YOUR LONDON AIRPORT
Gatwick

13 MARCH 2013

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

Reference: Q5-050-LGW54

Dear Iain,

CAA Stansted Market Power Assessment – Europe Economics advice on the application of long run incremental cost estimates for Gatwick and Stansted

We welcome the publication of the CAA's analysis of Stansted's market power and its associated Annexes and will provide a response by the 26 April as requested. However, we consider it might be useful to provide some early comments on the advice from Europe Economics on the application of long run incremental cost (LRIC) estimates for Gatwick and Stansted. In particular we have concerns with some of the conceptual points raised by Europe Economics, as well as a number of further concerns on issues of principle and approach that we consider may have a material effect on the LRIC estimates generated by Europe Economics in its report.

We are concerned that the approach and assumptions adopted by Europe Economics risk underestimating the value of long run average incremental costs (LRAIC) in its advice to the CAA. This is of concern to Gatwick. We consider it should also be of concern to the CAA, because this could have implications for the CAA's estimate of the prices that it would expect in a competitive market. This in turn risks the CAA reaching an erroneous conclusion on the questions of whether Gatwick has substantial market power (SMP), whether it should be subject to economic regulation, and on the form of future regulation, if any.

This point is highlighted by a table summarising some of the key metrics in Europe Economics' report that shows low capital expenditure assumptions and lower incremental costs to provide a complete new airport, compared to an additional runway and terminal at an existing airport.

Table 1 – Summary of Europe Economics' assumptions and calculations (2011/12 prices)

	Increment 2 Additional Runway)	Increment 3(a) New Airport (a)	Increment 3(b) New Airport (b)
Incremental passengers (mppa)	35	35	35
Present value of incremental passengers (mppa)	48	401	401
Capital investment costs	£2.27bn	£3.74bn	£3.3bn
Incremental costs per passenger	£17.0	£10.6	£8.4

We provide a brief summary of some of our concerns below. In addition, we attach to this letter an Annex which provides further details.

Dismissal of Increment 2 – additional runway capacity

Europe Economics dismisses repeatedly the relevance of Increment 2 (additional runway capacity) for both the estimate of the competitive price level and the estimate for any price cap based on forward-looking costs. Instead Europe Economics relies on the estimates of Increment 3 (a modern equivalent asset valuation of Gatwick) in coming to its preferred estimates. Europe Economics' main argument against the use of an additional runway as a relevant increment is that capacity expansion is determined by government policy and as such is not indicative of market signals as to the need for, or costs of, expansion.

We agree that government policy is a key determinant of whether and where any additional capacity will be developed, but this does not mean that decisions to proceed with capacity expansion will not reflect underlying market fundamentals. Indeed, were they not to reflect such fundamentals, the project would not be viable. Moreover, given government recognition through establishing the Airport Commission of the need for more capacity, it seems probable that an additional runway is the form that any significant incremental increase in capacity is likely to take. As such it is important that estimates of forward-looking costs include those derived from the provision of additional runway capacity at Gatwick.

Inappropriate scale of Increment 3 – inappropriate assumptions about passenger throughput

We are concerned that, in estimating the forward-looking costs of an efficient new entrant, Europe Economics models the costs associated with an airport that would be full from the first day of its operation. This approach is not consistent with the reality that any new entrant to a market would face. Traffic would be built up over time as, indeed, the experience of UK regional airports and, in the London and South East market, London City and Stansted demonstrate.

Exclusion of material cost categories from cost estimates

There are a number of areas where Europe Economics appears to exclude major elements of costs from its calculations. These include:

1. The costs and time associated with the design, planning and associated preparatory activities which must be undertaken prior to the commencement of construction work. We have previously estimated these costs to be in excess of £250 million (based on the experience of the Stansted G2 project) and for the total elapsed time for all pre-construction activities to be up to 5 years. The inclusion of these additional costs and the deferral of incremental passengers by a further five years would increase Europe Economics' estimates of LRIC (we note the impact timing sensitivity is blank in Table 11 of Appendix 4 in respect of Gatwick, but that in respect of Stansted it is shown to be significant in Table 16 of Appendix 3).

2. The costs of linking any efficient new entrant airport to existing infrastructure and services e.g. surface access road upgrades, new rail infrastructure, connections to utilities etc. We have previously estimated the costs of such essential expenditure to be in the region of £500 million.

