

# Issues of Immediate Interest to easyJet, in regard to the CAA's 30<sup>th</sup> March 2007 Statutory Reference of Heathrow and Gatwick Airports to the Competition Commission.

## Introduction

1. easyJet has submitted evidence and views to the CAA, in response to its initial price control proposals for Heathrow, Gatwick and Stansted. Whilst this submission should be read in conjunction with that document, it seeks to highlight areas of particular interest to easyJet, following the CAA's reference to the Competition Commission.
2. As easyJet does not operate from Heathrow, this submission is made with reference to Stansted and Gatwick airports.

## The Regulatory Framework

3. easyJet supports the regulatory process, however it is concerned that regulatory framework and initial pricing proposals do not reflect outcomes that would be achieved in a competitive market.
4. easyJet believes that in a competitive market service quality would better reflect prices, and would be the outcome of a proper supplier/purchaser negotiation. Inevitably regulation affects how the airports and airlines interact, and in itself this does not negate its value; however, easyJet believes that where regulation is needed, it is the role of the regulator to both facilitate effective supplier/purchaser negotiations, but also if necessary to act as the final arbiter.
5. easyJet is concerned that the CAA has focussed on the operational economics of airports, without applying appropriate weight to those of airlines.

## The Treatment of Stansted Airport

6. The CAA has extended the current price control period at Stansted by a year. It has also proposed that Stansted should be de-designated, and has advanced a theory that Stansted does not possess market power. easyJet does not agree, and believes that there is a considerable weight of evidence to show that Stansted does possess market power.
7. While Stansted has not in this instance been referred to the Competition Commission, easyJet believes that price cap regulation will continue to be necessary at Stansted. Any findings of the Competition Commission that are applicable across the designated airports are therefore likely to apply to Stansted.

## The Cost of Capital

8. easyJet is pleased to note that the CAA has specifically indicated the cost of capital as an issue on which it seeks further Competition Commission advice. easyJet has concerns with both the development of the cost of capital and with the CAA's final proposal.
9. In developing the cost of capital from its individual components, it appears that the CAA has consistently taken either point estimates above the mid-point of the suggested ranges, or used range estimates from the upper end of initial proposed ranges. This creates a systematic bias in its estimate of the cost of capital.
10. This bias is compounded by the CAA's indication that in setting the final cost of capital it will err towards - or even at - the upper end of its proposed range. The rationale for this is that the regulatory risks of under-incentivising investment outweigh those of over-incentivising it.

11. easyJet understands the importance of a regulatory system that does not unduly distort investment incentives; however, it is widely recognised that RAB-based regulation over-incentivises investment, so it seems odd to add an upwards bias to the cost of capital. Furthermore, increasing the cost of capital for an entire RAB is an imprecise way of achieving a balanced investment incentive.
12. easyJet believes that the CAA is particularly concerned by the potential for BAA to withhold investment, a view reinforced by BAA's recent public statements suggesting that the proposed investment incentives are inadequate.
13. If the cost of capital is under-incentivising investment, this may reflect mis-pricing of the elements that make up the cost of capital, for example, the risk of future investment is not properly reflected. But it may also reflect distortions within the RAB-based regulation. easyJet believes these should be addressed by reviewing whether future investment should be regulated using RAB-based regulation. Furthermore, under the current system a higher cost of capital would be applied across the entire RAB, while the increased risk is with future investment, by definition investment that is not yet in the asset base. It is consequently unclear how increasing the profits on the current RAB incentivises future investment.
14. This issue also raises a wider question of how to best regulate airports where significant capital investment is planned. If RAB-based regulation cannot provide appropriate incentives for new investment, then easyJet believes that the CAA should develop a regulatory approach that does provide the right disciplines on capital investment.
15. Allowing airports a higher cost of capital than is suggested by the underlying analysis transfers risk from airports to airlines and passengers, despite evidence suggesting that airports have a significantly lower risk profile than airlines.
16. easyJet believes that the CAA's range of 6.3% to 6.7% for the cost of capital at Gatwick is too high and supports the findings of the CEPA paper of July 2006, '*Setting the Weighted Average Cost of Capital for BAA in Q5*'.
17. In addition, it appears to easyJet that the CAA has assumed a 30% corporate tax rate in its calculation of BAA's cost of capital at Gatwick, when from 1<sup>st</sup> April 2008 this will be 28%. Adopting the CAA's assumptions, this would lead to a cost of capital range of from 6.16% to 6.61%, rather than the 6.7% that it proposes.

