

easyJet Submission to the Competition Commission in Relation to the CAA's April 2008 Statutory Reference of Stansted Airport

Introduction

1. easyJet welcomes the opportunity to comment on the CAA's April 2008 statutory reference of Stansted Airport (STN) to the Competition Commission (CC).
2. This comes at a time of considerable associated regulatory activity, in particular:
 - in March 2000 the CAA published the regulatory price caps for Heathrow (LHR) and Gatwick (LGW) Airports, which is subject to a legal challenge by easyJet¹;
 - the CC's Market Inquiry into BAA Ltd (BAA) and the recent publication of its *Emerging Thinking*, to which easyJet will continue to provide evidence, as requested;
 - the DfT Review of Regulation, to which easyJet is a contributor;
 - the DfT Strategic Review of the CAA, to which easyJet is a contributor;
 - the Planning Inquiry (yet to conclude) into Stansted Generation 1 (SG1), to which easyJet was party, through the STN ACC;
 - the forthcoming Planning Inquiry into Stansted Generation 2 (SG2), to which easyJet intends to make representations, through the STN ACC.
3. The CAA's reference is 349 pages long and is supported by four papers totalling a further 200 pages, as well as a fifth, not yet published at the time of writing². The points and issues raised by the CAA and its advisers are lengthy and detailed, so it is difficult for easyJet to allocate the level of resources that would be needed to respond to every point in equivalent detail.
4. Instead, in this submission easyJet will focus on what it considers to be the key issues that the CC should consider; however, it remains willing to assist the CC where it can, during the course of its two Inquiries into airport charges at STN and into BAA.
5. This submission follows the following structure:
 - **Executive Summary.**
 - **Engagement between BAA and Airlines:** *enhanced information disclosure; Annex 4; a central business plan; and Constructive Engagement.*
 - **Market Power and De-Designation:** *development of the CAA's view of STN's market power; the CAA's consultation on regulation of STN; the DfT's consultations on designation of STN and MAN; and the CAA's enduring view.*
 - **The Prevailing Situation:** *airport charges; and planned capacity expansion.*
 - **The Regulatory Options:** *the CAA's approach to regulating STN; option 3 - Terminal Development Tendering (TDT); option 1 - Augmented Building Block Price Cap (BBPC); option 2 - Legacy Price Cap (LPC); and options 4 and 5 - Market-Led Price Cap (MLPC) and Precautionary Price Cap (PPC).*
6. Unless stated otherwise, all references are to the 'CAA Reference to the Competition Commission for Stansted Airport, April 2008'. All emphasis is easyJet's own.

¹ easyJet has applied to the High Court for a Judicial Review of the CAA's setting of the Q5 price cap at LGW.

² Supporting Paper V - Review of evidence submitted to DfT's consultation on the designation status of Stansted Airport.

Executive Summary

7. The failure of Constructive Engagement (CE) to begin at STN was due in large part to the failure of BAA to provide a 'central business plan', as it is required to provide under the terms of Annex 4 of the Q4 Regulatory Decision (Annex 4), which airlines insisted on being provided, coupled with the failure of the CAA to enforce Annex 4.
8. The CAA had known that CE at STN was failing since December 2005; yet, it did not undertake the analysis that it had itself acknowledged would be necessary in order to set a price cap. It only undertook an *initial* analysis of operating costs and commercial revenues after publication of its January 2008 consultation.
9. Also from December 2005, the CAA had been progressively suggesting that STN did not have significant market power - and in July 2007, it advised Government that it should be de-designated for the purpose of setting price caps³. On the basis of Government's review of the regulatory status of STN, the CAA extended the forth quinquennium (Q4) by a year at STN, until 31st March 2009; however, during that time it did not undertake the work that was required at STN.
10. In January 2008 the Secretary of State delivered her decision, which was that STN would remain designated. She said that STN met all the criteria for continued designation – the first being that the airport had or could be expected to develop significant market power. In contrast, she said that Manchester Airport (MAN) did not meet the first criterion and so would be de-designated, without consideration of the second or third.
11. The CAA appears to have simply presumed that STN would be de-designated – and so for over two years did not do the work that it had itself said would be needed to set a price cap. Following the Secretary of State's decision and because of the Q4 extension, there is no more flexibility in the regulatory timetable: the CAA *must* set a price cap for Q5, before 1st April 2009, but it is *unable* to do so in the usual manner.
12. The upshot is that the CAA has, by its own admission, presented the CC a statutory reference that is lacking the level of analysis that was presented for LHR and LGW. The required work has not been done - and because of the delay caused by the extension of Q4, it appears difficult or impossible to make up lost ground. The CAA has through its own actions, come to a situation wherein the regulatory choices it faces are limited and its deliberations are uninformed. In view of this, easyJet hopes the CC will definitively set out such recommendations and make such public interest findings that are appropriate to ensure that the CAA sets an appropriate price cap and adopts regulatory policies best suited to STN's situation.
13. Despite the clear and quantified evidence to the contrary, Government's decision that STN would remain designated and its own lack of empirical analysis, the CAA persists in its assertion that STN does not possess significant market power. This view permeates the entire reference and is particularly concerning, because it is leading the CAA towards unsuitable regulatory approaches and causing it to be unduly dismissive of suitable regulatory approaches.
14. easyJet considers that the maintenance of its position on STN's market power is necessary for the justification of the 'loose' price caps the CAA is advocating – and which would not require the analytical work that the CAA has not done. In its consultations, the CAA has not sought to differentiate between the *problems of* regulation and the *requirement for* regulation. Whilst regulating STN may be problematic, what is required is a solution to the problems, not the abandonment of regulation.
15. The CAA's approach to regulating STN places considerable importance on ensuring that it does not distort the airport market; although, the extent to which this is possible is unclear; however, the CAA has not set out how the market works. Neither has it presented any view of the long-run dynamic of airport prices in a competitive market. At STN, the CAA has argued that prices need to rise to the Long Run Average

³ Paragraph 1.25.

Incremental Cost (LRAIC) of new capacity, but has not said why prices rising to a certain level would lead to STN investing in new capacity.