3. The costs associated with the acquisition of land on which any efficient new airport would be built as these costs, as far as we can tell, are largely excluded from the accounting data used by Europe Economics. To the best of our understanding, the value of land included as the starting point for Europe Economics' calculations may only have been £57.3m, and not the replacement cost of the land on which the airport is built. To the extent that the accounting data used by Europe Economics include any land costs, there are also issues about the use of inappropriate indexation. Europe Economics uses COPI or RPI to inflate land values even though these rates are not appropriate for indexing the price of land put to industrial use. The use of a more appropriate alternative index would increase the costs to any efficient new entrant.

Detailed points

We also have a number of more detailed observations and comments on Europe Economics' report which we set out in the Annex. We consider that many of these issues would have

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benefitted from a detailed discussion between Gatwick, our consultants FTI Consulting and Europe Economics. We were clear on a number of occasions that we were open to such meetings after an initial conversation, but these were declined. As a result we consider that the report is not as useful for the CAA as it might otherwise have been and that the results contain material deficiencies. Therefore, considerable caution needs to be applied when interpreting its results.

Next steps

While we understand that Europe Economics has now completed its work for the CAA, we see benefit in having a discussion with Europe Economics to explain our concerns and for the report to be amended accordingly. In the absence of any revision to the report we trust that the CAA will take our comments into account when it interprets the conclusions in the report and comes to a view on the level of prices that could be expected in a competitive market.

We are happy for you to publish this response on the CAA's website.

Yours sincerely

Colin Garland

Colin Garland
Senior Manager, Economic Regulation

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Annex 1- Gatwick's detailed comments on Europe Economics' advice to the CAA on the application of LRIC

Introduction

1. As part of the CAA's initial views of Stansted's market power, it published advice commissioned from Europe Economics on the application of long run incremental cost estimates for Gatwick and Stansted. In part this sought to build upon the work conducted by FTI Consulting for Gatwick, which we submitted to the CAA in November 2011.

2. While there are many aspects of the report from Europe Economics with which we agree, there are others that cause us considerable concern. In particular, we are concerned that the approach and assumptions adopted by Europe Economics risk underestimating the value of long run average incremental costs (LRAIC) in its advice to the CAA. This is of concern to Gatwick. We consider it should also be of concern to the CAA, because it could have implications for the CAA's estimate of the prices that it would expect in a competitive market. This in turn risks the CAA reaching an erroneous conclusion on the question of whether Gatwick has substantial market power (SMP), whether it should be subject to economic regulation and on the form of future regulation, if any.

3. In this Annex we provide detail on our concerns, which relate to three broad areas:

   A. The conceptual framework adopted by Europe Economics;

   B. The manner in which Europe Economics has implemented its chosen LRAIC approach and its comments on the approach adopted by Gatwick and FTI Consulting in November 2011; and

   C. Points of principle relating to Europe Economics' consideration of the merits of LRIC.

A. Europe Economics' Conceptual Framework

4. In this section we set out two principal concerns that we have about the conceptual framework adopted by Europe Economics. The first of these is that because government policy is a key driver of whether new runway capacity is developed or not, the forward looking costs of such capacity cannot be considered an appropriate indicator of the competitive price level. The second concern is that Europe Economics' approach to assessing the costs of building a new airport tends systematically to underestimate the LRIC.

Government role in new capacity does not invalidate market signals

5. Europe Economics assumes that the fact that a decision on new runway capacity will effectively be taken by Government means that LRIC estimates based on such investments

are irrelevant for the purposes of defining a competitive price level. This is mistaken on a number of counts.

6. First, it fails to recognise that government policy is itself effectively influenced by market signals as intermediated by parties involved in the industry. These include, but are not limited to, various parties being increasingly vocal about the need for additional capacity e.g. airports, airlines, user representatives and politicians; and evidence, including that of the CAA, showing that air fares are rising, and are expected to continue to rise, as a result of lack of capacity.

7. Second, any Government decision will need to take full account of underlying market signals – to do otherwise risks chosen projects being unviable. To ignore therefore scenarios which involve additional runway capacity in coming to an estimate of the competitive price level would clearly risk the CAA failing to take into account all of the evidence and data available to it. It is clear, not least from the setting up of the Airport Commission, that estimates of the costs of the provision of additional runway capacity are a relevant factor and should be taken into account, along with other evidence.

