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Gatwick

5 MARCH 2013

Iain Osborne
Group Director, Regulatory Policy
Regulatory Policy Group
Civil Aviation Authority
CAA House, 45-59 Kingsway
London, WC2B 6TE

Reference: Q5-050-LGW53

Dear Iain,

RE: Comparing and Capping Airport Charges at Regulated Airports

This letter and annex sets out Gatwick Airport's response to the report "Comparing and Capping Airport Charges at Regulated Airports", prepared by LeighFisher for the CAA, which was published as part of the CAA's assessment of Stansted's market power.

Gatwick considers that this study represents a missed opportunity. Many of the substantial flaws we have identified, as set out in the attached annex, could have been avoided with better transparency and improved industry engagement. We are also disappointed that so few of the points we made in an earlier submission appear to have been taken into account, as well as by the substantial delay in the CAA delivering this report, which we understand was originally due to be published in October 2012. The report appears to have been ready since early December and yet was not published until the end of January 2013.

This is an exercise with inherent limitations (like any benchmarking exercise). However, the methodology used has added to these a number of other, substantial deficiencies. It is questionable, therefore, how far the results can be used for any of the purposes that the CAA intends. And any use must necessarily be carefully qualified in the light of these limitations and deficiencies.

Against that background, it is of particular concern that the CAA is using the LeighFisher results in a context (assessing the competitive price at Stansted) for which, on the basis of the terms of reference given to LeighFisher and the analysis undertaken by them, they were not intended.

The attached annex sets out the details of our response. Please do not hesitate to contact me if you require further information.

Yours Sincerely



Mattias Bjornfors
Economic Regulation Manager

Annex: Gatwick Airport response to “Comparing and Capping Airport charges at Regulated airports”

This Annex is structured as follows: The first section provides specific comments on the benchmarking exercise presented in the report. The second section then discusses the use of the benchmarking exercise.

COMMENTS ON THE BENCHMARKING EXERCISE

This section discusses detailed concerns we have regarding the methodology and results of the benchmarking exercise. We recognise that benchmarking is not an exact science and indeed a number of its general limitations are outlined in the First Economics report on Price Monitoring. These general comments made by First Economics, however, presuppose that the benchmarking exercise has been carried out using a methodology appropriate for the purpose envisaged. Unfortunately, this is not the case with this project and, as a result, Gatwick has a number of serious concerns about the methodology adopted for the LeighFisher report.

Selection of comparators

We have concerns about the composition, and small size, of the comparator sample. We note in particular that the Gatwick comparator set includes a number of smaller regional airports, including Birmingham, Newcastle and Brussels Charleroi, ahead of much more obvious comparators such as Manchester, Munich, Zurich, Brussels, Dublin or Paris Orly. These appear more comparable in terms of scale of operation.

The methodology for selecting comparators also appears to be at odds with the approach used previously by LeighFisher in a study for Melbourne Airport where LeighFisher noted the following:

“The sample of airports has been selected on the basis of two criteria:

- They are all located in OECD countries; and
- They are all operated on a scale comparable with those of the Australian Airports.

These criteria were intended to ensure that there was a reasonable level of comparability within the sample. OECD country membership ensures that the costs of operation are broadly similar, to a much greater extent than would be the case if airports in, say, Africa had been included. The scale of operations is also relevant because it is often felt that airports achieve economies of scale as they grow

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larger. This is a complex issue, and one to which there is not a straightforward answer, but this complexity is avoided by selecting a sample which is reasonably homogenous in terms of throughput.”¹

The resultant comparators in the study quoted above were all airports with a throughput of more than 10 million passengers per year, when comparing against Melbourne with 25.2 million passengers. The smallest airport included in the sample was Perth (10.1m passengers in 2009) and the largest Sydney (33 million passengers in 2009)². This contrasts with the inclusion of a significant number of smaller regional airports in both the global sample and LeighFisher’s comparator group for Gatwick. The inclusion of a significant number of these smaller regional airports skews the results of this exercise³ downwards. There is no discussion regarding the extent to which the methodology delivers a credible result beyond “objective selection criteria” which are themselves open to serious question as discussed below.