16. easyJet considers that the CAA's contention that headroom in the price cap would encourage investment is wrong. The CAA seems to suppose that STN would better be able to charge higher prices to airlines if it were to invest in capacity, when in fact the opposite is true⁴. STN would be able to charge airlines a higher price if it constrained capacity by not investing, so benefiting from both reduced costs and increased revenues. easyJet considers that this is a likely outcome, should either a MLPC or a PPC be applied at STN for Q5.
17. easyJet is also concerned that the CAA is taking a different regulatory approach at STN than it has at LHR and LGW. If, as the CAA argues, airport prices should be set at LRAIC, it is unclear why this is not equally true at LHR and LGW. easyJet does not understand how the CAA has come to - and continues to stand by - such contradictory positions.
18. TDT was first proposed to the CAA by easyJet in December 2007 and was further refined between then and the publication of a full description, by Frontier Economics Ltd (Frontier), in March 2008.⁵
19. easyJet considers that the adoption of TDT would represent a significant step forward for UK aviation. It would address the looming issue of capacity expansion, through the introduction of market disciplines, whilst at the same time removing the requirement for regulators to scrutinise the complexities of BAA's (often controversial) capital and operational costs. It would allow regulators to focus attention on access infrastructure that is a natural monopoly, but relatively easy to cost – and so suitable for regulation. At the same time it would allow the development of competition that would discipline prices for facilities infrastructure, where barriers to entry are relatively low.
20. easyJet believes that TDT the best regulatory option for STN – more so, given the situation in which the CAA has placed itself.
21. TDT is a single integral approach, not the hybrid portrayed by the CAA. It is a natural consequence of using TDT to trigger investment in capacity that such capacity would not be remunerated in advance of a successful tender. As such, there is no place for capital or operational costs linked to capacity enhancement in any preceding price cap. A price cap based on building block principles, but using costs of existing capital and operational expenditure (as well as historical commercial revenues), is therefore part and parcel of a TDT approach. As such, the CAA's description of option 6, DPC, cannot be considered as a standalone option.
22. The CAA set out four other options for the future regulation of STN. Of these, option 1, BBPC, appears to have been effectively dismissed by the CAA itself as overly-intrusive, in light of its perception of STN's lack of market power. In addition, the CAA points to the known distortions created by RAB-based regulation and the volume of analysis that this approach requires, much of which would be forward-looking, but hasn't been done.
23. Option 2, LPC, could potentially distort airline competition and in this regard, easyJet agrees with the CAA that it is unsuitable. So whilst airlines at STN are entitled to protection against excessive prices, easyJet does not consider that an LPC approach is an appropriate way of achieving this.
24. Options 4, MLPC, and 5, PPC, are both founded on the CAA's enduring view that STN does not have significant market power. The underpinning assumption is that BAA would be unable to price to such caps at STN, but that the 'headroom' would allow it to 'test the market' for its appetite for investment. The CAA's support for a these approaches is based on its view that STN does not have significant market power, while at the same time it points out that these approaches would be inappropriate should its view turn out to be wrong. easyJet considers that adoption of either of these

⁴ The De-Designation of Stansted Airport, Frontier Economics, October 2007, paragraphs 148 to 157.

⁵ Regulation of capacity investment at Stansted Airport, a report prepared for easyJet, Frontier Economics Ltd, March 2008.

approaches would be tantamount to regulatory abandonment; in effect, de-designation by another name.

Engagement between BAA and Airlines

Enhanced Information Disclosure

25. The requirement for improved and proper information disclosure by BAA has long been recognised. At the time of the last Airports Review in 2002, there was considerable criticism of BAA's failure to provide information to, and to consult with, stakeholders such as airlines and other airport users. As a result, the CAA required BAA to give an undertaking that it would provide enhanced information disclosure to airlines.

Annex 4

26. The disclosure details are contained in Annex 4. In referring to this requirement, and in recognising the need for improved disclosure and consultation from BAA, the CAA stated *'The CAA agrees that BAA's disclosure of information to, and consultation with, users, should be improved. This should be addressed under the agreed framework for improved information disclosure and consultation by BAA.'*⁶
27. The Chairman of the CAA, Sir Roy McNulty, expanded upon the CAA's view when he addressed Merrill Lynch's European Transport Conference in March 2004:
- *'... as a starting point, we would expect BAA to initiate their planning by taking full account of the needs of its current users.'*
 - *'... in consulting on its plans with users, BAA should take care to present properly justified and costed options for development.'*
 - *'BAA will need to adopt a transparent process whereby users can examine what the main options are, how the project is being costed, and see for themselves why costs are as they are;'*
 - *'...it would be odd, and apparently contrary to their interests, if airlines failed to engage with BAA in discussing the merits of alternative development options.'*
 - *'... with hindsight, too much [previous development] was built too soon. [However there is] the opportunity to do a much better job at Stansted this time round.'*
28. As Sir Roy made clear, it is in airlines' interest to understand and engage with BAA and this is precisely the reason why easyJet and others have expended considerable time and effort in requesting information from BAA and attempting to consult with it.

A Central Business Plan

29. Annex 4 states that consultation should take place around a *'central business plan'*; something that airlines have insisted on, that BAA has refused to provide and the provision of which the CAA has declined to enforce. Airlines did not, as BAA has claimed, insist on a *'detailed business plan'*; rather, they insisted on a *central business plan*.⁷ This was not an obstinate refusal by airlines to engage, based on some vague point of principle. It was recognition that it was impossible to engage meaningfully without a *central business plan* – and that being the basis for discussions, it was needed from the outset. This requirement had been explicitly recognised by the CAA in 2003 and 2004.

Constructive Engagement

⁶ Economic Regulation of BAA London Airports (Heathrow, Gatwick and Stansted) 2003 – 2008, CAA Decision, February 2003 (Executive Summary, Page viii)

⁷ Paragraph 5.10.