The treatment of passenger build-up does not match commercial reality

8. Gatwick accepts that information about the replacement cost of an existing airport can be a relevant input into the estimation of the price level that could be expected in a competitive market. This is because, as explained by Europe Economics, this will be reflective of the costs incurred (and subsequent prices charged) by an efficient new entrant. However, we are concerned with the approach adopted by Europe Economics. In particular, Europe Economics models the costs based on replacing an existing airport with one that is full from the first day of its operation. This proposed approach is not consistent with the circumstances that an efficient new entrant would face. A new airport would need to gradually build up its traffic, consistent with experience in the UK market. This might take considerable time.

9. We therefore consider it far more likely that an efficient new entrant or an existing operator provisioning a replacement airport would have to provide capacity to meet existing and forecast demand such that there was the ability to grow over time. The lumpiness of airport investment tends anyway to push in this direction. The associated costs of provision and profile of traffic over time would then inform the estimate of forward-looking costs, which in turn would inform, with other evidence, an estimate of competitive price level. We consider that the approach proposed by Europe Economics risks underestimating the average forward-looking costs and as such, if used by the CAA, will underestimate the price expected in a competitive market.

10. The inappropriateness of the assumptions used by Europe Economics and their impact on the LRIC estimates is illustrated by the results of its calculations of LRIC for Increment 3 (a large project involving a replacement airport), being lower than that for Increment 2

(additional runway capacity and terminal)[1]. This appears to be a function of certain key assumptions, most particularly those made about the passenger profile, but also those relating to the preparatory and surface access costs.

11. Europe Economics presents two sets of passenger figures, one representing the incremental passenger capacity that will result from the project and the second the present value of the future incremental passengers, as shown in the table below.

Table 1: Passenger figures presented for Increments 2 and 3

	Increment 2	Increment 3
Passengers increment (mppa)	35	35
Present value (mppa)	48	401

Sources: Europe Economics report, Tables 5.2 and 5.4

12. The incremental capacity is 35 million passengers per annum (mppa) for both Increment 2 and 3 but the present value of the incremental passengers over the life of the assets is much less in the case of Increment 2 than Increment 3. Asset lives are 50 years for both increments. The key difference is that for Increment 3 the incremental capacity is taken up when the airport becomes operational, while for Increment 2 the incremental passengers numbers rise slowly after the capacity becomes operational and the maximum incremental volumes are only achieved later.

B. Europe Economics' implementation of its chosen LRAIC approach and its comments on the approach adopted by Gatwick and FTI Consulting

13. We have a number of comments on the detailed application by Europe Economics of its proposed approach as well as on some of its observations on the approach adopted by Gatwick and FTI Consulting in its November 2011 submission. We consider that in the absence of these comments being taken into account, the CAA risks underestimating its calculation of forward-looking costs.

Point estimates versus ranges when estimating competitive price levels

14. Europe Economics' advice to the CAA presents point estimates of per passenger prices for each of the scenarios considered[2]. In our view, the use of a LRAIC calculation to arrive at a range of prices would be much more informative in the context of estimating the price that

[1] Europe Economics report, Table 5.5, p.61

[2] Europe Economics report, Table 5.5, p.61

would be expected in a competitive market. This would recognise the inevitable uncertainty and discretion that is inherent in determining the values to ascribe to particular parameters and the effects of alternative modelling approaches. It would also be more reflective of pricing in a competitive market, particularly in a sector where the combination of lumpy investment and traffic build-up over time means that pricing will vary according to demand around a long run trajectory.

15. As explained below, this is of particular concern as we consider that in its calculations Europe Economics has tended to use assumptions that lead to underestimates of forward-looking costs. For the purpose of assessing the competitive price level, in our view the CAA should be more interested in central estimates rather than the lower bounds that the Europe Economics report is likely to generate.

Increment 3 estimate of replacement airport costs for Gatwick is likely to be materially understated

16. Increment 3 was developed by Gatwick and FTI Consulting to represent the capital costs which may be faced by a new entrant. This was done using data available to Gatwick at the time. The decision to develop an estimate for an increment of this nature was taken following discussions with the CAA.

