits all' approach. They should take full account of the evidence on risks of abuse. This is because the conditions necessary to control behaviour at some airports with significant market power would be disproportionate for airports with less market power. We believe that a one size fits all approach would distort the already existing competition between key London airports and could potentially slow down its future development;
- **Licence best practice:** We look forward to the CAA's more extensive review of licences in other sectors, as indicated. In particular, it will be most instructive for the CAA to review sectors where competition has been introduced, such as telecoms, postal services and energy supply. Reviewing other sectors where the prospect of competition is more limited such as water, rail and energy networks will likely be less relevant or informative for the purposes of the CAA's work.

2.18/Figure 2.8 – **Specific licensing issues:** We look forward to further engaging with the CAA in the development of any licence conditions.



**Chapter 3:**

**Question 2: How can the CAA ensure that its review of economic regulation is passenger-focused?**

**Overall:** In the main body of our response, we highlight how economic regulation is likely to hold back the development of Gatwick and competition in the market. We identify the reasons why Gatwick does not need economic regulation, and that it can be allowed to deliver the dynamic benefits of competition and innovation to our passengers and airline customers.

We note the four key elements of the CAA's approach to ensuring that the forthcoming regulatory review is passenger-focused. We are very concerned that the CAA does not include in this list a focus on competition. The CAA's general duty clearly states that the CAA must further the interests of users, where appropriate, by carrying out the functions in a manner which it considers will promote competition. The list in paragraph 3.20 does not mention competition, let alone give active consideration to measures which could promote competition. Therefore, we request the CAA to include an additional element that considers how its actions promote (and also affect) competition, in order for the CAA to fulfil its duties.

**Specific comments:**

**3.6/3.15/3.21 – Alignment of airline and passenger interests:** We continue to believe that, while there will usually be a consistency of interests, there could be issues where our current airline customers may not represent the interests of future airlines, future airline business models and current and future passengers, and that mis-alignment is particularly likely to occur in key areas of developing the airport and its future capability to compete.

**3.22 – Working assumption that airlines reflect their passengers' requirements:** We question the CAA's working assumption that airlines will always want the price and quality of these services to reflect their passengers' requirements. Airlines are commercial businesses and as such will naturally seek to maximise profits from passengers, thereby representing their own interests rather than necessarily those of passengers.

**3.9 – Appropriate research:** We acknowledge the case for preventing the duplication of research during the upcoming regulatory review. However, we note that the CAA should distinguish between the need to avoid duplication of research and the need to avoid a 'one size fits all' approach to the review. Specifically, some work may not be required for all airports given varying market power at different airports, and given varying performance at the airports. Therefore, the CAA should equally prevent nugatory costs by ensuring that research is focused only on issues relevant to individual airports rather than conduct such research on a blanket basis.

**3.12 – Passenger priorities (CAA research):** The outcome of the research conducted by consultants for the CAA, summarised in Figure 3.1, illustrates one of the key concerns that we have around continued regulation of Gatwick. Economic regulation is focused on airport facilities while the CAA's research demonstrates this is a distant fourth passenger priority. The main passenger priorities are relatively unaffected by the scope of airport economic regulation. In contrast, airport competition and the resulting commercial interaction between airports and airlines is well placed to deliver against these passenger priorities, particularly in terms of securing a broad range of airlines and airline routes that are attractive to

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passengers. This has been demonstrated by experience at Gatwick since the sale by BAA. In particular, the development of airport/airline contracting would give airlines a firmer base against which to invest in routes, as well as giving the airport greater assurance about the nature and volume of custom for additional facilities.

**3.14 – Service continuity:** We welcome the opportunity to continue our voluntary collaborative arrangements with partners across the airport campus to ensure continuity of service. We agree with the CAA that a voluntary approach, which recognises the imperative on GAL and partners to ensure resilience, allows for the most flexible and effective solutions, within a complete end-to-end service offering.

**3.16 – Overall passenger experience and service quality incentives:** We welcome the CAA's recognition that there are some important activities in the passenger journey where the airport is not the provider of the service. We request the CAA to consider how far the airport can influence the overall passenger experience where service provision is beyond its control. This request is heightened by the financial impact of service quality incentives. Any future incentives should not financially impact GAL where the cause of the quality change or level is beyond the airport's direct control. However, we will continue to work with all other parties at the airport to deliver the best service to passengers. We believe that more comprehensive commercial arrangements between the parties, consistent with a competitive market, are the best approach to ensuring a good end to end passenger experience.