Box 1 sets out a sensitivity analysis applying the criteria used by LeighFisher in their report for Melbourne Airport.

Box 1: Sensitivity analysis using LeighFisher’s Melbourne airport report methodology

This sensitivity analysis seeks to use the criteria adopted by LeighFisher in their report for Melbourne airport in selecting airports from the LeighFisher long list (but excluding airports where they found there to be lack of data).

There is not sufficient detail available in the report for Melbourne airport to replicate the analysis exactly undertaken there. However, an approximation based on reasoned assumptions is possible. The range chosen by LeighFisher was between 10.2m and 33m passengers, or between 0.4 and 1.32 times Melbourne’s size (25m). For the purpose of this report we have defined “being of a comparable scale” as having at least 0.4 of Gatwick’s passengers (i.e. 13.5m) and no more than 1.4 or 47.15m passengers per annum. This has the effect of excluding many of the larger airports, in particular Heathrow, Charles de Gaulle, Frankfurt, Amsterdam and Madrid.

¹ P.15 Melbourne Airport Charges and performance benchmarking study, LeighFisher, April 2011: http://www.pc.gov.au/data/assets/pdf_file/0017/107801/sub029-attachment1.pdf

² Full sample of airports used by LeighFisher was: Auckland (13.3m), Brisbane (19,1m), Calgary (12.2m), Copenhagen (19.7m), Manchester (18.8m), Melbourne (25.2m), Perth (10,1m), Stockholm (16.1m), Sydney (33.5m), Vancouver (16.4m), Vienna (18.1m) and Washington (23.1m). The sample was further subdivided into Northern and Southern hemisphere airports.

³ We note that the simple average aeronautical revenue of the full LeighFisher sample is £7.95/passenger. If the airports with less than 10m Passengers are excluded from the full sample, then the average increases by 18% to £9.42/Passenger.. Similarly, calculating a weighted (by passenger) average of the full sample, rather than a simple average increases the aeronautical yield by 17% to £9.31/Passenger.

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When these criteria are applied a list of 14 airports remains from LeighFisher's long list⁴. The average aeronautical revenue per passenger of the sample is £9.38 (or £9.32 if calculated using a weighted average).

This sensitivity analysis helps illustrate that another, less complex but transparent methodology used elsewhere by LeighFisher themselves can achieve a list of airports that are more comparable to Gatwick in terms of scale and more intuitively plausible as comparators than many of the airports in the list that LeighFisher have used for this exercise. The results are also less sensitive to different averaging methods.

Significant variables have been excluded

We consider it likely that the results of this report are weakened significantly by analytical shortcomings in the selection, and use of, variables. At a general level this is illustrated by the apparent poor fit of the regression model used by LeighFisher, including all the tell-tale indicators such as: unexpected signs of coefficients for significant variables (journey time), unexpected insignificant variables (MPPA) and relatively low "goodness of fit", with an R Square as low as 0.77.

Service quality not considered:

The LeighFisher report dismisses the relevance of service quality to explaining price variations. The reason given is that; "it is the match of service quality to the customer's requirements that is more properly assessed rather than the absolute comparison between different service levels delivered..." We note that while matching services to user requirements is clearly relevant (indeed essential) to how an airport conducts its business, this is not a reason for ignoring the evident differences in types and levels of service that different airports provide (with the consequent impact on costs incurred and prices charged). The Competition Commission, for example, was very clear in recognising the important dimension of service to airport offerings. Against this background, failing to take of differences between services provided by airports to airlines and passengers has the potential to skew any benchmarking results. This is particularly important where, in the case of Gatwick, the regulator has (understandably) specified service level standards certainly higher than those delivered at some non-regulated airports in the sample.

We recognise that service quality can be difficult to measure, and that differences in service offering and service quality can therefore be challenging for exercises such as this to take into account. Yet, the explanation offered for not trying to do so – or recognising the resulting uncertainty around the outcomes derived – is insufficient to conclude that service is not an important driver. Aside from high level service differences between airports, there may be other more detailed and readily quantifiable differences which could impact on the results. These

⁴ These are: Sydney, Melbourne, Zurich, Copenhagen, Vienna, Oslo, Brisbane, Stockholm, Manchester, Brussels, Dublin, Stansted, Athens and Auckland.