17. We agree with Europe Economics that the costs used in its Gatwick Increment 3 (replacement airport) model "*should reflect modern equivalent asset values and should be based on the most efficient way of providing the existing service*"[3]. Due to insufficient information being available on the "*configuration*" of such a replacement airport, we understand that Europe Economics has estimated the replacement airport's capital cost by adjusting the value of Gatwick's RAB using either the construction price index ("COPI") or retail price index ("RPI") as it considers appropriate[4].

18. However, the modelling approach adopted by Europe Economics report[5] does not, in our view, provide a value that is representative of the costs that would be incurred in a re-provision of Gatwick. In our view, Europe Economics understates the potential scale and likely directionality of the inaccuracies of its approach when it asserts "*that the replacement costs are indicative and subject to uncertainty regarding the true modern equivalent asset values*"[6].

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3 Europe Economics report, p.55, although, as noted above, this should not be restricted to the provision of a quality of service, which does not reflect the needs of passengers.

4 Europe Economics report, p.55

5 We do not have access to Europe Economics's figures and calculations

6 Europe Economics report, p.57

19. According to Europe Economics, modern equivalent values for pre-1999 assets are derived from BAA's 1996 Q3 price control submission which reported assets on a replacement cost basis[7] [8]. Our specific concerns relating to the treatment of the pre-1999 values are:

- uncertainty as to the land values included in the calculations;
- the implicit indexation of land values using COPI;
- inadequate allowance for the cost of connections to utilities and transport networks; and
- the inclusion of depreciated asset values in the calculations.

20. In Gatwick's view, each of these issues is likely to result in a lower cost estimate than is reasonable. In aggregate, the effect is a systematic downward bias in the estimates.

Land value estimates

21. It is unclear under which cost headings and at what value (or cost) the land used at the airport was included in the pre-1999 assets. After an initial investigation it appears that only a limited amount of land was included in the 1995/96 accounts in the sum of £57.3m. The starting point used by Europe Economics therefore does not include the full replacement cost of the land on which the airport is built.

Land value indexing

22. Even on the assumption that that appropriate land values were included in the terminal and airfields values reported in BAA's Q3 financial accounts for 1996, then the approach of indexing these values to COPI rather than an appropriate land value index will result in inappropriate asset values. Between 1997 and 2011, COPI increased by approximately 80%[9] whereas industrial land values in England and Wales excluding London increased by close to 90%[10] with a compounded annual growth rate (CAGR) of 4.71%. This same index for Croydon from 2001 to 2011 (the years for which the data is available) had a CAGR of 4.94%. The divergence of construction and land value indices suggests that an alternative estimation approach would be appropriate.

23. If the land was included in the 1996 figures at cost (as opposed to value), the likely understatement is even more significant.

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7 Europe Economics report, p.57

'8 BAA plc, A report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd), June 1996

9 ONS, Construction output price index, All work index

10 "Property market report 2011", Valuation Office Agency, 2011, Chart of industrial land values in England and Wales (excluding London), p.29

Estimated value of utility and transport connections

24. Europe Economics is unsure whether the terminal and airfields values, taken from BAA's Q3 financial accounts for 1996, include the value of utility and transport connections. From our understanding of the formulation of these accounts we do not believe that the costs of utility and transport connections are included in the numbers used by Europe Economics.

25. In our view this uncertainty introduces a significant risk that the cost estimates produced by Europe Economics are significantly understated. When calculating our own estimate for Increment 3 with FTI Consulting we used a figure of £500m to cover the replacement cost of such connections. From our review, it seems unlikely that a figure of this amount could have been included within Europe Economics' estimates for Increment 3.

Reliance on depreciated costs

26. We have reviewed the report referenced by Europe Economics as being the source used to calculate the value of pre-1999 assets[11]. It appears to us that Appendix 4.6 of the report is the likely source for the value by category of the pre-1996 assets reported on a replacement cost basis. This appendix is a replacement cost balance sheet and accordingly the reported asset values are the net, or depreciated, replacement costs. If this appendix is the basis for Europe Economics' calculations, then any assets which were in place in 1996 and remain in place in 2011 will be understated by the cumulative depreciation charged through to 1996 plus the effect of indexation between then and 2011.

Planning costs and pre-construction activity

27. It appears to Gatwick that Europe Economics may have excluded from its calculations the full costs and time associated with the design, land acquisition, planning and associated preparatory activities which must be undertaken prior to the commencement of construction work. We have previously estimated these costs to be in excess of £250 million (based on the experience of the Stansted G2 project) and for the total elapsed time for all pre-construction activities to be up to 5 years.

