

Aberdeen

1. In our provisional findings we stated that ‘Aberdeen’s comparatively isolated geographical location relative to other centres of population combined with other general factors that make it unattractive to serve a catchment of Aberdeen’s size with more than one airport and so deter entry are features that restrict airport competition’ (see paragraph 8.4(b)).
2. In our provisional findings we noted that over the 20 years to 2006/07 Aberdeen’s EBITDA of £187 million compares with capital expenditure of £69 million (see Table 9). This proportion of EBITDA (37 per cent) is far lower than the rest of the group (eg Edinburgh 73 per cent, total BAA 100 per cent) suggesting significant lack of development. Projections for capital expenditure for the next 10 years for Aberdeen are also comparatively modest (£40 million, see paragraph 2.23). Aeronautical revenue per passenger was higher at Aberdeen in 2006 (£6.5) than for any other BAA airport other than Heathrow (see Table 11). The real rate of return at Aberdeen in 2007 of 21.4 per cent was considerably higher than the next highest BAA airport of 13.3 per cent (Edinburgh) (see Table 8). All indicators point to high levels of profitability and relatively low levels of investment.
3. There are some limitations to the inferences that can be drawn from the above accounting data. Given the limitations in measuring profitability, a comparison of prices with more competitive airports may be more appropriate as an indicator of the effectiveness of competition. This shows that in 2006 and 2007, Aberdeen’s average net revenue per passenger was higher than that of all non-BAA airports we looked at (though possibly similar to Cardiff in 2004 and 2005) and also that it was higher than BAA airports except Heathrow and Southampton.

4. In the remedies notice we stated that:

Aberdeen Airport does not appear to be subject to any significant potential constraint from other airports and, as noted in our provisional findings, its local market position is a feature which adversely affects competition in its own right. Views are sought regarding the need for and form of measures to address the AEC. These measures may involve behavioural undertakings or, alternatively, some degree of regulation. (See paragraph 25.)

Responses to the remedies notice

5. BAA's initial response was focussed on disputing the AEC and did not provide any suggestion regarding any remedial measures that the CC might employ. BAA claimed that the CC's assessment of pricing and profit levels 'has been inadequate and falls a long way short of the standard of analysis that would normally be considered acceptable' (see paragraph 6.2). BAA disputed our analysis of profitability and alighted in particular on the profitability of the Belfast airports (cited as competing) to dispute our claim that Aberdeen's profits are high. BAA also considered that if the CC 'is not claiming that the profits are excessive then Aberdeen's profitability cannot be relied upon to support regulatory intervention' (see paragraph 6.6). On airport charges, BAA conceded that Aberdeen's airport charges are 'perhaps above average' but 'it is not out of the normal range and indeed some other airports (such as Exeter and London City) have much higher yields. BAA claimed that costs of serving Aberdeen's customers are higher than serving low cost carriers. BAA also disputed our concerns regarding route development.
6. Notwithstanding its views on the AEC, BAA considered that the CC's concerns could be met by improving its consultation processes in respect of Aberdeen airport's capital investment plans. This would involve the provision of information on the

airport masterplan, the annual capital plan and individual key projects to the airlines and other interested parties and the creation of a forum for the proposals to be discussed.

7. The CAA did not make any suggestions on the form of behavioural measures but made the following points with regard to the case for such measures:
 - (a) The CAA could find no evidence in the CC's provisional findings to support the view that some form of regulation or behavioural remedy should be imposed on Aberdeen. The CAA had seen no evidence that Aberdeen had sufficient market power to merit the sort of intervention the CC was proposing. The CAA encouraged the CC to consider the totality of constraints on Aberdeen's market power, including those stemming from airlines switching operations between airports across Europe.
 - (b) There are other airports located in remote regions which shared similar characteristics (eg Inverness, Orkney, Norwich). It was important not to create a disproportionate system in which Aberdeen, due to it being owned by BAA, was made subject to more burdensome behavioural requirements than other non-regulated airports.
 - (c) The CAA has received no complaints from airport users about Aberdeen under section 41 of the Airports Act.
 - (d) The airport has observed a voluntary price cap of RPI-1 for a number of years.
 - (e) The airport has fully complied with a discretionary accounts condition.
 - (f) The airport is currently below the EU threshold (5 million passengers) to be subject to the EU charges directive.
8. Aberdeen Airport Consultative Committee said that there were other airports serving a dedicated local population with no suitable alternative facility close by. These other airports were not part of the CC's investigation and it would appear to be inequitable

if the CC deemed it necessary to impose regulatory or behavioural remedies on Aberdeen simply because it was covered by the investigation. The Committee believed that the recent substantial investment in Aberdeen negated earlier criticisms. It was concerned that regulatory measures could have a negative effect on investment. This concern is mirrored by the Aberdeen Central MSP.