30. In May 2005 the CAA set out the process of CE, the process whereby airports would consult and hopefully come to agreements with airlines on issues that would otherwise be subject to a more traditional regulatory approach.⁸
31. On 18th May 2006, the CAA launched a consultation on BAA's compliance with Annex 4. The terms were set out by the CAA as, *'The CAA's February 2003 decision stated that the basis for information disclosure and consultation would be BAA's annual capital investment plan (CIP). This review will therefore focus on whether the CIPs meet the terms of the Annex 4 agreement.'*⁹
32. This is incorrect: Annex 4 does *not* state that the basis for information disclosure and consultation would revolve around the CIP; rather, it states that this should take place around a *central business plan*. The CIP is much less than a *central business plan*: it is little more than a list of projects and associated capital costs, from which it is impossible for airlines to weigh the costs and benefits of BAA's proposals.
33. As early as December 2005 it was clear that CE was failing at STN and indeed the CAA states that at the time it concluded that *'the issues identified for Constructive Engagement at Stansted should revert to scrutiny by the CAA.'*¹⁰ It is also clear that although in December 2005 the CAA recognised the need to undertake such scrutiny at STN, it did not begin to do so until over two years later, at the end of January 2008, when *'Following its January consultation document'*¹¹, *the CAA has... undertaken initial analysis of Stansted airport's operating costs and commercial revenues...'*¹² This came 10 days after the Secretary of State's decision to continue designation of STN.¹³ For the intervening two years, the CAA appears to have simply presumed that STN would be de-designated – and based on this presumption, did not do what it had itself said would be needed to set a price cap.
34. easyJet agrees with the CAA that the reason CE did not begin at STN was largely due to airlines' insistence on a *central business plan* and BAA's refusal to provide one – and has always considered it perfectly reasonable for airlines to insist on this. The CAA's view on the other hand, seems to have shifted between its publication of Annex 4 in 2003 and 2005, when BAA refused to comply. Not only did the CAA fail to enforce its own Annex 4 requirements, it also failed to take the steps it had itself said were necessary, in the event of the failure of CE, which it acknowledged was happening.

Market Power and De-Designation

Development of the CAA's View of STN's Market Power

35. As far as easyJet can tell, the issue of STN's de-designation was first raised by the CAA on 20th December 2005, when it said, *'At present, any case for de-designation would, on the face of it, appear to be stronger for Stansted and Manchester than for Heathrow and Gatwick. For example, the more severe restrictions on capacity at the latter two airports, and the fewer opportunities for competition from other airports, provide greater opportunity for these airports to increase charges to users. However, the CAA has not taken a view on these issues. It stands ready to advise the Secretary of State under section 16 of the Civil Aviation Act 1982 if called on to do so.'*¹⁴

⁸ Airport Regulation – the Process for Constructive Engagement, CAA, May 2005.

⁹ Letter to the STN ACC of 18th May 2006, from Mr Nick Fincham, Director of Economic Regulation & Competition Policy, CAA.

¹⁰ Paragraph 5.13.

¹¹ Price control review – consultation on the framework and options for the economic regulation of Stansted Airport, CAA, 25th January 2008.

¹² Paragraph 3.

¹³ Decision on the Regulatory Status of Stansted Airport, the Right Hon. Ruth Kelly MP, Secretary of State for Transport, 15th January 2008.

¹⁴ Airports review – policy issues, CAA, December 2005, paragraph 4.4.

36. The CAA's views appeared to have crystallised to a degree by 11th January 2006, when the Director, Economic Regulation Group, Dr Harry Bush, gave evidence to the House of Commons Transport Committee. He said, *'Heathrow is a natural monopoly because of its network characteristics. Gatwick is pretty much full up and therefore has a certain degree of pricing power potentially. There may be growing question marks in some ways around Stansted and Manchester and certainly these are issues that we have said we would consider if people wished to raise them, but ultimately it is a matter for the Government.'*¹⁵
37. Dr Bush subsequently expanded upon his suspicions that STN did not have significant market power. *'I am not sure that the decline in fares paid by passengers is necessarily relevant. The question is whether the airports would be able, in the absence of economic regulation, to raise their charges to the airlines, particularly where the airlines do not necessarily have a choice. In the Heathrow case that is probably true and it may be true for certain elements of Gatwick, but it might be less true for some elements of Stansted and Manchester. Certainly for two of the airports I suspect there is still quite a strong case.'*¹⁶
38. It appears to easyJet therefore, that sometime between 20th December 2005 (when it had not formed a view) and 11th January 2006 (when it suspected there was quite a strong case), the CAA had somehow concluded that Stansted did not enjoy significant market power; however, as Dr Bush made clear at the time, this could not have been informed by a market analysis that the CAA was yet to complete. *'As part of the current review, as we set out in the document we published just before Christmas, we are doing some market analysis which will look at the market for each of the airports. As a result of that, if we came up with a view that said there is sufficient competition, for example, around Manchester, I think we would at that point have discussions with the Government about whether it would be appropriate at some point for the Government to think about de-designation. But I think we need to assemble that evidence and look at it and see what the prospects are. It rather depends on how much competition there is and how fast it has been growing around Manchester. There has been quite a big increase, but Manchester in size terms is still fairly dominant in that area.'*¹⁷

The CAA's Consultation on Regulation of STN

39. In its response to the CAA's December 2005 paper, easyJet identified a number of issues related to BAA's actual and potential abuse of market power at Stansted, saying, *'Despite [capacity] growth at LTN and STN, competition in the London market has not approached a level that reduces the need for - or the degree of - regulation.'*¹⁸
40. easyJet's views were broadly representative of those put forward by other airlines; however, despite the weight of opinion contradicting its view on Stansted's market power, in May 2006 the CAA indicated its intention to lighten or remove regulation from Stansted. *'The CAA identified particular challenges for this price control review in devising a regulatory approach which provided sufficient incentives for timely investment in large 'lumpy' investment against a background of some uncertainty around future demand growth. These challenges are likely to be most acute at Stansted. It identified a range of regulatory tools which might be deployed, including pricing flexibility to assess market demand, advance profiling of revenues, and mechanisms to enable later recovery of costs in the event that demand was less strong than projected. In light of consultation, the CAA will continue to develop these options, and to assess*

¹⁵ House of Commons Transport Committee: The Work of the Civil Aviation Authority: Thirteenth Report of Session 2005-06 – response to question 29.

¹⁶ Ibid – response to question 31.

¹⁷ Ibid – response to question 33.

¹⁸ Response to Airports Review – Policy Issues; CAA Consultation Paper of December 2005, easyJet, March 2006, paragraph 30.