3.20 - See the comments at the beginning of this section about the need for the CAA to consider how to promote competition.

**3.26 – Place of CE:** We recognise the need to communicate and work closely with our airline customers. However, we note that a commercial relationship between the airport and individual airlines would take a very different form, without the distorting presence of regulatory initiatives. Therefore, a regulator-driven CE is not representative of commercial interaction between airport and its airline customers. The incentives on parties that result from such multilateral engagement sponsored as part of a regulatory process are inherently different than those present under more "normal" commercial conditions. This is why regulators have tended to introduce such customer engagement mechanisms where customers face a monopoly supplier rather than in circumstances where customers can interact through more normal commercial and competitive processes. The CAA needs to consider the place of CE in this light. While the CAA has instituted CE for the forthcoming regulatory review, we consider that giving the airport and airlines the commercial freedom to interact, without the distorting effects of regulation, would produce better outcomes.

**3.33 – Guidance on passenger research:** We welcome the CAA's guidance on passenger research, which appears sensible. We would welcome the opportunity to further understand the passenger preferences revealed through airline customer surveys/research, which is conducted in addition to GAL's own passenger research. Naturally, we would protect the commercial confidentiality of our airline customers in doing so.

**3.34/3.36 – Evidence of passenger requirements:** It is interesting to note that the CAA's survey does not identify any need for improvements to airport facilities. This suggests that the imposition of economic regulation focused on airport facilities would be disproportionate and inconsistent with the principles of 'Better Regulation'. However, Gatwick is clear that from commercial, competitive and passenger perspectives there are improvements that need to be made at Gatwick. This is particularly so in light of investments that have been made at Heathrow and at other airports in the UK and Europe which have increased

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passenger and airline expectations of what airports should deliver in terms of service and facilities. We have used detailed passenger research to better understand where these future investments should be focused, in order that we will be best placed to attract passengers and airlines in the future.

**3.41 – CAA seeking wider passenger views:** We welcome the CAA seeking the views of consumer bodies, and the setting up of the new Consumer Panel. We believe that each CAA decision should be informed by passengers' latest experiences, especially at a time of operational innovation and competition.

We have set up an Airport Passenger Panel in order that we can be better informed of passenger views. The Panel is made up of individuals covering a broad spectrum of passengers, including leisure, business, families, shoppers and passengers with disabilities. The Panel meets to discuss current airport experiences and to explore how different types of passengers behave as they arrive, experience and leave an airport, both at the beginning and the end of their trip. The Panel's informed recommendations will enable GAL better to devise customer-orientated solutions designed to deliver a better experience for all travellers and therefore to enable it to compete.

**Chapter 3 cont'd:**

**Question 3: How can regulatory incentives towards service quality be improved?**

**Overall:** We believe that service quality is a key area of discussion with our airline customers and with passengers which could benefit from the removal of regulation and its distorting effects. However, should the CAA decide not to remove regulation from Gatwick, we would welcome discussion with the CAA about the future development of regulation in this area. This should include a clear articulation from the CAA of what service quality problem is present at Gatwick and of the associated detrimental passenger impact that arises. Any future regulation (including of areas currently covered by the CAA's schemes) should clearly address the identified problem, contribute specifically to its solution, and have no detrimental impact on competition.

In general, we believe that the CAA needs to understand and articulate clearly the problems to be solved before designing regulatory incentives and/or mechanisms. For example, we believe that the CAA should study closely passenger views on airport service quality before developing or redeveloping regulatory mechanisms in this area.

**Specific comments:**

**3.47 – Limitations of regulatory approach to service quality:** We welcome the CAA's recognition of the possible constraints on competition that could ensue from wrongly calibrated service quality incentives. We remain firmly of the view that the operation of competition is most likely to lead to the service quality most appropriate for the market and that such competition should be allowed to drive service and innovation at the airport.

**3.48 – Variation of SQR approach between airports:** We encourage the CAA to vary its approach towards service quality between airports, rather than pursuing a 'one size fits all' policy. We believe that the needs and requirements of passengers and airlines at the different airports can vary significantly and an inappropriately set service quality regime could damage actual passenger service, as well as competition between airports. Moreover, any service quality regime needs to address the specific and evidenced risks of abuse of market power identified by the CAA at each of the airports.