9. Aberdeen City and Shire also believed that recent investment has addressed earlier concerns about lack of investment but would wish to see BAA make a clear and unambiguous commitment to the fulfilment of this investment plan. The authority was concerned that regulation or behavioural remedies could lead to disadvantages in terms of investment and development of routes.

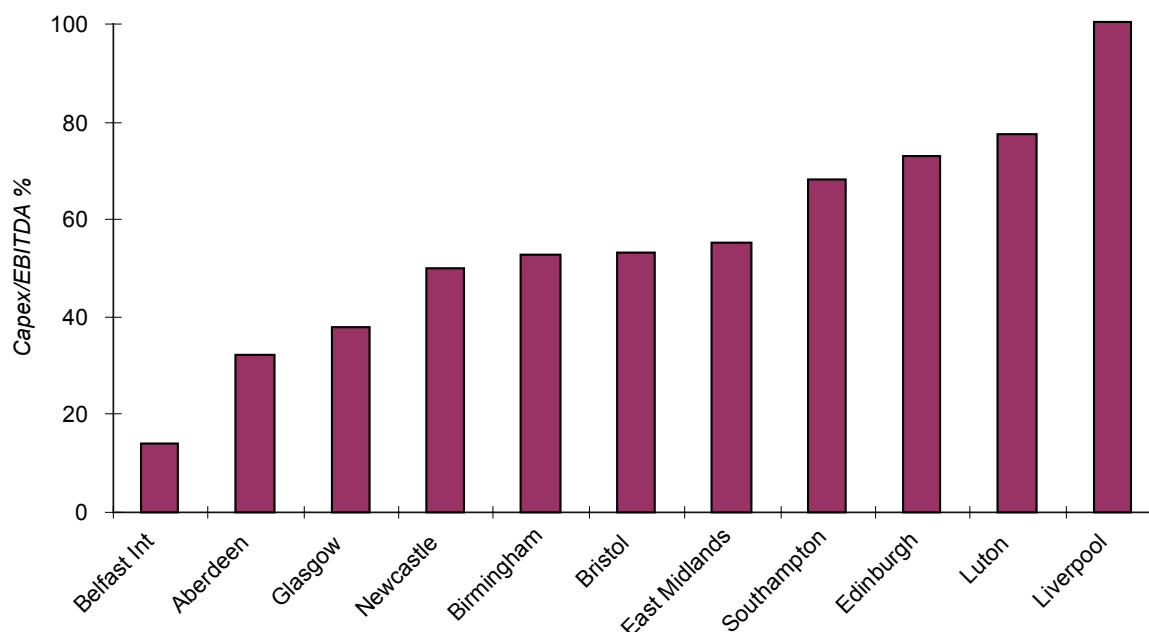
10. Aberdeen City Council fully endorsed the detailed submission from NESTRANS (The North East of Scotland Transport Partnership). The NESTRANS submission noted that 'There has been over the years a lack of investment at the airport but this problem now appears to be being addressed, although it is not clear that whether the current and proposed investment, which we believe could include surface access improvements, is at a level to meet the needs of passengers into the future. Neither is it clear how we can be assured that necessary future investment will be made.' (see page 4). The submission was concerned that Aberdeen's charges have fallen slower than Edinburgh and Glasgow and 'We also note the Aberdeen airport's view that prices at all 3 airports have been frozen for the last six years' (see page 6).

The need for a remedy

11. Figure 1 below shows that Aberdeen has spent less on capex (as a percentage of EBITDA) than comparable UK airports, other than Belfast International, for the eight years ended March 2007:

FIGURE 1

Capex as a percentage of EBITDA for the eight years ended March 2007 or December 2006 (depending on year end)



Source: CAA and Companies House.

Note: Liverpool data not shown: capex/EBITDA over 100 per cent.

12. BAA's view that the level of charges at Aberdeen results from the higher costs of serving its customers does not explain the disparity. It is true that Aberdeen's costs are higher per passenger than for other BAA Scottish airports but, as shown below, Aberdeen's total income per passenger (including commercial revenue) is considerably higher with the result that Aberdeen's operating profit per passenger is higher than BAA's other Scottish airports and higher than any other BAA airport except Heathrow:

TABLE 1 Comparison of BAA airports financial performance-£ per passenger 2007/08

Airport	Traffic charges	Operating revenue	Operating cost	Operating profit
Heathrow	9.41	19.46	11.95	7.51
Gatwick	5.01	11.45	8.01	3.44
Stansted	5.88	10.65	5.90	4.75
Glasgow	5.05	9.82	5.55	4.27
Aberdeen	6.73	12.10	6.92	5.17
Edinburgh	5.41	9.57	4.84	4.73
Southampton	6.40	11.59	8.13	3.46

Source: CC analysis of BAA data.

