

The Competition Commission's Quinquennial Review of Stansted

The Civil Aviation Authority's response to the Issues Statement

June 2008

1. Introduction

- 1.1 This document sets out the CAA's response to the Competition Commission's (CC) Issues Statement on the Q5 price control review of Stansted Airport. It should be read alongside the CAA's reference document¹ and the other submissions and evidence provided to the CC over the course of the inquiry.
- 1.2 The CAA's response focuses on two areas:
- the issues that that CAA considers to be particularly relevant to the context of the Stansted price control review (chapter 2); and
 - the potential for alternative price control approaches (chapter 3).
- 1.3 This paper also contains an annex that sets out a number of clarifications of the material set out in the Issues Statement.

¹ 'Price control review – CAA reference to the Competition Commission for Stansted Airport', CAA, April 2008

2. Issues for the Stansted price control review

- 2.1 The CC's Issues Statement correctly identifies a number of the issues that are important to identifying an appropriate price control framework and applying that framework in practice. For example, the CC correctly states that the strength of competitive constraints facing Stansted is an important consideration when determining the overall price control approach.
- 2.2 The CAA does not propose to comment on all of the issues raised by the CC, in part reflecting that its current views on many of these issues are set out in the reference document and other relevant publications. However, there are three broad issues on which the CAA would wish to comment:
- the impact of competition on the assessment of price control options;
 - the incentive effects of different price control options (notably of the 'standard' RAB-based approach); and
 - the importance of assessing the competitive price level.

Impact of competition

- 2.3 The CAA's statutory duties relate to all UK airports, rather than to the price-controlled airport in isolation. This means that in setting a price cap for Stansted it is necessary to consider the impact that this price cap might have on both Stansted and other UK airports (both designated and non-designated).
- 2.4 To the extent that the price and service quality offered, and investment undertaken, by Stansted affects the operation of other UK airports (i.e. their pricing, service quality and investment) the CAA should consider the impact of the price cap on both Stansted and these other airports. In short, if there are competitive interactions between Stansted and other UK airports then the impact of the price cap at Stansted on other airports must be considered.
- 2.5 In this respect, the CAA considers that there is considerable evidence of significant competitive interactions between Stansted and other UK airports. This is not to suggest that there is a consensus on the strength of these competitive constraints. Rather, that the available evidence suggests that, to some degree at least, Stansted airlines compete for passengers with airlines located at other airports (exposing Stansted to inter-airport competition for passengers) and that Stansted competes directly for airline business with a number of other airports.
- 2.6 Furthermore, there appears to be a reasonable degree of agreement between the DfT and the CAA as to the market position of Stansted Airport. Whilst the DfT disagreed with the CAA's recommendation to de-designate the airport, and adopted a different approach to applying the designation criteria from that adopted by the CAA, there was significant agreement on much of the substantive evidence base, such as on the magnitude of switching costs faced by marginal customers.

- 2.7 Indeed, the CAA and DfT agreed that Stansted Airport² does not currently enjoy a position of substantial market power and also that there is no certainty that the airport will acquire such a position in future: the DfT's overall conclusion was that, on balance, the airport would be more likely than not to acquire a position of substantial market power, whilst the CAA concluded that, on balance, it was more likely that it would not. This distinction, whilst important when the DfT assessed the first de-designation criterion, is less material when considering the appropriate price control framework to be applied to the airport, as setting a price control does not involve making a binary decision against a defined criterion.
- 2.8 What appears clear is that Stansted Airport has not enjoyed a market position equivalent to that enjoyed by Heathrow or Gatwick airports. Stansted has heavily discounted its airport charges below the price cap and has not been able to recover its allowed (regulated) cost of capital for a prolonged period of time.
- 2.9 Furthermore, recent market evidence suggests that traffic growth – and indeed the current level of traffic – appears more sensitive to price and/or broader economic factors than either Heathrow or Gatwick. Looking to the longer term, there is still considerable uncertainty as to the ability of Stansted to deliver the proposed second runway project in a way that delivers a reasonable commercial return. In short, the circumstances at Stansted are different from those at Heathrow and Gatwick, suggesting that there should not be a presumption that the price control approach for these latter airports is necessarily appropriate for Stansted.
- 2.10 In paragraph 6 of the Issues Statement, the CC states that it intends to conduct the Stansted Q5 inquiry on the basis of the current status quo, i.e. without considering possible remedies which might arise from the market inquiry. While the CAA understands that the CC cannot pre-judge the final outcome of the BAA market inquiry, the issue could be dealt with, as elsewhere in a price control process, by issuing recommendations that are robust to a range of market inquiry outcomes, or by indicating the impact that changing circumstances might have on these recommendations. So, just as price controls are designed to be robust to variations in, for example, future demand, they could take account of differences in the future degree of competitive pressure arising from any remedies in the market inquiry.