**3.48 – Bilateral service level agreement between airline and airport:** We agree with the CAA's proposal that airlines and airports should be free to negotiate differing characteristics of service quality outside of any regulatory SQR process. However, we note that in practice the scope for doing so within a regulatory environment may be limited as identified in our main response. That further argues for keeping regulation in this area to a minimum.

**3.53/Figure 3.10 – Potential areas for future SQR incentives:** We suggested changes to service levels and coverage in our Initial Business Plan which will be reflected in our proposed Commitments. We welcome the opportunity to discuss these suggestions further with the CAA.

**3.55 – Passenger Charters:** We can confirm that we are developing a Passenger Charter for Gatwick. The Charter adds to the steps we have already taken to provide transparency to customers about what they can expect from the airport in terms of service.

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3.58 – **CAA’s publication of consumer information:** We already promote passenger choice through the provision of relevant information. Currently, we publish information about our performance and that of some of our partners in delivering the passenger journey, in an effort to better inform passengers. This includes the performance of airlines in delivering baggage and for border control waiting times. Therefore, it appears doubtful that there is a need for additional regulatory requirements in this area. If the CAA determines otherwise, it is important that any approach allows flexibility in the generation and publication of data, enabling the airport to provide relevant and up-to-date information to passengers, while ensuring that it is able to respond to changing circumstances.

**Chapter 4:**

**Question 4: What is your view of the rationale for economic regulation at Heathrow, Gatwick and Stansted?**

**Overall:** We continue to believe that the CAA has not yet substantiated its case on SMP. We are concerned that the CAA has yet to conduct a full assessment of tests B and C of its market power assessment and that it has begun work on the different forms of regulation that could apply before doing so. Therefore, we strongly urge the CAA conduct a full and detailed analysis of tests B and C as a matter of some urgency. Without completing such work it does not have the basis for assessing the rationale for any form of economic regulation, or the suitability of alternative regulatory arrangements based on Better Regulation principles.

In general, we believe that our proposed framework of contracts and Commitments, together with the constraints provided by competition, will deliver better results than economic regulation.

**Specific comments:**

**4.9 – Tests B and C:** We do not think that the CAA needs to await the passage of the Bill for this work to take place. Indeed, the fact that it has reached initial views (even if on the basis of limited analysis) confirms this view. We fear that if tests B and C are conducted too late in the process the resulting haste and lack of time for analytical effort could affect the test outcomes.

We also believe that there should be a logical order for the CAA's work: first, the CAA should conduct the market power tests; then the CAA should assess, and identify with evidence, any risks of abuse of any market power present; finally the CAA would then need to identify whether there are any cost effective – in its widest sense – regulatory mechanisms that could effectively and proportionately address the risks of abuse of market power that have been identified. We are concerned that by delaying detailed work on tests B and C, while beginning detailed work on the forms and mechanics of regulation that could apply, the CAA is effectively prejudging whether economic regulation is necessary and should be applied at Gatwick. The work it is undertaking, which is particularly focussed on RAB style approaches, is building up expectations and a momentum that will be difficult to change.

**4.18/4.19 – Reliance on competition law:** We look forward to receiving, once it has considered the risks of anti-competitive abuse at Gatwick, the CAA's full view on whether competition law would provide adequate safeguards against such abuse for the period beyond 1 April 2014. We also welcome the CAA's statement that it would be more likely to remove economic regulation, should it have confidence that abuse is less likely to occur and could be tackled by competition law. It is important that the CAA's view on the efficacy of competition law is calibrated against the risk and harm of abuse taking full account of evidence to date, now including our offer of Commitments.

In carrying out this analysis, the CAA should therefore ensure that it clearly relates the adequacy of general competition law to its evidenced views on market power at Gatwick and the risk of abuse of that market power. It should also ensure that it explains how the application of general competition law in the airports sector differs (if indeed it does) from



other sectors in the economy, in which there is an absence of natural monopoly and where competition is present. This analysis is very important to the CAA identifying the need for, and coverage of, any potential economic regulation at Gatwick.