*carefully the prospects for future demand, capacity, investment and market power which give rise to the particular regulatory challenge at Stansted.*¹⁹

41. The CAA did not seek to differentiate between the problems of regulation in a potential high investment environment, and the requirement for regulation itself. easyJet considers that whilst the existent form of regulation at Stansted is problematic, what is required is a solution to the problems, not the abandonment of regulation.
42. On 5th December 2006, the CAA published initial price proposals for Heathrow, Gatwick and Stansted, separating and summarising the situation of Stansted from that of the other two airports. *'At Stansted, the CAA has undertaken a fundamental assessment of the current and prospective market power of the airport. It has also analysed the impact of applying a standard regulatory 'building block' approach to setting price caps against its statutory duties, and considered whether the current framework, and the behaviours engendered by that framework, work against achieving those duties. The CAA's emerging view is that price control regulation should be radically reshaped to reflect the circumstances at Stansted, preferably through complete de-regulation from price controls or, falling short of that, a less restrictive price cap which would not be directly linked to investment at the airport.*²⁰
43. In stating its clear preference for de-regulation, the CAA repeated its previous statement that difficulties at Stansted stemmed from the linkage between investment and the price cap, entailed in the existing regulation. easyJet understands those difficulties, but considers that the regulator has a statutory duty to set a price cap – and that it is self-evident that such a price cap should constrain prices at STN.
44. In its response, easyJet concluded, *'easyJet believes that the CAA has revealed significant issues related to the regulation of airports in the SE. It welcomes the raising of these issues; however, it does not agree with the CAA's proposed response. easyJet would welcome the opportunity to discuss these issues with the CAA.'*²¹ Since that time, easyJet has presented a considerable body of analysis to the CAA:
 - evidence demonstrating the extent of STN's market power; and
 - proposals to address the specific regulatory difficulties that the CAA is facing.

The DfT's Consultation on Designation of STN and MAN

45. On 14th December 2006, the Secretary of State published the Government's progress report on the 2003 'Future of Air Transport' White Paper. This stated, *'A common theme that runs through both the CAA and Transport Select Committee reports is a call for economic regulation to be appropriate and proportionate, in particular reviewing how airports are designated for the purposes of setting a price cap on their charges. We are considering these reports carefully, including specific cases for de-designation of Stansted and Manchester airports, proposed by the CAA and Manchester Airport Group respectively, with a view to consulting on them in 2007 and reaching conclusions based on the criteria referred to above.*²²
46. This makes clear Government's view that calls for de-designating STN came from the CAA. A week later, on 21st December 2006, the CAA initiated a consultation on extending Q4 at STN by a year. Referring to the Progress Report on the 2003 'Future of Air Transport' White Paper, it said, *'In particular, the CAA considers that there is now benefit in deferring what could prove to be significant amounts of nugatory work by the airport operator, the Competition Commission, the CAA, airlines and other interested parties, by postponing any price control reference of Stansted Airport to the*

¹⁹ Airports review – policy update, CAA, May 2006, paragraph 12.

²⁰ Airports price control review – Initial proposals for Heathrow, Gatwick and Stansted, CAA, December 2006 paragraph 11.

²¹ easyJet Submission in Response to Airports price Control Review – Heathrow, Gatwick & Stansted, December 2006, 7th February 2007, Executive Summary.

²² Progress Report on the 'Future of Air Transport' White Paper, paragraph 4.29.

*Competition Commission until after the Government has consulted on and decided on the future designation status of Stansted Airport.*²³

47. This statement is seemingly at odds with the CAA's previously stated view of December 2005, when it said that it would have to do such work, as CE was failing. In the event, the work wasn't done, as the CAA made clear in its reference to the CC.²⁴
48. On 14th March 2007, the CAA issued a letter requesting evidence or analysis in respect to Stansted's market power. It did so in view of the DfT's consultation on revised designation criteria and an expectation that subsequent to the Secretary of State's decision, it would be asked to provide advice in respect of MAN and STN.
49. easyJet responded to the CAA in May 2007, concluding that *'easyJet believes that Stansted possesses significant market power, and needs continued economic regulation. Competition law will not provide adequate protection against abuse of this power and easyJet believes that there are ways to avoid the unnecessary costs of regulation.'*²⁵
50. On 31st May 2007, the Secretary of State published her decision to retain the proposed designation criteria²⁶ and wrote to the CAA, requesting advice on whether STN and MAN should be de-designated.²⁷ Her letter set out the three criteria, all of which should be met for an airport to remain designated:
- the airport, either alone or together with any other airport(s) in common ownership or control, has or is likely to acquire, substantial market power; and
 - domestic and EC competition law may not be sufficient to address the risk that, absent regulation, the airport would increase and sustain prices profitably above the competitive level or restrict output or quality below the competitive level; and
 - designation under Section 40 of the Airports Act 1986 would, taking account of the magnitude of the risk identified in (2) and its detrimental effects were it to materialise, deliver additional benefits (i.e. over and above competition law) which exceed the costs and potential adverse effects of such designation (i.e. the incremental benefits are positive).
51. On 25th July 2007, the CAA advised the Secretary of State that both STN and MAN should be de-designated.²⁸ In its advice, the CAA concluded that Stansted met none of the criteria for continued designation. *'Based on the available evidence, the CAA considers that Stansted Airport does not meet any of the three criteria for designation and should, therefore, be de-designated.'*²⁹ On 25th July, the DfT duly launched a consultation into whether Stansted met the three designation criteria.³⁰
52. At a meeting with easyJet on 31st July 2007, the CAA stated that there were growing calls for a review of the regulation of MAN and STN – and that these had come from the House of Commons Transport Committee, MAN and the OFT market study into UK airports; however, easyJet considers that the initiative for de-designation and subsequent recommendation from the Transport Committee can be traced directly to the evidence that Dr Bush gave on 11th January 2006. So for the CAA to suggest 18

²³ Extending the current price control on Stansted Airport - a consultation, CAA, December 2006, paragraph 14.

²⁴ Paragraph 5.13.

²⁵ easyJet response to the CAA request for evidence and analysis in relation to the designation of Manchester and Stansted airports, May 2007.

²⁶ Decision on proposed designation criteria for airports, DfT, 31st May 2006.

²⁷ De-designation of Manchester and Stansted airports for price control regulation, the CAA's advice to the Secretary of State, July 2007, Annex B.

²⁸ De-designation of Manchester and Stansted airports for price control regulation: the CAA's advice to the Secretary of State, July 2007.

²⁹ Ibid, paragraph 48.