Incentive effects of different approaches

- 2.11 The CAA set out in the reference document the reasons why the 'standard' building-block approach to setting price controls would be likely to distort the incentives faced by both the airport operator and the current airline users.
- 2.12 The CAA explained that the airport operator could face an incentive to bring forward over-specified investment plans and/or to undertake premature investment due to

² The analyses undertaken by the CAA and DfT differ in their treatment of common ownership. The DfT sought to distinguish between 'Stansted alone' and Stansted as owned by BAA. The CAA did not make such a distinction and, instead, considered the scenario where Stansted remains owned by BAA and that price control remain in effect at Heathrow and Gatwick. However, as the DfT also recognised that the price caps on Heathrow and Gatwick addressed the market power arising from joint ownership, it seems that the CAA's analysis of the actual competitive constraints faced by Stansted corresponds to the DfT's 'Stansted alone' scenario.

the link between actual expenditure and the level of the price cap. Where, in the absence of such investment, the price cap is likely to be below the competitive price level this would be expected to distort the airport operator's incentives.

- 2.13 However, this link between investment and the price cap is also likely to affect the incentives faced by the current airline users at Stansted. For example, the act of investing in a second runway would increase the price cap applied to the current airlines at Stansted, potentially providing a strong financial incentive for these airlines to delay and/or oppose efficient investments, particularly if these investments are undertaken to offer services to potential new entrant, competitor, airlines.
- 2.14 In practice, this means that the views of the airport and of incumbent airlines might not be aligned with those of passengers. This is likely to reduce the ability of the CC and the CAA successfully to identify the appropriate investment programme for Stansted, as it reduces the weight that can be placed on these views. An implication of this is that, if the 'standard' building-block approach were applied it would need to be supplemented – or 'augmented' – by extensive analysis of any major investment proposals, both in terms of the up-front cost and any variations in specifications and/or later phases of development.
- 2.15 In contrast, if the price cap were to be set in a way that is unrelated to the actual investment undertaken and/or proposed by the airport operator this would remove a mechanistic link between costs incurred and the level of the price cap. As a consequence, the airport's incentives to invest would not be conditioned by a desire to increase the price cap, whilst airlines' views on investment would not be affected by the impact that supporting investment might have on the prices they would pay for their current operations.
- 2.16 The CAA considers, therefore, that the choice between various options can be summarised as being a choice between:
- price caps based on historical costs incurred, which would require greater ongoing regulatory involvement in determining the appropriate investment programme, not least given the likely extent of disagreement between airline and airport expected under the building-block approach; and
 - price caps based on an assessment of the competitive price level, which would better align incentives, reducing the need for detailed regulatory involvement in determining the appropriate investment programme.
- 2.17 In respect of the latter, the CAA has proposed two approaches that use the principle of setting the price cap based on the Long-run Average Incremental Cost (or LRAIC).
- 2.18 However, whilst such approaches appear likely to have beneficial incentive effects (for both the airport operator and incumbent airlines) it would also affect the current level of charges and, therefore, have impacts on the charges faced by incumbent airlines and revenues generated by the airport operator.

- 2.19 A key issue is, therefore, the relative importance of:
- (a) ensuring that airport pricing is efficient (and thus more likely to deliver aligned incentives and less likely to distort competition); and
 - (b) the consequential impacts on airline costs and airport revenues (i.e. distributional impacts).
- 2.20 It seems that efficient pricing – that is, prices no lower than those that would prevail in a well-functioning market – would appear consistent with the CAA's duties with respect to all UK airports, and would ensure that the application of the price cap did not risk having adverse effects on competition. Distributional impacts should be analysed and could inform the price cap that is applied, but should not necessarily determine the level of the price cap in the first instance. Indeed, where there are significant concerns about distributional impacts this would suggest that transitional arrangements might be appropriate, mitigating the impacts of a step-change in the price cap, whilst still maintaining prices that reflect those that would be expected in a competitive market, albeit only over the longer term.

Importance of analysing the competitive price level

- 2.21 The preceding sections have focused on the importance of assessing the competitive constraints faced by Stansted and the impact that different price control approaches have on incentives and outcomes for passengers.
- 2.22 The CAA considers that these issues can only be fully analysed in light of an assessment of the likely level of airport charges in a well-functioning airport market. However, this assessment is complicated by a number of factors, including the:
- heterogeneity of airports, particularly in respect of size; and
 - different levels of capacity scarcity across airport markets.
- 2.23 These two factors appear to limit the degree to which the prevailing prices at one airport can be meaningfully compared to another. This suggests that any analysis of the competitive price level might need to be undertaken based on the underlying cost structure of an airport such as Stansted – that is, of a relatively large airport operating in a market that is approaching a point where additional capacity needs to be funded.
- 2.24 The CAA considers that an assessment of the long-run average incremental cost (LRAIC) provides a suitable approach to gathering information about the likely level of airport charges in a well-functioning market. Whilst there are issues associated with the estimation of LRAIC, the CAA considers that these do not undermine the rationale for this cost measure and, therefore, the need to undertake some assessment of LRAIC in order to understand the incentive effects of various price control approaches and the market position of Stansted Airport.