**4.20 – Ability to analyse benefits and adverse effects of regulation:** We are concerned that the CAA has been unable to come to an initial view on the effects of regulation before putting forward a package of regulatory measures. The new Bill envisages the CAA conducting a test to assess whether the benefits of regulation outweigh the adverse effects before setting the package of regulatory measures (i.e. if the adverse effects outweighed the benefits, then regulation would not be introduced). We propose that the CAA should consider the generic adverse effects of regulation as part of its test C upfront, using evidence from Q5, from the analysis of the strategic and competitive challenges facing Gatwick, and from regulatory and competitive situations in other industries. Further, should the CAA decide to regulate Gatwick, we believe that the CAA should consider the regulatory benefits, and impact of the specific measures that it proposes in order to limit the extent of regulatory distortion, in particular to competition.

**4.20 – Defining the adverse effects of regulation:** Test C requires the CAA to understand the adverse effects of regulation. However, we note that while the CAA defines some circumstances under which adverse effects could be lessened, it has not comprehensively defined what those adverse effects might be, in particular given the development of competition and its new duty in this area. As pointed out above, the CAA's document is remarkably silent on the competition issue despite the dramatic changes in market structure and the new statutory duty envisaged by Parliament. Therefore, we are concerned that the CAA has yet to consider these issues despite the more detailed work it has now initiated on regulatory mechanics.

**Chapter 5:**

**Question 5: What do you think is the most appropriate form or model for price regulation at each of the airports?**

**Overall:** The main body of our response document builds on our core proposal contained in our November 2011 submission that Gatwick no longer requires formal economic regulation. Each of the proposals contained in chapter 5 of the CAA's May 2012 Policy Update is based on the assumed retention of some form of regulation. In the spirit of engagement, we offer comments on the CAA's initial proposals below. However, such comments should not detract from our core belief that Gatwick does not need to be economically regulated.

In general, we support the principles behind the CAA's 'dual-track' strategy (described in figure 5.1), which allows for bilateral deals between GAL and individual airlines, while still protecting remaining airlines. Of course, the key difference between the CAA's approach, as stated in the Policy Update, and our proposal is that the Commitment under our proposal would replace any form of *ex ante* regulation.

Should the CAA pursue a policy that includes regulatory mechanisms, we request the CAA to consider carefully and to express clearly the problem that such mechanisms are designed to solve.

**Specific comments:**

**5.1 – Form of regulation should reflect the degree of market power:** We agree that the form of regulation to be applied at an airport should reflect the degree of market power held by the airport – and more specifically the potential risk of abuse of that market power. Moreover, the form of regulation should seek to fulfil the CAA's proposed duties, including the promotion of competition.

**5.12 – Flexible or enhanced RAB-based price controls:** If the CAA continues to pursue a RAB-based approach, then a number of enhancements would be preferred (as discussed in the main body of this response document). Specifically, concerning the CAA's comments:

- **Duration:** It is not yet clear to us whether changing the standard 5 year duration of the price control would be beneficial for GAL, its airline customers or passengers. This would depend on whether the CAA is prepared to establish a transition away from regulation, with clear targets/gateways for the removal of regulatory distortions;
- **Improving capital incentives:** We discuss the CAA's initial ideas on capital incentives in our response to chapter 6 below and we note that the CAA has not as yet evidenced that there is a capital incentives problem at Gatwick that needs to be addressed. In particular, the CAA needs to recognise that the re-phasing of capital expenditure within Q5 was in part at the request of the airlines; and
- **Flexibility to respond to exceptional circumstances:** We welcome the new CAA ability to reopen price controls in exceptional circumstances. We encourage the CAA to consider fast-track methods to make decisions within appropriate time frames, in order to prevent an unnecessarily drawn out process. However, the CAA will need to clearly define up front what constitutes 'exceptional circumstances' in

order to guard against unnecessary reopening of regulatory decisions and associated regulatory uncertainty.

**5.16 - Price caps based on LRAIC:** If the CAA chooses to continue regulating Gatwick, then we see merit in establishing a LRAIC framework. In particular, setting prices based on forward-looking costs would be consistent with price setting in a competitive market. We note that this form of price setting has been used successfully in other regulated sectors that feature developing competition, notably telecoms. Such an approach would aid the CAA in fulfilling its general duty to further the interests of passengers through the promotion of competition.

We have submitted independent analysis to the CAA estimating a LRAIC price for Gatwick for the purposes of the CAA's competition assessment and have requested enhancements to the analysis, following comments. We will submit to the CAA as evidence this new report, once it is available. We encourage the CAA to conduct its own analysis in this area, in order to ensure that it applies its own competition guidelines not least in relation to the importance of defining the competitive price level as a step towards a decision on market power.