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include, for example, consideration of whether or not the airport sells certain passenger facing products for which it earns revenue, such as pick-up and drop-off charges, rental fees for baggage trolleys and security friendly plastic bags (for liquids), or whether these are offered without charge.

Input cost factors not considered

The LeighFisher report dismisses input costs factors, or proxies for them such as GDP per capita. The reason provided is that the purpose of the report was to “compare prices across airports to establish whether this could be used to regulate charges”. Comparing prices in different parts of the world (including Asia and Africa, or even South or East Europe) without consideration of whether the cost factors are comparable will clearly introduce a bias to the disadvantage of an airport located in the South East of England, a geographic area with some of the highest labour and living costs in the world. This affects both the cost and supply of Gatwick’s services as well as the underlying demand for air travel. We do not consider the reasoning provided for excluding such factors to be analytically sound. This is of particular relevance to the reliance the CAA has placed on LeighFisher’s results in its assessment of the competitive price for Stansted.

Impact of balance between capacity and demand

The study fails to recognise important drivers of price such as how capacity and demand can drive price formation at airports. Given the relatively lumpy nature of investments in airports, the relationship between price and capacity should exhibit a degree of cyclical, as the CAA itself recognises. There will, however, be differences between competitive and regulated markets to how this relationship materialises⁵. This relationship is not constant and changes depending on the details of the regulatory system. While difficult to model or measure, these differences will have an impact on pricing at both Gatwick and any comparators. .

We further note that the effect of regulation on demand factors at Gatwick was examined using econometric modelling in a recent report prepared for Gatwick by FTI. This demonstrated, as expected, that regulation prevents Gatwick from taking demand factors into account when setting prices⁶.

The assessment of regulation insufficient

The report asserts that price cap regulation appears to elevate revenue per passenger by £2.60, and that this “could reflect a number of factors, for example the degree of competition or market power enjoyed by price capped airports that are operating as scarce resources, the control exerted by regulators being less effective than competition and distortions created by the price cap...” This assertion is not analysed further to indicate the degree to which the cost of and distortions of

⁵ In regulated markets price has a tendency to rise as investments occur, while in competitive markets prices increase with scarcity to allocate capacity to those users which value it the most, and thereby also to signal that investment is needed. Prices may well weaken when capacity is added and the constraints are resolved.

⁶ This study is available on Gatwick Airport’s website on:
<http://www.gatwickairport.com/regulation/competition1/>

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regulation are factors in levels of prices at different airports, and it disregards more obvious explanations such as missing variables e.g. service quality, input costs and the balance between supply and demand.

It is also important to note that “regulation” is used in a very broad sense by LeighFisher. It is not clear to the reader what the criterion for inclusion in one category or another is actually based upon, or why this categorisation would be expected to result in differentiated effects on aeronautical revenue. We note for example that while conceptually both the London airports and Paris are subject to price cap regulation, in practice the scope of the till and levels of intrusiveness of the two regimes are very different. In addition to economic regulation, the form of ownership and government policy on matters such as tourism can also influence the aeronautical revenue earned by airports.

Methodology does not ensure like for like comparisons:

In benchmarking it is seldom the case that companies operate in completely comparable environments, or operate facilities with the same characteristics. It is therefore important to ensure that comparisons are conducted on a “like for like” basis to the greatest possible extent. This is partly a matter of selecting the widest possible range of comparators so that inconsistencies are to some extent ‘evened out’. It will also be done by adjusting, or normalising, the base figures in order to obtain valid comparisons. The fewer the number of comparators that are available the more important this is likely to be.

While LeighFisher has sought to do this by selecting a group of comparators which are (in their view) closest to Gatwick, no attempt has been made to ensure that the resulting comparisons are really “like for like”, and there is limited evidence that any attempt has been made to check, if only at a rudimentary level, that the results are intuitive and consistent with common sense observations. Indeed LeighFisher recognises that comparability between the airports in their sample is an issue in section 8.3 of the report. There is however no discussion around the potential scale or impact of these problems with the methodology.