28. The inclusion of these additional costs and the deferment of incremental passengers by up to a further five years would increase Europe Economics' estimates of LRIC. We note the impact of timing sensitivity is blank in Table 11 of Appendix 4 in respect of Gatwick, but that it is included in respect of Stansted and is shown to be significant in Table 16 of Appendix 3.

Increment 2 capital expenditure assumption of £2.27bn

29. Europe Economics' capital cost estimate of £2.27bn (2011/12 prices) for Gatwick Increment 2 differs considerably from FTI's Consulting's £3 to £5bn range (2013/14 prices). Our

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11 BAA plc, A report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd), June 1996

concerns are that: (1) Europe Economics' capital expenditure figure is derived from an unrealistically low estimate; and (2) it ignores the range of higher values that are likely.

30. The capital costs for Europe Economics' Increment 2 is based on a SG2 cost option of approximately £1.8bn (2011/12 prices)[12] presented by ASA in the Competition Commission's 2008 review of Stansted's Masterplan[13,14]. To adjust for higher land costs at Gatwick, Europe Economics adds half of FTI's Increment 3 land acquisition costs, i.e. £471m, to calculate an Increment 2 total cost of £2.27bn. We agree that an uplift for the higher land costs around Gatwick is appropriate. However, we do not understand why this is limited to only half of the land acquisition costs. Moreover, we do not believe that the cost option selected from the Competition Commission report represents a central cost estimate of delivering the additional capacity at Gatwick.

31. Indeed, it appears to us that Europe Economics' £1.8bn (2011/12 prices) figure is based on the "minimum cost option" presented in the Competition Commission report[15]. This is consistent with the figures presented by Europe Economics in the discussion of its Stansted model on page 105 and in Table 5 on page 106. In the Competition Commission report, ASA describes the 1.8bn option as follows[16]:

Our minimum cost option shows where reductions in quality, space or reduced build costs could represent a value engineering approach with a lower quality and level of service terminal and development as a product which is likely to involve passengers in queuing and walking unaided some considerable distances.

We are fully aware that our assumptions in some cases may not be realistic but may allow the Competition Commission to enter into debate with BAA with a view to reducing total investment costs.

32. In our view the use of a minimum cost assumption for a model's central estimate is not appropriate as it will bias the LRAIC result downwards. Moreover, basing a LRIC calculation on Gatwick on a lower-bound Stansted cost estimate is in our view, in principle, not appropriate. Gatwick serves a broader range of airline business models, and has to serve a broader range of passenger needs. This has a tendency to increase costs. In addition, we are also very mindful of our need to develop a competitive proposition to appeal to passengers and airlines that use other London airports, including Heathrow and as such

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12 According to the Europe Economics report discussion on pages 105 and 106, the £1.8bn (2011/12 prices) figure is calculated by removing a 128m allowance for risk from the £1.85bn (2006 Q2 prices) total for the SG2 cost option. The resulting cost of £1.7bn (2006 Q2 prices) is then inflated to 2011/12 prices to calculate the £1.8bn cost figure.

13 Europe Economics report, para 3, p. 55

14 "Review of the Masterplan options and costs of the Generation 2 proposals at London Stansted Airport", Competition Commission and ASA Consulting, September 2008, Section 5.7

15 "Review of the Masterplan options and costs of the Generation 2 proposals at London Stansted Airport", Competition Commission and ASA Consulting, September 2008, Section 5.7, Table 5.39

16 "Review of the Masterplan options and costs of the Generation 2 proposals at London Stansted Airport", Competition Commission and ASA Consulting, September 2008, Section 5.7

need to develop the facilities, infrastructure and services to attract those passengers and airlines. Again, this has a tendency to increase costs.

33. FTI based the £3bn lower end of its range on the CAA's estimate of £2.5bn inflated from 2008/09 to 2013/14 prices[17]. The higher end estimate of £5bn was intended to reflect uncertainty about future costs and capture the range of likely scenarios. We believe performing the analysis on a range of values provides a more useful set of results than restricting the result to a single point estimate, particularly one that does not reflect the circumstances of Gatwick Airport.