**5.20 – Price caps based on pegging tariffs to comparator airports:** In principle, we also see some merit in a comparator based approach as a possible way of providing backstop regulatory protection. However, this is dependent on the CAA choosing valid comparators, and, in practice, this is likely to be challenging. We believe that a narrow focus on comparing Gatwick to smaller, less congested UK airports misses the more relevant European comparator group which have characteristics more aligned with Gatwick.

**5.25 – Price monitoring:** We have called for the replacement of *ex ante* economic regulation by the normal *ex post* competition law safeguard. This could potentially be enhanced with sector specific requirements around the provision of information to the CAA concerning, for example, prices and service quality. This would enable the CAA effectively to monitor the airport's performance over a reasonable period of time. The CAA's proposal appears to be similar to our request. However, we note a number of important caveats:

- **CAA's decision criteria based on the principles of competition law:** There needs to be a clearly articulated basis for any CAA intervention, which we believe should derive from the principles of competition law, the implications of which should be clearly articulated in guidance to be issued by the CAA. This clarity is important to avoid speculative complaints and to minimise the risk of developing a list of requirements for *ex post* regulation that would not be placed on other sectors of the economy; and
- **Prices need to be monitored over a reasonable time period:** A potential unintended outcome of a price monitoring regime is that it could introduce a system of *ex post* price control. This could be seen for example if prices, returns and service were monitored, reviewed and acted upon on an annual basis. It would be important that prices, returns and service are reviewed and acted upon over a more prolonged period, in order that a more holistic review of performance could be undertaken and the inevitable fluctuations in airport traffic and associated costs can be better taken into account.

We are encouraged to hear that the CAA could pursue such a methodology for a transition from regulation to deregulation.

We do not understand how the alternative proposal to set a price threshold is different from the status quo. We request further clarity from the CAA on this proposal.

**5.28 – Regulatory default price cap:** We are interested in the concept of a default price cap, but applied in a potentially different way than suggested by the CAA. In particular, we are concerned that the CAA has mischaracterised the Q5 price cap as a default, when it is in reality a binding price cap. In neither Q4 nor Q5 did the airport make its allowed regulatory return.

Regulatory default price caps have been used in other sectors where competition has been introduced to set backstop protection for consumers. The non-binding element of a default price cap is important as it allows space for competition and market dynamics to influence price and service outcomes, rather than these being determined by regulatory decisions. The CAA adopted, to some extent, this approach in its price capping of Manchester airport in 2003 and reflected it in thinking around Stansted regulation after the Government's rejection of de-designation. Therefore, we reserve our position on this proposal and would like to discuss this further with the CAA, once it has made a decision on the three part test.

**5.44 – Scope of the regulatory till:** We note that many regulated airports are regulated on the basis of a dual, or hybrid till rather than a single till model. Moving toward a dual or hybrid till could provide a basis for the setting of a backstop price cap. This would provide protection for passengers, while also allowing space for competition and commercial arrangements to develop. Moreover, single till regulation results in services being subject to economic regulation that would otherwise be contestable. We believe that this runs counter to the Better Regulation principle of proportionality.

**5.55 – Requirement to undertake a RAB-based calculation:** The CAA states that it expects to calculate the RAB-based price because it provides a reference comparator for alternative models of regulation and that it might be required as a fall back option. We believe that this could distort the decision making of the CAA. The right form of deregulation / regulation should be selected on the merits of the case and the incentives that they bring to improve innovation and the passenger experience. If multiple prices are calculated based on different forms of regulation, then many interested parties are likely to pursue the form of regulation which delivers the lowest price, regardless of the long term benefits from more preferable regulatory models.

**Chapter 6:**

**Question 6: What are the priorities for improved efficiency incentives within the price control settlements?**

**Overall:** In this chapter, the CAA discusses possible mechanisms for incentivising improved opex and capex performance. We note that these mechanisms are generally associated with RAB-based price caps in other industries. We believe that such regulatory efficiency mechanisms are inferior to competition and other market forces, which would be encouraged to develop if the CAA decided to remove economic regulation from Gatwick. However, should the CAA decide to retain regulation, we note that a number of different changes to incentive mechanisms may be beneficial.

In general, we are concerned that each of these ideas for regulatory mechanisms increases the complexity of the regulatory framework. We request the CAA to consider the proportionality of any such regulatory mechanisms applied, in line with Better Regulation principles.