³⁰ Consultation on the Status of Stansted Airport, DfT, 25th July 2007.

months later that the Transport Committee recommended that the CAA investigate the issue, when it was the CAA itself that first suggested this to the Transport Committee, is disingenuous. Nor did the OFT suggest that Stansted's status as a designated airport should be reviewed, nor (to the best of easyJet's knowledge) has MAN commented on the designation of STN.

53. In October 2007, easyJet commissioned Frontier Economics Ltd (Frontier) to examine rigorously the two-way relationship between prices and capacity in an unregulated airport market, and use statistical analysis of its customer sales data to explore the relationship between passengers' preference for air services offered at different airports and travel distance to each of the available choices. The ensuing report showed that STN enjoyed significant market power. It has been provided in confidential form to the DfT, the CAA and the CC, while a non-confidential version was also published.³¹
54. On 15th January 2008, the Secretary of State decided that Stansted should remain designated. In a statement on the DfT website, she said *'After careful consideration, I have concluded that Stansted meets all of the criteria for designation, and should continue to be designated.'*³² (The full text of the decision expands on the evidence that has been reviewed and the reasons for the Secretary of State's conclusions.)

The CAA's Enduring View

55. Subsequent to the Secretary of State's decision to retain the designated status of STN the CAA has continued to argue that Stansted does not have market power – and has made its views explicit and central to its proposed regulatory treatment of STN. In its January 2008 consultation, the CAA said, *'... the CAA's analysis, supported by more recent market evidence, indicates that Stansted Airport does not currently enjoy a sufficiently strong market position (i.e. of substantial market power) that would normally be a necessary precondition for applying price caps.'*³³
56. There are numerous and repeated references to its enduring view throughout the CAA's reference of STN to the CC. For example, the CAA says:
- *'... regulation needs to take proper account of the competitive pressure – current and prospective – to which the airport is subject [and] the existence and evolution of competition within the airports market.'*³⁴
 - *'The objective [of a MLPC] would be to balance the risks of prices being unduly high (if competitive pressures were not as strong in practice as assessed)...' [and] '[There is] a strong expectation that competitive constraints would in practice hold charges some way below [a PPC].'*³⁵
 - *'The possibility of a substantial increment of capacity at Stansted in the form of SG2 places particular emphasis on assessment of the actual and potential competition to which Stansted is, or may be, subject since a price cap with inappropriate incentives could both generate inefficient investment at Stansted and, in the process, damage existing competition and the potential for it to develop further.'*³⁶
 - *[The CAA] would argue for recognising... the risks of regulation becoming a determining factor in a competitive market;*³⁷

³¹ The De-designation of Stansted Airport, a report prepared for easyJet, Frontier Economics, October 2007.

³² Statement to Parliament by the Secretary of State for Transport, Ruth Kelly, 15th January 2008.

³³ Price control review – consultation on the framework and options for the economic regulation of Stansted Airport, CAA, January 2008, paragraph 4.

³⁴ Paragraph 6.

³⁵ Paragraph 7.

³⁶ Paragraph 13.

³⁷ Paragraph 16.

- *'[The CAA considers that the CC should request] from the airlines, clearer quantified evidence than has been forthcoming to date to support their argument that the airport has and will continue to enjoy substantial market power';³⁸*
57. The evidence and analysis provided by easyJet and Frontier is clear and quantified, in a way that the CAA's is not – and indeed the summary of Frontier's main findings provides a critique of the CAA's analysis, saying that:
- *'The CAA's airport catchment analysis is not sufficient to demonstrate that Stansted operates in a wide geographic market, as it provides no empirical evidence of the likely extent of passenger switching in response to an increase in airport charges at Stansted.*
 - *'The CAA's analysis of passenger switching is based on the assumption that airlines will pass on a significant proportion of any increase in airport charges in the form of higher airfares, despite the lack of evidence to support this. In practice, because of the competitive pressure between airlines and the way in which airlines price their services to drive load factors it is far from clear that an increase in landing charges at one airport would be passed through to passengers to any material extent. In any case, the CAA's own analysis indicates that the number of leisure passengers who would be prepared to switch airports would be insufficient to make a fully passed through 10% increase in airport charges unprofitable.*
 - *'The CAA's analysis of airlines switching between airports is largely anecdotal and does not contain any proper quantification of the likely strength of this competitive constraint. The CAA also does not adequately consider the relevance of airport capacity constraints to the decision to relocate services.*
 - *'The CAA uses the fact that airlines operate multiple bases to conclude that airlines can readily switch aircraft to alternative locations. This disregards the likelihood that airlines offer services from multiple airports because these airports are complementary to one another in their overall offering because of the local nature of passenger demand. In other words the fact that airlines base aircraft in various locations may be a demonstration that these airports do not fall within the same market.*
 - *'Finally, the CAA's analysis ignores the potential response of inbound passengers (as opposed to passengers originating in the South East of England) to an increase in airport charges at Stansted airport and the implications of these for airline switching.*
58. Nevertheless, the CAA continues to request information on STN's market power. In its January 2008 consultation the CAA said, *'[that it has] requested further information from airlines to enable the CAA to better understand the market power of the airport.'*³⁹
59. easyJet considers that it has presented appropriate, clear and quantified analysis of STN's market power and that, not least in the light of the shortcoming of its own analysis, it is unreasonable for the CAA to persist in its requests for ever more evidence. Whatever evidence it brings forward, easyJet does not believe that it will be able to change the CAA's view.
60. This enduring view that STN has no significant market power has shaped the CAA's view of the regulatory issues facing STN. In particular, the CAA has confirmed that its view that STN does not have significant market power has led it to an initial preference for a MLPC - and subsequently for it to propose a PPC.

³⁸ Paragraph 21.

³⁹ Paragraph 3.