Note: Aberdeen passengers include helicopter passengers.

13. It should also be noted that whereas Heathrow, with the highest operating profit per passenger, has the lowest real return on capital in the group (3.1 per cent), Aberdeen has the second highest operating profit per passenger and the highest real return on capital (21.4 per cent). At present, our provisional finding that Aberdeen's local market power is reflected in relatively high levels of prices and profitability and low levels of investment appears to be sustained.
14. The CAA raised the concern that measures applied to Aberdeen might be disproportionate as comparable airports would escape such measures because they were not owned by BAA. The following points may be made in response to this:
- (a) All the other isolated airports referred to by the CAA are much smaller in scale than Aberdeen as each serves less than a million passengers a year compared with Aberdeen's passenger count of well over 3 million. As such, the other airports are not comparable to Aberdeen in scale or complexity.
 - (b) The CC has a duty to remedy the market situations referred to it if it finds an AEC irrespective of whether there are comparable situations outside the reference markets which it cannot address.
 - (c) In certain situations if the CC imposes a remedy in a reference market it may need to consider whether this may create a distortion in a related market. Such a distortion may need to be considered as a potential cost of the proposed remedy. In this case there is no suggestion that a remedy imposed on Aberdeen would significantly affect any other isolated airports in an adverse manner.
15. The absence of complaints noted by the CAA with regard to Aberdeen cannot be taken as a reliable indicator that there is not an AEC. To raise a complaint, a complainant needs to be in possession of the relevant facts *and* consider that raising the complaint will not jeopardise its position *and* consider that the authority it is complaining to is empowered and willing to address its complaint. An impediment to

any of these conditions would prevent complaints being raised. For example, certain Aberdeen respondents appeared surprised to learn that Aberdeen charges were subject to a less onerous price cap than Edinburgh and Glasgow. Most local respondents felt that there had been underinvestment in Aberdeen in the past but this does not seem to have reached the CAA in the form of complaints.

16. The CAA notes that Aberdeen airport has observed a voluntary price cap of RPI-1 for a number of years. BAA has acknowledged that its observance of voluntary price caps in Scotland has been intended to reduce the likelihood of regulation being imposed on its Scottish airports. The existence of a voluntary price cap may be taken as an indication that there is a market situation to be addressed but provides no assurance that the level or form of the cap is sufficient to address the market detriments.
17. In summary, the points raised by BAA and the CAA do not appear to diminish the provisional AEC or the need to find an appropriate remedy.
18. A number of themes emerge from local Aberdeen respondents:
 - (a) Capital investment has been inadequate in the past but has improved in recent years.
 - (b) It is not clear that the improvement in recent years has enabled Aberdeen to catch up to where it ought to be in serving its customers.
 - (c) There is concern that BAA has not committed itself to a significant forward investment programme.
 - (d) There is concern that inflexible regulatory/behavioural measures may imperil future investment.

19. The key issue to emerge from local responses is that any remedy should not provide a significant disincentive to future investment.
20. Airlines have not made any significant responses to the possibility of measures at Aberdeen other than BA noting that behavioural undertakings were better suited than ownership separation to remedying the AEC.

Remedy options

21. In this case, it is not practicable to remedy the AEC directly through measures that introduce competition but it may be feasible to address the detrimental effects on customers through regulatory/behavioural measures. Whilst recognising that any regulatory/behavioural remedy may introduce some distortion to incentives, we consider that the formulation of such a remedy should have the following objectives:
 - (a) to address Aberdeen's relatively high charges;
 - (b) not to disincentivize investment; and
 - (c) be less onerous than a full RAB-based price cap.
22. This remedy would stay in place either until either a new regulatory regime is put in place for airports or until there was another major change in circumstance, such as a major new investment programme, which triggered a review for release or variation of undertakings.
23. BAA's proposals on consultation would not be sufficient to address our concerns, in particular as they would not address issues relating to prices and would not guarantee that an appropriate level of capital investment was undertaken. However, appropriate consultation of key stakeholders, including airlines operating from Aberdeen, would be a necessary element of any behavioural remedy for Aberdeen airport.