Accuracy of data:

LeighFisher prefers the use of aeronautical revenues, above the alternative metric of published tariffs. In principle, this is the right approach. However, in practice, as LeighFisher acknowledge, analysis of aeronautical revenue data gives rise to potential problems, in particular:

- limited access to data as not all airports report the breakdown between aeronautical and other revenue;
- ensuring the data is comparable between different airports and over time;
- even if the data is comparable, the drivers behind prices at the comparator airports are likely to vary on a case by case basis. As First Economics recognises in its separate report to the CAA on price monitoring, this does not necessarily invalidate the results. However, care needs to be taken, both to ensure that the metric and criteria are based on sound and well understood

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relationships and, when interpreting the metrics, not to assign them a weight which underlying data cannot support.

- the data will by its nature always be 12 to 18 months old, and furthermore not all airports have the same reporting periods.

The implications of these inherent weaknesses of using aeronautical revenue data must be kept in mind when considering their use as a regulatory tool or in other contexts.

We also note that the study uses group level data for ADP, AENA and Fraport. As no individual airport data is available for the airports within these groups, LeighFisher has chosen to either replace the airport with the group, or to use the group data as a proxy for the respective main airports. While, in principle, this may appear a reasonable work around we would note that there are resulting problems:

- AENA appears to make revenue broken down by airport available on its website: hence, there appears to be no need to use the group level data as a proxy. In addition, the AENA (reported as Madrid) revenue of £5.36 appears to be low. Our estimation from the data available on the AENA website for 2011 suggests the group revenue should be in the region of £7.12, with Madrid around £9.87 and Barcelona £7.76⁷. While these numbers may need adjustment for items such as cargo, they appear to represent better estimates than those used by LeighFisher, as AENA is very diverse and includes a large number of regional airports, including a substantial number (such as on the Canary Islands) where government mandated discounts/subsidies to aeronautical charges apply.
- The use of group level data as a proxy for the main airports will almost certainly underestimate the charges for Paris Charles de Gaulle, as well as Frankfurt. This reduction in accuracy of the estimates has to be considered when interpreting the results.

We also note that some of the input variables into the regression equation, outlined on page 12 of the report, are either not described, or have unexpected values. We note for example that the catchment area of Manchester airport is noted as 15m, significantly higher than both London (5.5m-6.9m depending on airport), Paris (10m) or Amsterdam (8m). In addition, we understand that the journey time from main conurbation is the time it takes to reach the airport by car. We would question whether this is the most relevant metric for surface access for the London airports from central London, given that, firstly, it ignores other forms of surface access transport, and, secondly, appears to be taken from an arbitrary point in London. The “(un)availability of alternatives” variable also lacks description, making it difficult for the reader to assess whether or not its form and uses are appropriate to the study.

Uncertainty in the results:

The report fails to bring out clearly enough the uncertainty of its results. While uncertainty is discussed in relation to not estimating price based on a regression equation, little prominence is given to the degree of accuracy of the averages they establish, other than to suggest that the

⁷ <http://www.aena-aeropuertos.es/csee/Satellite/conocenos/en/Page/1237548068940//Documents.html>

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averaging method and statistical choices suggest a 10-15% spread⁸. This does not, however, take into account the potential bias introduced as a result of the size of the comparator basket. The report claims that the effects are limited; however, no sensitivity analysis is provided to substantiate this. Moreover, the other issues we have raised above would suggest an even wider range of uncertainty than that simply deriving from the statistical methodologies used.

We note that, during the workshop in September LeighFisher, noted orally, that its estimates were not suited to point estimates and that the methodology was more suited to establish ranges. Although the LeighFisher final report mentions briefly the option of considering the benchmarks as a range of prices, this idea is not taken further and the resultant focus on the simple un-weighted mean to derive a point estimate conveys a very misleading sense of accuracy to the results at odds with the opinion previously expressed to stakeholders.

Overall, LeighFisher suggests that the level of confidence in their estimate is as high as +/- 10%. However, the main regression equation used for the purpose of identifying comparators in the report (found on page 13 of the LeighFisher report) indicates that a benchmark comparator price for Gatwick could be between £8.92 and £10.09 (depending on whether the insignificant variables are excluded or not). This regression was based on 2010 data (found on page 12), and is between 12% and 27% above the actual reported aeronautical yield for Gatwick of £7.96. In section 8.3 LeighFisher describes an alternative approach based on a regression model, and observes that this would avoid some of the “apples-to-oranges” comparisons of its current methodology. Curiously the results of this alternative methodology are not reported, despite clearly having been derived.