The Prevailing Situation

Airport Charges

61. Since 1st April 2007, airlines at Stansted have not benefited from the discounts that they had previously enjoyed; indeed, BAA had announced that it would discontinue these as long ago as 2004. The current price per passenger is £6.34, the increase over the 2007/8 price of £5.50 coming from £0.15 in respect to the recovery of unforeseen security charges, £0.23 for RPI inflation and £0.46 for the incorporation of Air Navigation Service (ANS) Charges into airport charges.
62. On 31st January 2008 the CAA wrote to airlines at Stansted, requesting views on BAA's proposed recovery of unforeseen security charges (S-factor). The Stansted ACC responded on 3rd March 2008, pointing out that while the CAA had yet to decide on the reasonableness of BAA's S-factor claim, on 29th February 2008 BAA had written to the Stansted ACC, indicating that it would levy charges at £5.88⁴⁰, irrespective of any decision the CAA might subsequently make. It said, *'Regarding the outstanding S factor claim, we are awaiting the CAA's determination on this. However, even with the inclusion of the S factor claim, BAA Stansted is still pricing below the maximum allowable yield for 2008/9 and the CAA has acknowledged this. I therefore confirm our intention to introduce the tariffs shown in Annex A of my letter dated 14 February 2008.'*⁴¹
63. The 2008/9 maximum allowable yield at Stansted is £7.11, which is comprised as follows:
 - £5.50 (2007/8 price cap); plus
 - £0.23 (RPI inflation); plus
 - £0.15 (S-factor claim, if allowed); plus
 - £0.46 (incorporation of ANS charges); plus
 - £0.77 (accumulated under-recovery, the K-factor).
64. BAA has stated on a number of occasions that it would not seek to recover the K-factor at STN, most recently at an airport charges meeting on 18th December 2007. Consequently, until such time as the CAA determines the reasonableness of BAA's S-factor claim, it follows that BAA is now intending to charge in excess of this level.
65. The K-factor itself is to a great extent a product of the significantly higher traffic volumes that have developed at Stansted during Q4, and the discounts offered by BAA in achieving this. In its 2003 regulatory decision, the CAA forecast 100.5m passengers would pass through Stansted between 2003/4 and 2007/8, whereas in the event, 111.3m passengers used the airport – a performance 11% ahead of forecast.⁴²
66. In this way, BAA was able to develop traffic growth ahead of the forecasts used in setting the regulatory price cap, whilst *'banking'* any revenue shortfalls (on a per passenger basis) for potential future recovery through the K-factor. easyJet considers that discounts offered in this way form a contract between BAA and airlines; however, under the existing regulatory system, once airlines have delivered increased traffic, BAA is able to recover the discounts it had paid in exchange. It follows that as BAA is currently pricing at £6.34 and the CAA has not approved its S-factor claim, it is effectively reneging on its agreement not to recover the K-factor, while recouping from airlines the value of the discounts it previously agreed.

⁴⁰ That is, £6.34 less £0.46 ANS Charges.

⁴¹ Letter of 29th February 2008 from Mr Stewart Wingate, Managing Director of Stansted Airport Ltd to Mr David O'Brien, Chair of the STN ACC.

⁴² Economic Regulation of BAA London Airports (Heathrow, Gatwick and Stansted) 2003 – 2008, CAA Decision, February 2003, Annex 5.

67. It is worth noting that over the same period of time, BAA has undertaken and is planning to undertake capital expenditure of £265.2m, against a forecast of £407.7m – a shortfall of £142.5m, or 35%.⁴³ Therefore, it follows that the baseline price cap throughout Q4 was itself, predicated on investment that has not taken place.

Planned Capacity Expansion

68. BAA is engaged in two broad capacity enhancing schemes at Stansted:
- Stansted Generation 1 (SG1): a scheme to increase the existing passenger cap of 25mppa to 35mppa and to increase the 241katm movement cap to 264katm; and
 - Stansted Generation 2 (SG2): a scheme to develop a second runway and ancillary infrastructure, leading to a forecast 68mppa by 2030.
69. BAA's SG1 planning application was rejected by Uttlesford District Council and BAA subsequently appealed to the Secretary of State. A Public Inquiry opened on 30th May 2007 and concluded on 19th October 2007. At this, the STN ACC said that BAA had not consulted properly on capital costs and that its plans could be prejudicial to cost-efficient SG2. It therefore argued for an interim lifting of the passenger cap to 30mppa, in order that:
- capacity would not be constrained in the short term; while
 - the long term development of the airport could be considered holistically.
70. The Planning Inspectors are yet to publish their decision for SG1, which had been expected by the end of March 2008; however, on 18th February 2008, BAA indicated that statements it had made on air quality in its environmental impact assessment were incorrect. As a result, it appears likely any decision will be delayed until at least the end of June 2008.
71. The capital costs for SG1 are forecast by BAA at £610m, from 2007/8 to 2017/18.⁴⁴
72. BAA launched its SG2 consultation on 9th December 2005, which set out four broad options for the location of a second runway. This included site acquisition and blight costs of £161m against its preferred '*wide-spaced*' runway option, which were also allocated to the airlines' preferred '*close-parallel*' runway option, but which would not have been incurred. Contrary to the wishes of airlines, BAA had started incurring these costs as early as 2004/5, seeking to capitalise these as '*preliminary expenditure*'. This suggests to easyJet that BAA had pre-determined the outcome of its consultation, or at least it had resolved to recover a return and depreciation on these costs, whether or not they were subsequently justified.
73. The first time a meeting between BAA and airlines on SG2 of any consequence took place was on 2nd November 2006. Although BAA again presented (and then rejected) only rough layouts of the alternative ideas, it made a commitment to take these away and develop them, in advance of a second meeting to be held on 4th January 2007. On 14th November 2006 BAA informed airlines of information it had received from NATS in the first half of the year, wherein it transpired that rather than the previously supposed 15mppa relative benefit of a wide-spaced runway over a close-parallel option, this would likely be around 5mppa. The costs presented, however, were relatively unchanged.
74. At the meeting of 4th January 2007, BAA again presented sketches and rough layouts for SG2 and it was agreed that a two-day joint workshop would take place on 15th and 16th January 2007, in order to fully explore alternative ideas. This took place as planned and it appeared that progress had been made.
75. On 23rd January 2007, BAA arranged a follow-up meeting with airlines for 29th January 2007, having been adamant that this must take place before 30th January 2007.

⁴³ BAA Regulatory Accounts 2003/4, 2004/5 and 2005/6, and STN CIP 2007.

⁴⁴ STN CIP 2007.

However, on 25th January 2007, BAA informed Mr Michael O'Leary, Chief Executive Officer of Ryanair, that on 30th January it would announce its decision to press ahead with its preferred wide-spaced option for SG2. It was therefore apparent that there was no point to the forthcoming meeting, since BAA had already made up its mind about its preferred option.