3. Price control approaches

- 3.1 The CC's Issues Statement sets out the six price control approaches identified in the CAA's reference document, and raises the prospect of an alternative approach. It also questions the applicability of price control approaches based on measures of long-run average incremental cost (LRAIC) in the context of airports.
- 3.2 Against this background, the CAA sets out in this chapter its views on: the rationale for, and application of, approaches based on LRAIC; and on the CC's suggested alternative approach.

Rationale for and application of LRAIC-based price caps

- 3.3 As discussed in chapter 2, the CAA considers that the price cap applied to Stansted should reflect the circumstances faced by the airport and, in particular, the existence of significant competitive constraints. Where there are competitive constraints there appears to be considerable merit in considering a safeguard price cap, rather than applying a price cap that holds airport charges down to the lowest possible level, irrespective of whether this is below the competitive price level.
- 3.4 It is in this context that the CAA has suggested price control approaches that are based on measures of forward-looking (i.e. current and future) costs. In particular, the CAA has identified that, in markets facing the prospect of investment in capacity, prices are likely to reflect long-run incremental costs.
- 3.5 In principle, therefore, there is a strong case for considering price control approaches that seek to reflect cost measures such as LRAIC, as a reasonable proxy for the level of prices that would be expected in a well-functioning airport market. The case is even stronger where a price cap is applied to a market where there is current and/or prospective competition.
- 3.6 This raises the issue of whether there is a strong case for LRAIC-based approaches *in practice*. In this respect, the CAA does not agree with the CC's assessment that the rate of technological change is an important factor determining the applicability of LRAIC to airports, due to the impact that technological change might have on the relationship between historical and current costs. Indeed, technological change typically affects the unit cost of investment and service provision, as well as affecting the nature of the product and/or service offered to consumers, making it more difficult to apply LRAIC. It appears, therefore, that the nature of technological change (and the lower rate of technological change relative to telecommunications industries) in airports markets makes it easier, not more difficult, to apply LRAIC approaches. Further, the potential divergence between historical and current/forward-looking costs does not appear to reflect rapid technological change in airport design. Rather, the divergence is more likely to reflect the accumulation of historical accounting treatment and regulatory policy applied to the airport.

- 3.7 Further, the CAA considers that it is important to view any estimation issues, and the resulting uncertainty about the eventual LRAIC estimate, in the context of the reliance placed on LRAIC-based price caps to determine the actual prices paid by users and the outcomes for consumers. For example, where there are significant competitive constraints and/or the ability of airlines to negotiate access arrangements this implies that the price cap will not, necessarily, determine the level of prices paid. The required level of accuracy for the LRAIC estimate, in the context of safeguard caps – and the need to limit the risk of significant consumer detriment – is much lower than that required when setting a RAB-based, building-block, price cap for an airport with a stronger market position where it is likely to determine prices paid.
- 3.8 Indeed, it is also relevant to consider the respective information requirements of LRAIC-based and RAB-based approaches. Due to the incentive effects arising from RAB-based approaches, it would be necessary for the CC and/or CAA to take a view on the timing and specification of major investment projects, and do so in a way that allows the CC and/or CAA to define a precise price cap number, as the price cap is more likely to determine actual prices paid³. In contrast, LRAIC based approaches do not require all of these parameters to be established – for example, there is no need to specify the timing or exact specification of investment as part of a LRAIC calculation. It is also relevant that a LRAIC estimate does not need to consider the costs or specification of the current facilities at Stansted Airport.

The CC's suggested alternative approach

- 3.9 The CC raises the possibility of an alternative approach, with a view to realigning the incentives of both the airport operator and airlines. This approach would retain a RAB-based calculation, but would only allow capital investment to be added into the RAB if the current airlines had approved the project. Once approved, Stansted would be permitted to recover the financing costs of the Assets In the Course of Construction (AICC).
- 3.10 The CAA's initial view is that such an approach would place considerable reliance on the proposition that the views of current airline users would lead to outcomes consistent with the CAA's statutory duties. Such an approach might be appropriate where the interests of current airlines are well aligned with those of current passengers and future airlines and passengers. Indeed, the CAA's (and CC's) use of constructive engagement at Heathrow and Gatwick relied upon a degree of alignment in incentives between the airport and airlines. However, importantly, the CAA reserved the role to assess whether constructive engagement outputs paid full regard to the current and future interests of passengers and future airline users (including potential new entrants).
- 3.11 However, as set out in the CAA's reference document, the nature of the RAB-based price control is such that it is likely to distort the incentives faced by the current airlines in such a way as to mean that their interests do not necessarily reflect those