24. We have considered four approaches to the development of a price cap, each of which we have assessed against the above objectives.
25. The first option consists in formalising, in an undertaking, the current informal price cap of RPI-1, or a similar price cap, but at a different level, eg RPI-2 or RPI-3. In addition, or as an alternative, an initial price reduction could be used to address perceived overcharging. Such an arrangement has the merit of simplicity and could address overcharging. However the option would do little to incentivize investment and may act as a disincentive if we incorporate a significant price reduction. There is an added risk that any binding price cap would create an incentive to degrade service quality.
26. A second option would be to combine a formal cap with some form of commitment to a forward investment programme over a given period. To the extent that the commitment was not delivered there could be a sliding scale rebate of charges to airlines. Unlike option 1 this would incorporate capex incentives but the adjustments that are likely to be required over time could be complex and create incentives for gaming. It would also be necessary to have consensus at the outset regarding the form, cost and timing of the proposed capital programme and further measures may be needed to deal with any incentives to degrade service quality.
27. A third possible approach would be a price cap on a rate of return on capital basis in which a proportion of the return achieved above a threshold linked to the likely WACC at Aberdeen would be rebated to customers. Such arrangements (so-called rate of return price caps) are used for the regulation of American telecoms. Rate of return price caps may incentivize investment but may also result in strong incentives for gold plating and poor cost controls. To address this it would be necessary to have

some intrusive measures, which would introduce gaming. Administrative and compliance costs could be substantial.

28. A fourth option would be to determine a price cap at Aberdeen by calculating the weighted average charges set in airports that are subject to competition, eg Scottish lowland airports following Edinburgh or Glasgow divestiture. This approach has previously been used in the First/Scotrail case. Such a measure could be relatively straightforward to implement, but might not provide a significant incentive for investment and would not take account of the particular circumstances of investment required for Aberdeen. However there may be practical difficulties, as prices in lowland Scotland may show a degree of volatility following the divestiture of Edinburgh or Glasgow. In addition, this approach may not deal with discounts effectively, even though competition in the airport market is more likely to manifest itself in the negotiation of discounts than published tariffs.
29. Having weighed up the advantages and drawbacks of each option, we consider that a variant of option 2 may fulfil our stated objectives better than any of the other options. We are aware of the adverse effects that price cap regulation creates, including administrative and compliance costs, distortion of investment and degradation of service quality or raising non-aeronautical charges to compensate. However, we have sought to minimise these issues in our proposed remedy. We note that in a revised regulatory regime with more flexible powers at its disposal, the CAA would be in a strong position to replace our straightforward remedy with measures more closely tailored to Aberdeen's particular circumstances.

Proposed price cap

30. In summary we propose a relatively straightforward price cap which consists of the following elements:

- (a) Increases in traffic charges are restricted to RPI-1 per annum (as under the current voluntary pricing policy).
- (b) The above charges are subject to a level of rebate to customers which, as we will discuss further below, we propose to set initially at 15 per cent. The rebate would apply annually retrospectively.
- (c) The level of rebate would be reduced by 12 per cent of the cumulative excess of capital expenditure over depreciation from the date of imposition of this measure. This incentive would only apply if the overall capital expenditure programme was subject to an adequate degree of consultation with airlines and local stakeholders.

The intention is to reduce charges to a more comparable level with other airports while providing incentives for new investment.

Level of rebate

- 31. We considered three possible approaches to estimating the appropriate level of rebate to Aberdeen's charges:
 - (a) a RAB-based approximation;
 - (b) an analysis of Aberdeen's profitability; and
 - (c) a comparison of Aberdeen's actual charges to those at other airports.

- 32. The first approach is to estimate an appropriate RAB (and cost of capital) for Aberdeen and from that to estimate the return that Aberdeen 'should' be earning. By comparing this return to Aberdeen's actual return we can estimate the level of overcharging which is occurring and the level of rebate we should propose. BAA provided us with data (based on data published for all Scottish airports in a BAA defence document, disaggregated and updated at our request) which we have used to perform the calculation (including a real cost of capital of 8 per cent). This is set

out in Annex 1. The conclusion from this calculation is that the detriment may be between £2.57 and £2.85 per head.