The level of uncertainty is further highlighted by the sensitivity analysis presented earlier using LeighFisher’s for Melbourne airport and applying it to the dataset presented in the current report. This sensitivity analysis illustrates how sensitive results are to selection of comparator criteria. In this case the two methodologies have been used by the same consultancy, yet they deliver results different by as much as 26%.

Overall the main issue are less whether use of comparators is "possible" but whether or not it will give results which are valid for regulatory purposes, whether or not it will give better outcomes than other approaches, and whether or not it meets the CAA's statutory duties. LeighFisher indicates that such issues are outside the scope of this report. However, these issues need to be addressed before conclusions are reached on the basis of this report. Overall, on the basis of the methodological issues, the data accuracy issues and the resulting level of uncertainty associated with LeighFisher’s work, we consider that the methodology would need to be amended significantly if it is to be used at all to inform any future regulatory arrangements.

⁸ We note from the report that the uncertainty figure presented does not appear to include any effects arising from varying the size of the comparator group.

USE OF THE BENCHMARKING

In view of the limitations and uncertainties attaching to this benchmarking, it is obviously necessary to take great care in using the results. This has two dimensions. First, it is important that the results are not used for purposes for which they were not intended. Second, the reliance placed on particular numbers must be suitably qualified to recognise both the limitations and uncertainties inherent in any statistical exercise of this sort and any particular factors, such as those we have evidenced above, which call into question the validity or usefulness of some of the comparisons.

In relation to the first point we note that, in relation to Gatwick and Stansted, LeighFisher's terms of reference were focused on one main question "Is it possible to benchmark prices at comparable airports in order to regulate charges at Gatwick and/or Stansted?" LeighFisher were not asked to use benchmarking to assess the competitive price at either airport and have clearly – and understandably – not organised their evidence in order to do so. Such a use of the report was not raised at the stakeholder meeting, which it clearly would have been had this been a focus for their efforts. And LeighFisher's argument for not pursuing cost/GDP per head issues quoted above is inconsistent with their having a mandate relevant to establishing the competitive price. Yet the LeighFisher analysis is clearly being used in the Stansted document as indicative of the "competitive price level" at that airport. This is a significant issue. The CAA has not identified the circumstances in which price comparators from outside a market can be used to establish a competitive price within it, or the extent to which the criteria used for selecting such comparators would differ from those that LeighFisher has used. The lack of any reference to cost/supply and demand issues, together determinant of pricing in a competitive market, would seem to be a major obstacle to using the LeighFisher analysis in the way the CAA has in its Stansted SMP document. First Economics has clearly identified the difficulties of using the LeighFisher work for price monitoring – such caution would apply a fortiori to purposes for which the work was not intended.

The second point relates to the use to which specific figures emanating from the analysis might be put. The concern here is highlighted by First Economics when it says in its report "we worry that the benchmarking analysis may not be able to bear the weight that the CAA would be placing on it if it tried to extract a specific metric from the analysis and were to build a binding price monitoring threshold around that metric". This is despite First Economics' evident concern not to call into question the quality of what LeighFisher have done. However, as we have identified above, there are significant concerns with the methodology which further underline the difficulties of placing reliance on this analysis. Even the best structured methodology would, in principle, be best used in terms of ranges rather than point estimates. In practice, the difficulties with the LeighFisher work may make the applicable ranges so wide as to call into question their usefulness.

Overall, we are concerned that this analysis is clearly being used in the Stansted document as indicative of the "competitive price level" applying there. Assessing the competitive price level was not the main purpose of the report, but rather to assess the feasibility of using comparators to set a price cap at Gatwick and Stansted and assessing the affordability at Heathrow. So far the CAA has failed to demonstrate understanding of the uncertainties around the LeighFisher results, to

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exercise due caution in interpreting them and to recognise that it should not simply transpose the (uncertain) results of a study intended for one purpose to another, different, one.