We recognise that the CAA is developing its thinking in this area. We provide some initial thoughts to aid this process below.

**Specific comments:**

**6.14 – Initial views on two tier capex incentive mechanism:** We note that the CAA has not yet established firm proposals on how a two tier capex incentive mechanism could work. In the meanwhile, we believe that there are some principles that are important to maintain in the event that capex is a key component of future regulation at Gatwick:

- **Flexibility:** Any incentive mechanism would need to allow the airport, in consultation with its airline customers, to vary the delivery of the capex programme from the version available at the start of regulatory period;
- **Regulatory uncertainty:** The CAA's policy should aim at reducing regulatory uncertainty. In this instance, this should mean that GAL is left with no doubt as to the size of its available capex funding in-period. If the CAA's policies leave GAL with uncertainty, then the company will not be able to plan appropriately, which could result in non-optimal solutions;
- **Financeability:** Under the new Bill, the CAA, in performing its general duty, is required to have regard to the need for licence holders to be able to finance their operations. In this instance, we note the risk to the fulfilment of capex investments if remuneration for significant capex outlay is not included within the calculation of any price cap. Therefore, in principle, we support the CAA's concept that development capex should be included in a price cap – to be removed if the amount is eventually unspent in-period;
- **Symmetry:** We note that we are as likely to need to bring capex projects forward, as we are to delay projects, to meet our airline customers' needs. We request symmetry in any mechanism, to allow for funding to be brought forward, as much as delayed;

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- **Decision criteria:** We note that the equivalent policy for NERL requires the company to *consult* on changes to its reference period capex plan, rather than to *agree* the changes with airline customers. We acknowledge the difficulty in trying to gain broad agreement on specific projects, particularly where the project may equate our service offering to one airline customer with the service already provided to another. Therefore, we request no tighter requirement than an obligation to consult on development capex, to prevent essential projects from being blocked unreasonably; and
- **Revenue neutrality:** We note the benefit/disbenefit to GAL between the funds received for capex through the price cap and the actual capex spend if projects are advanced or delayed compared with the original plan. We believe that any mechanism should ensure that capex funding is revenue neutral and controls for this benefit/disbenefit.

6.16 – “**At risk**” capex: We request the CAA consider the following points concerning this proposal:

- **Name “at risk”:** We believe that the name “at risk” is unfortunate because it suggests a high level of project risk, which may not be true. We request the CAA refer to “discretionary” capex, which we feel more closely describes the intention behind the category;
- **Investment outside of the single till:** In principle, we can envisage investments for which we may want both spend and revenue to lie outside of the single till;
- **Decision criteria:** Similar to the development capex category, we see the risk that projects important to one airline could be blocked by another airline through the requirement to secure agreement. Therefore again, we request no tighter requirement than an obligation to *consult* on this category; and
- **Project fulfilment risk:** We note that projects that lie outside of the single till require a direct investment decision from shareholders because they would be required to fund the investment. We can envisage important projects that may be not be included in the core and development categories, but which on a stand-alone basis may be too risky or do not provide sufficient benefits to secure shareholder investment.

Specifically, this could be the case for those projects where the investments enable wider projects to be completed, due to the inter-relationships between different capex and different operations at the airport, but may not in themselves provide sufficient benefits. Therefore, we request CAA to consider safeguards to ensure that the existence of this category of capex is not used to delay or defer projects that some airlines do not in themselves value.

6.18 – **Capex triggers:** The Q5 capex triggers have been problematic in a number of ways. First, they have proved to be extremely unwieldy and inflexible, mainly because they were defined and fixed at the start of the quinquennium. Second, on occasion the presence of triggers has resulted in airlines arguing that the definition of the triggers should not be changed, even if there has been agreement to making changes to the specification of the triggered projects. Third, the triggers have risked driving inappropriate behaviour,



incentivising the airport to spend the money on projects implied by the triggers, rather than trying to seek to deliver the project for less expenditure. In fact, the airport has not gone down this road but that is contrary to the incentives with which it has been faced.

The CAA's proposal for two tiers of capex might go some way to addressing some of these problems with the formulation of the Q5 capex triggers.