76. In light of these events, easyJet considers that BAA had at the eleventh hour feigned consultation and that this was a meaningless and wasteful exercise.
77. The events of December 2006 and January 2007 are further evidence of BAA's approach to consultation. Although it attended a workshop in January 2007, it is apparent that BAA had no intention of taking into account airlines' views, because it had already decided which option for SG2 it would pursue. This does not and cannot constitute effective consultation. At a meeting on 12th April 2007, BAA offered to reopen consultation on SG2; however, added that whatever the outcome, it would not change its proposals.
78. The capital costs for SG2 are forecast by BAA at £1,489m, from 2007/8 to 2017/18.⁴⁵
79. BAA lodged its SG2 planning application on 11th March 2008; however, as is noted on its website, this had not been influenced by its airline customers. *'The proposal has also been shaped by the thousands of responses received from residents, elected representatives, community organisations, businesses and travellers as part of several extensive consultations. Stansted airlines have also been consulted as part of the planning process.'*
80. Moreover, it appears that BAA has not sought to justify its plans to the CAA, which points out that:
 - *'As part of the work that the CAA subsequently carried out on the Stansted price control review in 2006 – and which is discussed in the next chapter – the CAA asked BAA to provide an appraisal of the costs and benefits of the Stansted Generation 2 (SG2) project (both phase I and phases I and II combined) stripped of the distortions associated with the effect of the RAB based regulatory framework. BAA agreed to consider the CAA's request, but did not provide a business case on the basis requested.'*⁴⁶
 - *'The CAA has also recently (in March 2008) requested from BAA an updated business plan for Stansted Airport, including a justification for future capital expenditure. At the time of making the reference to the Competition Commission, BAA had not provided such a justification. However, at a meeting on 18 April 2008, BAA undertook to provide such a justification in respect of both SG1 and SG2.'*⁴⁷
81. easyJet supports efficient expansion at Stansted – but as a first step, considers that the best use should be made of existing infrastructure, including the existing runway. A second runway may be needed in future; however, the timing of this depends on a number of factors, including its cost.

The Regulatory Options

The CAA's Approach to Regulating STN

82. The CAA has placed considerable importance on ensuring that any price cap it sets for STN does not distort the airport market; although, the extent to which this is possible is unclear, in a market as heterogeneous and requiring such 'lumpy' investment - and also in a market that is very thin, there being very few airports serving the South East. easyJet is concerned that while the CAA has stated that it has worked to ensure the

⁴⁵ Ibid.

⁴⁶ Paragraph 4.22.

⁴⁷ Paragraph 4.23.

airport market is not distorted, it has not set out any comprehensive picture of how it works, or STN's place in it. In addition, the CAA has not set out how regulation may interact with the balance of supply and demand at an airport, over time.

83. Frontier argued that competing airports would tend to under-invest, as they could only recover investment costs when capacity was constrained and prices rise above LRAIC of new investment. It suggested that airport prices move in an 'S-curve' over time, being significantly below LRAIC as capacity fills up, then rising above this level as capacity becomes constrained. The CAA on the other hand, has not presented any view of the long-run dynamic of airport prices in a competitive market. At STN, the CAA has argued that prices need to rise to the LRAIC of new capacity to incentivise further investment; however, it has not said why prices rising to a certain level would on its own lead to STN investing in new capacity. Investment decisions at airports are forward-looking, based on expected revenues over decades, not on the current price.
84. easyJet considers that the CAA's contention that headroom in the price cap would encourage investment is wrong. The CAA seems to suppose that STN would better be able to charge higher prices to airlines if it were to invest in capacity, when in fact the opposite is true⁴⁸. STN would be able to charge airlines more if it constrained capacity by not investing, so benefiting from both reduced costs and increased revenues. easyJet considers that this is a likely outcome, should either a MLPC or a PPC be applied at STN for Q5.
85. easyJet is also concerned that the CAA appears to be taking a different regulatory approach at STN than at LHR or LGW. If, as the CAA argues, airport prices should be set at LRAIC, in order to send the right price signals for future investment and to reflect 'reasonable' prices at an airport, it is unclear why this is not equally true at LHR or LGW.
86. The CAA has said that the proportionately different level of investment required at STN is the key factor; however, it remains unexplained why at airports regulated under the same statutory duties the 'reasonable' price for using an airport can be based on historic, near-term future costs (the RAB approach) or on the much higher LRAIC approach. In addition, given the scale of new investment at LHR, it is not clear why STN requires one regulatory approach and LHR another. The CAA has not set out what scale of new investment at an airport is required for it to prefer one regulatory method over another.
87. In considering the CAA's approach, it is useful to assess what this might mean for the price at STN in the short-term. The CAA has argued that STN does not possess market power; that the current price is not excessive; and also that LRAIC provides a 'reasonable' price cap. In its January 2008 consultation, the CAA provided an indicative figure of between £8.50 and £12.50 for the LRAIC at STN. This suggests that the CAA believes a price of £12.50 could be reasonable. easyJet estimates that this would provide a return of 20% on BAA's current assets, equivalent to a profit margin of 59%.
88. easyJet understands the CAA's position to be that LHR and LGW operate in a different context to STN, with both airports possessing market power, so requiring different regulatory approaches; however, it is unclear why the CAA is content with different regulatory outcomes. While different approaches may be required, one of the main objectives of regulation is to reflect the outcomes that would have been achieved in a competitive market. If the CAA believes that STN is a competitive market, and finds the returns it has outlined as reasonable there to be appropriate, surely it should be using this as a benchmark for LHR and LGW.
89. easyJet does not understand how the CAA has come to - and continues to stand by, such contradictory positions.

Option 3 - Terminal Development Tendering (TDT)

90. easyJet presented the TDT approach to the CAA in December 2007 and subsequently commissioned Frontier to consider its viability and how it could be implemented.

⁴⁸ The De-Designation of Stansted Airport, Frontier Economics, October 2007, paragraphs 148 to 157.

Frontier's report was published on 18th March 2008.⁴⁹ This submission does not seek to repeat the findings of that report, which easyJet considers presents a compelling case for the adoption of TDT, but instead, focuses specifically on easyJet's views.