³ Particularly where the price cap is set below the level that would be expected to prevail in a well-functioning, competitive market.

of future airlines and/or future passengers. Under a RAB-based price control, if the current airlines agreed to an investment proposal this would have the effect of increasing the charges that they would face on their current operations. As such, there can be no general expectation that these airlines would necessarily support efficient and economic investment projects.⁴ The CAA notes that allowing BAA to recover the costs of AICC would increase the cost to the current airlines of agreeing to an investment project, increasing the magnitude of the incentives to oppose efficient and economic investment projects.

- 3.12 Further, such an approach would risk having broader anti-competitive effects, particularly as two airlines account for over 80 per cent of the services currently operating at Stansted. It appears, therefore, that such a regulatory mechanism might increase the risk of coordination between the current airlines, which could have the effect of foreclosing airport access to new entrants. Indeed, the fact that Ryanair accounts for more than 50 per cent of the traffic at Stansted suggests that such a regulatory approach would risk handing economic control of the airport to a single, incumbent airline.

⁴ Indeed, it appears that the incumbent airlines would have a strong incentive to oppose investment projects that are intended to deliver benefits to airlines that are currently not operating at Stansted, including new entrants.

Annex A. CAA's comments on points of detail

- A.1 This annex contains a number of clarifications and points of detail arising from the Issues Statement.

Paragraph 27(a)

- A.2 The CC stated that "...the CAA has always adopted a regulatory asset base approach to the price regulation of BAA's designated airports...". As set out in chapter 3 of the reference document, the CAA did not base its Q4 price control decision for Stansted on an application of a RAB-based building-block calculation. The CAA also notes that the previous price control decisions at Heathrow, Gatwick and Stansted were based on a "system" approach, which meant that the price caps for each airport did not solely reflect the RABs of each airport individually.

Paragraph 27(d)

- A.3 The CC states that under a LRAIC-based price "... the price control would be based on the facilities projected to be built at the airport." The CAA considers that the estimation of LRAIC should not be based on BAA's projections of the cost of capacity expansion. Rather, the principle of LRAIC requires that an incremental project is defined – this does not need to be the project promoted by BAA, or even be a project based on expansion at Stansted. Further, when applying a price cap under the MLPC and PPC approaches it is important that the LRAIC estimate is not based on BAA's projected (or actual) capital investment costs, as this would provide the airport operator with an incentive to inflate these cost projections (or to 'gold plate').
- A.4 The CC also states that the CAA believed that "Stansted's market power was cyclical". This is not the CAA's position. Rather, the CAA considers that in well-functioning airport markets the changing balance between demand and available capacity will tend to result in the competitive price path varying above and below the average competitive price level⁵. This pattern of expected pricing does not depend upon the airport acquiring, or enjoying, market power, as it simply reflects the changing (competitive) market-clearing price level.

Paragraph 24

- A.5 The CAA notes that the CC agrees with the Secretary of State's view that "competition law alone might not be a sufficient safeguard against a possible exercise of market power" by Stansted.
- A.6 As set out in the reference document (see paragraph 6.24), the CAA's understanding of the Secretary of State's decision is that she expressed a view on whether competition law might not be a sufficient safeguard against an assumption that Stansted enjoyed a position of dominance and that it chose to abuse it. In contrast, the CAA considered whether competition law represented a proportionate

⁵ See Figure 7-1 of the reference document.

response to the risk of the airport acquiring a position of substantial market power and the risk that it would seek to abuse it.

- A.7 The CAA also notes that this view was expressed in the context of exploitative abuse by the airport operator, rather than other forms of abuse, such as discriminatory charging. In respect of the latter, the CAA set out the cases where competition law has been applied to airports in its advice to the Secretary of State.⁶

Paragraph 46

- A.8 The CC refers to the CAA's initial analysis of the cost of capital, referring to six approaches that give an overall range of between 4.91 and 9.39 per cent.
- A.9 The bottom end of this range relates to one of the three examples that the CAA presented. The CC correctly states that this represents a re-calculation of the Gatwick cost of capital calculation. However, whilst the CAA did not provide a view on the appropriate point estimate under any of the examples identified, it appears relevant that both the CAA and CC adopted a cost of capital of 6.50 per cent for Gatwick. As such, it is likely that the bottom end of the range is likely to be bounded by this value, unless a significantly different view was taken on some of the key underlying parameters.

⁶ See, in particular, paragraph 3.33 of 'De-designation of Manchester and Stansted airports – the CAA's advice to the Secretary of State', CAA, July 2007