33. A second possible approach to calculating the level of rebate required would be through an analysis of profitability. We considered a return on capital employed (ROCE) calculated using a historical cost based accounting approach and one using current cost accounting. These produced ROCEs of approximately 37 per cent and 21 per cent in 2007 respectively. We have noted the limitations in both calculations elsewhere. Nevertheless we found that Aberdeen had earned higher profits than other BAA airports.
34. A reduction in traffic charges of £1 per passenger would reduce the ROCEs shown above by approximately 20 percent, ie reducing historical ROCE of 37 per cent to 30 per cent, and current cost ROCE from 21 per cent to 16 per cent.
35. A third approach is to consider the levels of charges relative to other BAA airports and bring Aberdeen in line with these. These are set out in Table 1 on page 5.
36. Based on 2007/08 figures, a rebate of 15 per cent would reduce the average traffic charge per passenger from £6.73 to £5.72 which would still leave it higher than Glasgow, Edinburgh and Gatwick but on a par with Stansted, and below Southampton. (The lower net traffic charge per passenger at Edinburgh and Glasgow in part reflects higher discounts—we believe that on average, before discounts, Aberdeen’s tariffs are about 15 per cent higher than Edinburgh and Glasgow.) Operating profit per head after this £1 reduction would be similar in size to other airports (other than Heathrow). Aberdeen’s high total income and operating profit per passenger reflect high property and other income as well as high traffic charges—the high property and other income may be related to the helicopter operations.

37. We therefore propose a rebate of 15 percent or approximately £1 per passenger in the traffic charges at Aberdeen.

Reduction in rebate

38. We propose to reduce the level of rebate by 12 per cent of any cumulative excess of capital expenditure over depreciation. Depreciation is effectively taken as a proxy for 'maintenance capital expenditure'. This is probably a generous assumption as maintenance capital expenditure is likely to be significantly higher than historic cost depreciation due to the low levels of investment in the last 20 years. It has been put to us that Aberdeen has invested too little in capex over the past 20 years and so the current depreciation charges may also be too low (in an extreme example where all assets have a 20 year life and there has been no replacement capex, after 20 years there would be no depreciation charge—although clearly maintenance expenditure would be more than zero).
39. The allowance of 12 per cent on the excess of capex over depreciation is intended to represent a high end estimate of nominal WACC. The objective is to provide a relatively generous incentive for investment in excess of maintenance amounts.

Conclusion

40. The rebate of £1 per head in charges would reduce Aberdeen's charges and operating profit per passenger to a level comparable with other BAA Scottish airports. However, this level of rebate could be eliminated in due course if Aberdeen's investment were to exceed depreciation by £25 million over the next several years. This would represent a significant step up in Aberdeen's investment plans as the latest investment projections forecast expenditure of approximately £40 million over the next ten years compared to depreciation of £39 million in the ten years ended 2007 (and the last three years have been a period of above average investment at

Aberdeen). It is unclear whether there is a need for this level of investment at Aberdeen, so it may be more likely that the proposal results in lower charges.

Aberdeen RAB

41. We set out in Table 1, a calculation of the yield implied by an RPI-X control at Aberdeen. This is based on data provided by BAA (based on data published for all Scottish airports in a BAA defence document, disaggregated and updated at our request). We note that BAA has told us that it believes the data is only suitable for a high-level review and not for such precise calculations of detriment.

TABLE 1 Yields implied by an RPI-X control at Aberdeen

Nominal prices	Units	2004/05	2005/06	2006/07	2007/08
Cumulative RPI	%	1.16	1.13	1.09	1.05
Cost of capital	%	8.0	8.0	8.0	8.0
Opening RAB	£m	47.7	52.2	59.0	68.3
Change in RAB	£m	3.0	5.4	6.7	7.0
Inflation adjustment	£m	1.5	1.4	2.7	3.0
Closing RAB	£m	52.2	59.0	68.3	78.3
Average RAB	£m	50.0	55.6	63.7	73.3
Return on capital	£m	4.0	4.4	5.1	5.9
Opex	£m	18.6	20.7	21.3	23.0
Depreciation	£m	1.9	2.1	2.2	2.8
Other revenues	£m	13.8	15.1	16.6	18.2
Implied airport charges	£m	10.7	12.1	12.0	13.5
Passengers	m	2.7	3.0	3.3	3.4
'Regulated' passenger yield	£	3.99	4.11	3.69	3.96
Actual per passenger yield	£	6.56	6.56	6.54	6.73
Detriment/pax	£	2.57	2.45	2.85	2.77
Total detriment	£m	6.91	7.24	9.28	9.42
Total detriment 08/09 prices	£m	8.02	8.18	10.12	9.89
Total detriment 2008/09 prices	£m	36.21			

Source: CC calculations based on BAA data.

Notes:

1. 06/07 figures for RAB are first nine months.
2. 07/08 figures for RAB are 12 months to 31/12/07.

42. Our calculations indicate that the yield estimated using a real cost of capital of 8 per cent and the RAB data provided by BAA is between £2.57 and £2.85 per passenger lower than the actual yield charged by Aberdeen.