### **The Price Cap**

18. easyJet believes that's the CAA's price cap proposals for Gatwick are too generous to BAA and is particularly concerned that in outlining a range for price cap indexation of -2% to +2%, the CAA has indicated an outcome of +1%, above the mid-point of the range.
19. easyJet notes that the CAA has allowed all Q4 **capital expenditure** into the RAB and remains concerned that in this way BAA is continually allowed a return on any such expenditure it makes, particularly in view of £105m preliminary expenditure at Stansted. For this reason, easyJet is supportive of increased use of capital triggers as a means of bringing forward and compensating timely investment.
20. easyJet also supports the CAA's suggestion that returns from forecast investment not undertaken, should be returned to airlines and passengers, and believes this serves the public interest. This would remove a major impediment to effective airport/airline cooperation, as both parties would share a mutual interest in accurate forecasting and the development of cost-efficient infrastructure. However, the CAA will need to adopt a rigorous approach to capital plans, as with the incentive to under-deliver gone, BAA will be left with an incentive to over-forecast and so enjoy 'capital efficiencies'.
21. easyJet is concerned that several of the elements making up the price cap are overly generous towards BAA. Within Q4 BAA has benefited from capital efficiency savings of £58.7m, or 10% of its forecast capital expenditure. Yet now, when the need for investment is critical, the CAA proposes to reward BAA with above inflation price

increases, to be paid by airlines and passengers that are currently paying for investment that has not occurred, and that have suffered consequential poor levels of service quality.

22. The CAA views that Constructive Engagement has been relatively successful at Gatwick and easyJet had been encouraged and had agreed that some progress had been made, while always maintaining that the proof would be in the delivery. The May 2006 Interim Results of Constructive Engagement show an agreed capital expenditure of £422.0m over Q5.
23. Since then BAA has reassessed requirements at Gatwick and currently proposes that Q5 capital expenditure of £723.9m will be needed to achieve what appear to be similar capacity and service quality outcomes. In contrast to its approach during the period of Constructive Engagement, BAA has not since demonstrated how this new level of capital expenditure will meet requirements at Gatwick. The CAA has accepted that BAA will submit a revised capital expenditure plan in May or June 2007. It seems to easyJet that if such a submission is accepted by the CAA without the agreement of airlines, this may undermine much of what was achieved.
24. Given its proximity and lack of explanation by BAA so far, easyJet is concerned that the CAA will accept a much higher forecast capital expenditure into the RAB at Gatwick, than was planned or agreed with airlines through Constructive Engagement.
25. easyJet has similar concerns over the underlying passenger forecast used by the CAA, which contains lower passenger numbers (and therefore leads to higher prices) than BAA's low end passenger forecast.
26. easyJet views the proposed annual 1.2% downward pressure on **operating costs** as insufficiently challenging, particularly in light of the recommendations made by the CAA's own consultants. The CAA's own evidence suggests there is significant scope for greater efficiency gains.
27. Of particular concern is that a considerable proportion of operating costs have been excluded from the efficiency gain target set by the CAA and are to be subject to further scrutiny. For example, security staffing costs (which comprise 15% of operating costs) have been excluded from this efficiency gain target.

### **The Use of the Retail Price Index**

28. easyJet would welcome a Competition Commission assessment of whether the Retail Price Index (RPI) or the Consumer Price Index (CPI) is more appropriate when considering the pricing of airport infrastructure. It is unclear to easyJet why RPI continues to be used, given that forecast inflation in construction costs are already included within BAA's capital cost projections, and the importance of food and housing costs in the composition of the RPI.

### **Security**

29. easyJet has concerns about the approach taken by BAA towards the management of security queues. Since 10<sup>th</sup> August 2006, there have been two significant changes affecting security queuing at UK airports:
  - the introduction of new security requirements post 10<sup>th</sup> August; and
  - the adoption of shorter (five-minute) security queuing standards.
30. In its statutory reference, the CAA has advanced BAA's proposed five-minute queuing standard, although this has neither been agreed by airlines, nor has the rationale for its introduction understood. At a time when BAA has failed to achieve a 10-minute standard, it is difficult to understand why it would choose to raise the benchmark against which it is measured. easyJet is unaware of any evidence that passengers are unhappy with a 10-minute queuing standard; rather, if they are unhappy, then it is because this has not been achieved.