New build costs should have quality uplift included

34. Europe Economics' advice suggests, in the context of Increment 2 at Stansted, that "*As Increment 2 is a discrete set of investments for an additional runway and terminal facilities, we consider all capital projects to be relevant, although this might be an overestimate as some of the investment is likely to lead to higher service quality for example in terms of airport ambience".*

35. Since the investments in question (additional runway and terminal facilities) and their respective costs form the basis of Europe Economics' estimate of the cost of Increment 2 at Gatwick, we presume that this comment also applies to Gatwick. However, we note Europe Economics does not make an explicit statement of this in the context of the Gatwick cost estimates.

36. We consider that an approach which references inherited service quality and facilities is not appropriate, particularly for an airport like Gatwick, and risks underestimating the value of forward-looking costs. We believe that a new entrant seeking to compete with the existing operators or the existing operators, when providing additional capacity in competition with one another, would be unlikely to wish to construct facilities which did no more than replicate the quality of service or ambience of existing facilities – not least where service quality and ambience are as historically constrained as at Gatwick. Gatwick would certainly not consider developing additional capacity which did not offer a better passenger experience than that which can currently be offered in some of the older parts of the existing airport. It is difficult to see why restricting the development of services and infrastructure to the quality currently provided would be in the passenger interest.

37. More generally, we observe that in other sectors, firms are constantly striving to improve service quality and regard this as the one of the areas in which they can gain competitive advantage. It would seem odd, in our view, to seek to suggest that improvements to the quality of service within the airport sector are wrong in general and/or principle, or for the estimate of forward-looking costs to be determined on the basis that such improvements would not and should not form part of the basis of competition. To take the approach

[17] "Price control review – consultation on the framework and options for the economic regulation of Stansted Airport", CAA, January 2008, para 10.38

proposed by Europe Economics would underestimate LRIC, with associated implications for the assessment of the competitive price level.

The estimate of the competitive price level should reflect the "economic value"

38. We note that Europe Economics' approach of setting regulated charges by reference to the replacement cost of the current RAB, or that even setting them by reference to LRIC, may not result in prices that are consistent with the competitive price level. This is because such prices would reflect only the resource costs of the assets (historic, current or future) and as such, are unlikely to reflect the full economic value of the services on offer, which prices in a competitive market would.

39. This issue is highlighted by the CAA in its application of Test B of the Market Power Test to Stansted. Here, the CAA identifies that legal precedent confirms that a range of factors including location, convenience, brand, reputation and reward for innovation may result in the economic value of a good or service – and the price which it can command in the market – being significantly above any cost based measure, while at the same time also not being excessive or abusive, even when the provider is dominant in the relevant market.

40. In the context of airports, factors such as location, convenience and reputation are often cited as being important, be that for airlines or passengers. Moreover, in airport markets with competition, factors such as the airport's brand and its innovation will become increasingly important and would be reflected in the economic value of the services on offer. In addition, to the extent that demand relative to scarce supply generates scarcity rents, then these would also be reflected in the economic value and be expected to be included in the competitive price level.

41. These points are demonstrated by the pricing practices of airlines. For example, airlines are able to achieve higher yields at Heathrow than Gatwick and in turn higher yields at Gatwick than locations such as Stansted and Luton. These higher yields reflect the range of factors listed above. Moreover, slots at Heathrow trade for substantial sums, which reflect the underlying scarcity of slots at Heathrow and the economic value of that scarcity (the scarcity rent). This clearly illustrates that in a competitive market it would be expected that factors such as scarcity rents would be a factor in the competitive price level.

Central assumption of a 50 year asset life

42. We note that Europe Economics has assumed that the average asset life for the replacement airport is 50 years[18]. The models previously used by the CAA were based on average asset lives of 35 years, and this is the assumption adopted by FTI Consulting for Increments 2 and 3. We note that Europe Economics, in the context of FTI's Increment 2, agrees that 35 years is reasonable, "*although a longer asset life might also be appropriate (up to 50 years)*"[19].

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18 Europe Economics report, para 7, p.48

19 Europe Economics report, para 2, p.41

Elsewhere, the report describes Europe Economics' view to be of assets lives being "*at least 35 years*".

43. The effect of a higher asset life assumption is to reduce the per passenger charge calculated under a LRAIC methodology. While we note from Europe Economics' sensitivity analysis on Stansted Increment 4 that moving from 50 years to 40 years and to 60 years does not have a particularly significant impact on the results of the calculations, the uncertainty here is another reason for using a range rather than a point estimate.