**6.21 – Timing of capex remuneration:** We note some issues associated with delaying capex remuneration until benefits are realised:

- **Defining benefits to be delivered:** We recognise the difficulty in defining both the benefits to be delivered (if this is not the project completion date) and when benefits have been delivered. We request the CAA to ensure that additional regulatory uncertainty around capex remuneration does not undermine financeability (as required by the CAA's duties under the new Bill);
- **Further post-dating returns:** The current regulatory approach already involves a significant deferral of returns because allowed returns are set in real terms while the company's financing is set in nominal returns. The difference is made up through the inflation uplift on RAB but the overall impact is to defer returns with a potential impact on financeability. Any proposal for delaying capex returns needs to be seen in this context. There seems to be no case for further deferral of returns and any move in this direction should also involve reconsideration of whether allowed returns should instead be set in nominal terms;
- **Increased risk for larger/longer projects:** Delayed remuneration increases the risk for larger/longer projects, as the company is required to bridge a large funding gap. This is likely to incentivise the company to promote smaller/quicker projects and deters larger/longer projects. Such larger/longer projects may be necessary, but may not be taken forward under this regime. In fact, larger/longer projects may provide more benefit for airline customers and passengers; and
- **Increased cost of capital:** In order to maintain the incentive on GAL to deliver larger/longer projects, we believe that the CAA would need to increase the cost of capital rate of return, proportionate to the increased risk profile. We believe that the CAA and airlines should consider carefully whether a change to capex remuneration is worth the increased cost of capital charge that it would imply.

We accept however that competitive businesses will normally only earn revenue once projects have been delivered. In that light, we look forward to working with the CAA on this issue.

**6.21 – Capitalised interest costs:** We acknowledge the need to ensure that re-profiled capex spend does not provide an undue financial benefit/disbenefit to GAL.

**6.21 – Triggers based on expenditure during construction:** We are concerned that the CAA should not increase the regulatory uncertainty surrounding the financing of key capex projects. If the CAA's policies leave GAL with additional uncertainty, then the company will not be able to plan appropriately, which could result in short term and/or non-optimal solutions.

Further, we note that any perverse incentive to manipulate the planning and timing of capex projects could be tackled through other mechanisms discussed by the CAA, such as for capitalised interest cost adjustments.

**6.21 – Increasing the payment rate from triggers:** We set out above in our discussion of 6.18 our concerns about the capex triggers regime in Q5. The objective of the introduction of capex in triggers in Q5 was to ensure that the airport did not gain financially from delaying capex. To increase the payment rate from triggers would in effect introduce a penalty for late delivery. Prior to moving to such a penalty regime the CAA should evidence that there is a capital delivery problem that requires to be addressed. Moreover, if the economic costs from late delivery are significant enough to warrant a financial penalty, then it is logical that any benefits of early delivery would be also be significant. In such a case, there should be a symmetric system such that there are payments to the airport for early delivery.

**6.23 – Recent opex reductions:** We are concerned that the CAA should not ignore the significant efforts undertaken by management and staff at Gatwick to reduce opex, particularly in the face of continued reduced traffic and a high fixed cost base.

**6.30 – Total expenditure incentives:** We recognise the CAA's concern that a focus on total expenditure ("totex") may distort incentives to deliver benefits from opex efficiency outperformance. Moreover, the adoption of such an approach would be a radical change in the regulatory architecture and may not be well suited to airports where there is a more complex set of interdependencies between opex and capex than perhaps in some other regulated sectors. A scheme being proposed for the monopoly water companies would not seem to be suitable for the more competitive airports sector.

**6.32 – Rolling opex incentive mechanism ("RIM"):** RIMs have been used in other sectors to improve opex efficiency incentives. However, the degree of complexity of implementation has been mixed. Any proposals in this area would have to be developed in a way that implementation minimises complexity and cost to the airport and the CAA. At this stage, given our focus on operating the airport in a commercial manner, we do not promote such a mechanism.

**6.36 – Opex gain sharing:** In principle, we support the concept of opex gain sharing in areas in which combined or joint effort from airline customers and the airport can produce benefits for both parties. However, in practice we are concerned that such a mechanism would not be successful in a price control environment. This is because its success would require both parties to commit ahead of time, and within the airport environment different airline customers have different areas where they could provide contributions to opex savings. Such gain sharing mechanisms would be much better suited to bilateral commercial agreements between the airport and individual airlines.

To the extent that the CAA considers that such mechanisms should form part of any price control, we encourage the CAA to set a symmetrical mechanism in order to avoid a scenario in which there are negative incentive and binding requirements on GAL, but no formal commitments on airline customers.