31. The new standard is that on the 95% of occasions on which it is measured, queuing time should be less than five minutes. This leads to two fundamental problems:
  - the frequency of measurement is critical to the outcome, but undefined; and
  - queue length at the busiest times is measured by frequency, not magnitude, but it is magnitude that has the greatest impact on passengers.
32. The costs of a five-minute queuing standard at Gatwick are estimated by the CAA at £8m over Q5; however, the costs of the new post-August 10<sup>th</sup> security requirements need to be subject to further scrutiny over the coming year. This leads to a question of the allocation of costs between the new security standards and the proposed five minute queuing standard. Understandably, BAA is seeking to increase the recovery of its expenditure on security, however:
  - the costs of introducing new security requirements are 75% recoverable during Q4, through the application of the 'S-factor'; but
  - fully recoverable in Q5; while
  - the costs of moving to a five-minute queuing standard cannot be recovered until Q5.
33. easyJet believes that there is a significant public interest issue in how these security issues are managed by BAA and the CAA, and is concerned that queuing standards are being developed and applied without clear principles or industry consultation. easyJet has seen no evidence to suggest that passengers are willing to pay for a five-minute queuing standard – and believes that the majority of passengers are happy to queue for up to 10-minutes. The issue is not that the 10-minute standard is inadequate, but that BAA has been unable to achieve it, and easyJet is unaware of any significant passenger complaints relating to 10-minute security queues.
34. There is a consequential danger that because costs of various elements of security are difficult to separate in practice, those associated with delivering a five-minute queuing standard will be allocated to achieving the 10-minute standard following the post-10<sup>th</sup> August requirements. This will inflate the cost of achieving the post-10<sup>th</sup> August requirements, but also increasing the amount that BAA is allowed to recover in Q4, as there is a 75% allowance through the 'S-factor'.
35. easyJet does not support the five-minute standard. But if it is imposed, easyJet is concerned that having created it, and bundling some of its costs into the post-10<sup>th</sup> August requirements, BAA may then it, allowing it to retain the misallocated costs.
36. easyJet believes the focus should be on BAA consistently achieving the existing 10-minute standards, before any consideration is given to a five-minute standard.

### **Service Quality**

37. easyJet welcomed the Competition Commission's finding that *'Prices do not reflect the quality of service provided...'*. easyJet supports the SQR system that the CAA developed as a result. However it was disappointed that the security queuing element was suspended, following the post-10<sup>th</sup> August security requirements.
38. easyJet believes that the SQR system has brought tangible benefits. However, it would like to see this incentive effect enhanced and an objective framework developed in order to set service quality standards.
39. easyJet notes that the CAA is suggesting increasing the number of elements in the SQR and on the basis that they will be objective and in line with current methodology, easyJet supports this.
40. easyJet is concerned that the CAA is suggesting introducing a *'bonus'* to BAA for exceeding service standards that are assumed in setting the price cap. Whilst supporting the CAA in seeking to increase the incentives on BAA, easyJet sees no benefit to such increases being symmetrical, particularly where operational savings available to BAA may outweigh potential rebates to users and therefore a strategy of

revenue optimisation would not necessarily lead to improved service quality. Furthermore, easyJet is concerned that were BAA to earn a bonus on service quality levels, passengers would once again be paying for service quality that they were not receiving.

41. It would be wrong to force airlines and passengers to pay twice for a single level of service quality and easyJet believes this also is an issue of public interest.
42. easyJet therefore believes that rather than by offering potential bonuses, the public interest would be best served were the CAA to place an additional or revised condition on BAA, in order to balance potential operational savings and potential rebates, so removing any incentive to sub-optimize service quality.

### **Differential Charging**

43. Airlines operating from Gatwick's North and South terminals pay the same airport charges, despite enjoying different levels of service quality. In this way, airlines at the North Terminal are effectively provided with a significant advantage over airlines operating from the South Terminal, such as easyJet. Not only do airlines/passengers pay the same charge for different quality terminals, but in some cases airlines/passengers may be cross-subsidising services they do not need, such as transfer facilities. easyJet believes this is an issue of public interest.
44. easyJet believes that charging similarly for the use of different quality infrastructure is just as discriminatory as levying different charges for similar infrastructure. Therefore if prices are to reflect the quality of service provided, these should be objectively differentiated, according to levels of service quality.
45. easyJet sees no reason why such differentiation should affect the regulatory mechanism or aggregate price cap applied at any of the regulated airports.

### **Public Interest Issues**

46. easyJet believes that the Competition Commission should consider the following public interest issues:
  - that the CAA's suggestion that returns from forecast investment not undertaken, should be returned to airlines and passengers serves the public interest; and
  - that standards for security queuing standards and contingency plans are developed within an objective framework which involves airlines; and
  - that the service quality regime exists within an objective framework, within which airport must seek to agree standards with airlines; and
  - that in line with the earlier public interest finding that prices should reflect the quality of service provided, BAA should be compelled to objectively differentiate airport charges.

### **Conclusions**

47. easyJet believes that the CAA's proposals do not go far enough in pushing BAA to be both efficient and to provide agreed service quality levels. There are a number of concerns about the CAA's statutory reference.
48. A combination of contributing factors have led to a proposed price cap that is too loose.
49. The CAA is applying insufficient downward pressure on operational costs, over significantly less than the operating cost base.
50. easyJet is concerned that security queuing standards are being developed and applied without clear principles or industry consultation, and believes this is a public interest issue.

51. easyJet has welcomed the CAA's SQR scheme and believes this requires an objective framework for setting service quality standards.
52. easyJet believes that it is also an issue of public interest that prices should reflect quality of service and that where these differ between terminals, prices should be objectively and appropriately differentiated.