Increment 1 – small incremental expansion – not relevant for determining the competitive price level of setting a price cap

44. We agree with Europe Economics that Increment 1 is not relevant for determining the competitive price level or for setting a price cap. Increment 1 was developed by Gatwick and FTI Consulting at the request of the CAA in the context of the wider programme work to inform CAA and other stakeholders about the application of LRIC. Its specific purpose was to illustrate the effects of taking a forward-looking approach to estimating the price required to support the provision of even a modest capacity expansion scheme to an existing airport, undertaken within the existing boundaries.

C. Points of principle relating to Europe Economics' consideration of the merits of LRIC

45. In this section we set out our comments on a number of points of principle related to the way in which Europe Economics considers the merits of LRIC.

Market signals are relevant to entry and expansion

46. We note that Europe Economics correctly identifies the importance of the signals provided to market participants when prices are set at the competitive price level. However, Europe Economics frequently appears to refer only to the signals sent to efficient new entrants to provide additional capacity. This omits the importance of signals sent to the market as whole, which would include current participants which might provide the additional capacity through the expansion of existing airports.

47. The fact that the government has set up the Airport Commission, together with the ensuing "race for runways" represented by the plans announced by Heathrow and Gatwick for provision of new runway capacity, as well as the proposed projects for entirely new airports, demonstrate that there is a vigorous market for the supply of additional capacity from existing operators as well as new entrants. In our view this underscores our view above of the relevance of the provision of additional runway capacity to the estimate of the competitive price level.

LRIC doesn't provide long term commitment from the regulator

48. In its advice to the CAA, one of the concerns raised by Europe Economics about the use of LRIC as an approach to setting a regulatory price cap is that it does not enable a long term commitment from the regulator. This, Europe Economics argues, is in contrast to a RAB-based price control. One of the claimed main benefits of the RAB approach is that it is seen as creating a binding commitment on regulators to set the price cap in a way which allows the remuneration of investments included in the RAB.

49. In its report, Europe Economics echoes comments made previously by the CC when it recognises "*the need for long-term regulatory commitment to a cap set at LRAIC to enable firms to recover their costs over the long run*".

50. Europe Economics also identifies, that because a LRIC approach is intended to deliver long-term signals in an industry characterised by long lead times for the delivery of lumpy increments of capacity using long life assets, it is important that there is a long-term regulatory commitment to using this approach. Without such a commitment there will be an increase in the risk faced by the airport.

51. Europe Economics also points out that the legal position is that the CAA, when making any determination on regulated charges, is unable to provide any binding commitment that charges will be set on the same basis in the future. The implication of this means that while use of the RAB-based approach for setting price controls over an extended period may have led to an impression of permanence or commitment, there is no reason why a change cannot be made.

52. In our view, changes should be made to the approach to regulation when these are consistent with changes in circumstances or the availability of additional information. Indeed, not changing the approach in such circumstances and continuing with the existing approach for reasons of consistency or custom would be inappropriate.

53. In the current case of the potential future regulation of airports in the South East of England, it is clear that market circumstances have changed significantly since the RAB-based approach of setting airport aeronautical price caps was introduced and since it was last applied when setting the Q5 price control.

54. As the CAA is aware, Heathrow, Gatwick and Stansted were historically under common control, with their planning and operations undertaken with a degree of coordination. This precluded the airport competition that has now developed. It was in this context that the RAB-based approach was introduced. While some of the details of the regulatory regime may have changed in the intervening years, and certain aspects may have been "flexed" to deal with major projects such as the development of Terminal 5 at Heathrow, the overall approach has changed little since it was first introduced.

55. The situation has now fundamentally changed with the development of competition and the possibility of new capacity following the creation of the Airports Commission. Both

developments create a context where having prices set at a level which is consistent with the competitive price level (either through regulation or through market mechanisms) which will foster the provision of additional capacity, whether by new entrants or existing operators, is critical. In our view the increasingly competitive environment and the need to invest in additional capacity is consistent with adopting forward looking cost estimates such as LRIC. In addition, the need to constrain the potentially abusive pricing practices of a regional monopolist which controlled over 90 per cent of the market is no longer relevant.