**6.37 – Opex security cost pass-through:** We support the continuation of the security cost pass-through. We believe that it forms the most appropriate way of ensuring that the key opex risks are suitably managed, while preventing an increase in the cost of capital. We note that the UK's security situation continues to be challenging, which may require the Government to alter security requirements quickly in response. Therefore, we believe that the requirement for the pass-through has in no way diminished and should be maintained.

6.38 – **Capex under and over-performance:** We note the CAA's interest in a RIM for capex and would be prepared to discuss further. However, different from opex, we note the difficulty in externally scrutinising the RIM baseline (i.e. the initial capex budget). This could lead to some perverse incentives to over-budget and change the scope of projects, to the extent that the RIM becomes unworkable.

6.40 – **Information incentives:** We recognise the effect of information incentives in other monopoly regulatory settings. However, these can be complex to implement with associated costs for stakeholders and the CAA. We note also that the incentive to reveal lower costs sooner is catered for by the RIM proposal, in which incentives to time cost savings at different times in a regulatory period is removed. To the extent that a workable RIM proposal can be developed, this would go some way to negating the need for separate information incentives. We note the CAA's concern about full participation in its regulatory process and we confirm our intention to work within the CAA's deadlines.

6.44 – **Publishing efficiency performance:** We note the CAA's thoughts about further publication of the airport's performance. Aviation generally, and the key London airports in particular, receive daily coverage all forms of media. Therefore, we do not believe that the expense of further regulatory publications borne by passengers is particularly necessary or of good value to them.

6.47 – **Surface access:** We believe that surface access represents a key passenger priority and a central airport strategic issue, and is something that the CAA should consider carefully, should it decide to pursue a regulatory regime in the future. We request the CAA consider whether its current policy is fit for purpose and we note that Gatwick's investment in the rail station is despite, rather than because of, the regulatory framework.

**Chapter 7:**

**Question 7: How should the CAA interpret its new financing duty?**

**Overall:** In general, we have not yet focused in detail on the issues associated with the cost of capital. Our main focus has been on market power and the development of Commitments. However, in a RAB-based framework, the cost of capital is a key input to any price cap. We are therefore currently undertaking work to ensure that – if necessary – we can participate fully in a conventional cost of capital debate. We intend our views to be put forward in our January 2013 regulatory submission. Our comments below should be set in this context.

We continue to support the CAA's new financing duty and in general, the way that the CAA has indicated that it will interpret the duty. We note a number of policy areas that the CAA has mentioned in Chapter 7. We look forward to working with the CAA on firmer proposals, as these are developed. The financing duty would have to explicitly consider the airport's investment programme and the risks inherent in it.

**Specific comments:**

**7.9 – Appropriate notional capital structure:** The CAA discusses a downside shock test on the company's financial structure. The CAA also implies that resilience may entail the non-fulfilment of the cost of capital, a requirement for additional equity and/or some pressure on the notional credit rating. While we welcome the use of such a test, we request the CAA also take into account the ability of the company to regain its cost of capital and former level of credit rating, within a reasonable amount of time, given a notional capital structure. This is necessary as the company will need to continue to operate and finance itself long after the immediate shock.

The CAA's discussion also highlights the tendency for shocks to be downward and the need for the presence of asymmetric shocks on the downside to be taken into account in any price control formulation. For example, this could be through an explicit adjustment to the cost of capital or through an adjustment to the traffic forecast on which a per-passenger price cap is calculated.

**7.15 – Financing duty and alternative forms of regulation:** We welcome the CAA's commitment to conduct its testing under the financing duty regardless which form of regulation is chosen, if the CAA continues to pursue the economic regulation of Gatwick.

**7.16 – Financial ring-fencing:** We note that the CAA intends to work with airports to understand whether and to what extent the standard financial ring fence licence conditions should be included in the initial licences and the extent of any derogations. We will want to understand how any derogations in relation to our financing arrangements will be granted. We also agree that it is the current financing arrangements (which also provide the framework for future debt issuance) that need to be derogated, rather than just the existing debt. We look forward to engaging with the CAA on this topic in the future.

**7.22 – Split cost of capital:** Our thoughts are contained in the main document.

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7.26 – **Skewness of financial returns:** Our thoughts are contained in the main document.

7.28 – **Indexation of the cost of debt:** Our thoughts are contained in the main document.