56. We also suggest that not only have circumstances changed but, as a result of the increase in competition in the market and the change in airport ownership, new information is also available to the CAA, which should inform its decisions. In particular, in the current circumstances, Gatwick has been clear that it is not looking for the claimed certainty of continuing to have regulated prices set under a RAB-based approach. Indeed as the CAA is aware, we are strongly of the view that there is no need for on-going regulation of Gatwick's prices beyond the end of Q5. We have been clear that we want there to be a change, to an approach that promotes competition between airports and serves the interests of passengers, delivered through our proposed Contracts and Commitments framework outside of a regulatory licenced regime.

57. We also note that the CAA itself has actively considered alternatives to the using the RAB as the basis for setting price controls, particularly in the context of Stansted, where the current price is based on ensuring the price cap is set on a basis consistent with prices expected in a competitive market. Moreover, the CAA has more recently indicated that the application of a further RAB-based price control at Stansted may result in significant increases in price to levels which are above those that could be borne by the market. This demonstrates that the regulatory commitment claimed for the RAB framework is not absolute and that a change in approach at Gatwick would not present insurmountable issues.

The key RAB advantages are that people understand it and it is more certain

58. Gatwick agrees that the RAB-based approach is familiar to stakeholders and that this provides them with some comfort about the way in which price caps will be set and also about how price caps will be affected by particular events. Additionally, because under a RAB-based approach the level of the price cap is driven to a significant extent by sunk capital costs, the RAB-based approach (when set on the basis of historical costs) offers greater certainty as to the future level of price cap than those which are based on estimated future levels of expenditure.

59. However, we do not accept that these are factors which should have a significant impact on selection of the appropriate methodology.

60. The explicit primary duty of the CAA is to further the interests of end users, where appropriate by promoting competition. Therefore, following the discussion by Europe Economics in its advice of the importance of prices reflecting the level expected in a competitive market, the objective of the regulatory regime should be to ensure that where a

price cap is put in place, it should be consistent with ensuring prices are allowed to be set at the competitive price level. We consider that this is especially important given the break-up of BAA's dominance of capacity in the South East of England. The sale of Gatwick has already led to greater competition between the London airports and in the CC's view (and ours) competition will increase further as a result of the recent sale of Stansted.

61. LRIC has a clear advantage over RAB in creating the price environment for real competition, as acknowledged by the Europe Economics report.

RAB is a traditional tool for price regulation, used where there is no realistic prospect of competition

62. We believe that, contrary to the Europe Economics report's assertion, there is an increasing case to be made that the future will be one of competition among London airports in the light of the split of BAA's airport portfolio. If so, by Europe Economics' own admission, LRIC is the more appropriate mechanism for setting prices.

63. This position is consistent with the CAA's finding in its discussion of Stansted's market power that "[*s]witching costs faced by Stansted's airlines are found to be relatively low, compared to the turnover and profitability of these airlines on relevant routes*"[20]. The CAA report continues, however, that a constraint on future switching is the capacity constraints at other London airports. However, to the extent that there are capacity constraints and these tighten going forwards, the discussion above relating to price and economic value indicates that the competitive price level would increase as scarcity increases and fall as new capacity is brought in to service.

A move to LRIC would take a long time and would need greater levels of consultation as it is new

64. We agree that a move to a LRIC basis of setting regulated charges would represent a significant change to the regulatory regime and that developing an agreed framework for determining and costing the relevant increments would be a complex, potentially controversial and necessarily time consuming exercise. Many of the same issues would arise if a change were made to using a RAB-based approach using MEA values as suggested by Europe Economics.

65. However, the time and effort required to make and implement the appropriate change should not be used as a reason for not making the change in circumstances in which a change would otherwise be seen as appropriate. Indeed, as Europe Economics explains, such a change has been implemented in other sectors where the regulator has determined that market circumstances have required such a change in regulatory approach e.g. in telecommunications markets.

[20] Stansted market power assessment – Developing our "minded to position, CAA, January 2013, para 10

66. Moreover, the CAA will recall that in 2011, in recognition of the time and complexities involved and the need for stakeholder engagement, Gatwick encouraged the CAA to begin a structured programme of the necessary work in conjunction with stakeholders. The failure to complete the necessary work, and the now increasing difficulty of completing it within the published timetable for completion of the CAA's market power assessments and the setting of any future price controls, should not be used as a reason for keeping in place the existing, and increasingly irrelevant, approach to setting regulated airport charges.