91. easyJet considers that the adoption of TDT would represent a *significant step forward* for UK aviation. It would address the looming issue of capacity expansion, through the introduction of market disciplines, whilst at the same time it would remove the requirement for regulators to scrutinise the complexities of BAA's (often controversial) capital and operational costs. It would allow regulators to focus attention on access infrastructure that is a natural monopoly, but relatively easy to cost – and so suitable for regulation. At the same time it would allow the development of competition that would discipline prices for facilities infrastructure, where barriers to entry are relatively low.
92. The TDT approach would trigger development of a new runway when it was viewed by the market as a viable investment, so removing the need to take this difficult decision from the CAA. Furthermore, it would introduce competition into the market for terminal provision, which would both bring competitive benefits further into the airport, and again, would reduce the need for CAA involvement. The CAA would be divorced from the complex issues of terminal efficiency, design and service quality. Finally, this approach would simplify the regulation of the remaining assets, the access assets, as the price for the new access assets (the new runway and linked surface access) would apply to the existing assets, removing the need for RAB-based regulation.
93. easyJet believes that not only is TDT the *best* regulatory option for STN, given the situation in which the CAA now finds itself, it is the *only* option that can be properly delivered in time to meet its statutory obligation to protect the reasonable interests of users.
94. TDT is a single integral approach, not the hybrid portrayed by the CAA. It is a natural consequence of using TDT to trigger investment in capacity that such capacity would not be remunerated in advance of a successful tender. As such, there is no place for capital or operational costs linked to capacity enhancement in any preceding price cap. A price cap based on building block principles, but using costs of *existing* capital and operational expenditure (as well as historical commercial revenues), is therefore part and parcel of a TDT approach. As such, the CAA's description of option 6, DPC, cannot be considered as a standalone option.
95. The CAA's consultation suggested that TDT would require significant and ongoing CAA involvement in the regulation of the airport. easyJet's view is that the opposite is true: in fact, TDT would allow the CAA to reduce its regulatory participation. Frontier's Report provides considerable detail on how TDT could be implemented, and what it would require of the regulator.
96. easyJet recognises that a TDT approach raises some legal questions; however, these do not represent an insurmountable barrier to further developing the option. As TDT offers the best regulatory outcome, the CAA should be setting out which parts of the legal framework should change, and how this should occur.

Option 1 - Augmented Building Block Price Cap (BBPC)

97. The problems associated with a standard building block price cap are well documented – and include:
 - incentives on an airport operator to over-specify ('gold-plate') capital expenditure; and
 - weak incentives to meet users' needs.
98. The concerns are set out in detail by the OFT in its reference to the Competition Commission⁵⁰ and were explicitly acknowledged and reiterated by the CAA in its January 2005 consultation. *'This approach will tend to provide the regulated company*

⁴⁹ Regulation of new airport investment – the tendering model, Frontier Economics Ltd, March 2008.

⁵⁰ BAA, the OFT's reference to the Competition Commission, April 2007, paragraphs 5.29 to 5.37.

*with an incentive to incur additional capital costs in order to boost the asset base and, therefore, its profitability and does not provide the company with an incentive to increase cost efficiency. [...] [An RPI-X] approach will tend to provide the regulated company with an incentive to reduce the outputs, such as service quality and investment, thereby reducing the company's costs and increasing profits.*⁵¹

99. easyJet agrees with these assessments – and considers that there are other, albeit less significant, problems with RAB-based regulation, in particular incentives to realise revenues beyond the boundaries of the single till. This may take a number of forms, including:
- asset disposals over book price;
 - a bias towards commercial activities; and
 - upward pressure on specified charges.
100. In its January 2008 consultation, the CAA considered that to augment the standard building block approach, it would be necessary to define a process for approving capital expenditure – and suggested two approaches:
- airline-airport led; and
 - regulator led.
101. The difficulties surrounding reaching agreements between airlines and airports for the types of investments envisaged at STN are have already been discussed at some length. In light of its experience and subsequent assessment, easyJet agrees with the CAA and considers it unlikely that any significant degree of agreement at STN is possible.
102. In suggesting that the regulator itself take forward and approve capital expenditure, the CAA tacitly acknowledges that this is something beyond the scope of its current activities. Indeed, the scale of regulation performed by the CAA would need to significantly increase – and that this would be worth the cost, if a successful outcome could be predicted. easyJet considers that the CAA's involvement at other regulated airports has done little to curb the capital plans of BAA.
103. The CAA makes the point that a BBPC approach would require significant additional regulatory oversight, in comparison with the current situation - and questions whether this would meet its statutory duty to impose the minimum restrictions necessary – and also that this might 'crowd out' normal commercial arrangements.⁵²
104. easyJet considers – and has been at pains to explain to the CAA - that there are no normal commercial arrangements at STN and so it has no need to concern itself on that account. Moreover, if increased regulatory oversight is necessary – as easyJet would contend it is, then applying this would be proportional to this statutory duty.
105. However, the augmented building block approach would do nothing to address the fundamental problems in securing airline/airport agreement brought about by divergent incentives – and a BBPC approach does not offer a credible solution to these issues. easyJet considers that only the type of market discipline that is encompassed in TDT can provide a suitable mechanism to define the scale, cost and timing of major airport investment.
106. easyJet notes that under a BBPC, the CAA has developed an illustration wherein BAA's yield per passenger would rise from £6.66 in 2009/10, to £7.93 in 2013/4, which easyJet notes is equivalent to an opening yield adjustment of 4%, followed by four

⁵¹ Price control review – consultation on the framework and options for the economic regulation of Stansted Airport, CAA, January 2008, paragraphs 5.4 & 5.5.

⁵² Paragraph 8.20.

annual increments of RPI + 4%.⁵³ The CAA subsequently undertook a sensitivity analysis, which led to two scenarios⁵⁴:

- a high composite: prices rising from £6.91 to £9.55; an opening yield adjustment of 8%, followed by four annual increments of RPI + 9%; and
- a low composite: prices falling from £5.94 to £4.49; an opening yield adjustment of -7%, followed by four annual increments of RPI - 7%.

107. These are based on issues such as traffic forecasts, operating efficiency, commercial revenues, capital expenditure (including BAA's approach to this during Q5) and the cost of capital. Given the wide ranges in these suggested price caps and the CAA not having done the work to narrow these, it is difficult to see how the CAA could propose BBPC as an option.

Option 2 - Legacy Price Cap (LPC)

108. An LPC approach has the attraction that it would in some way 'lock in' previous investment to a price cap, whilst subjecting new investment to commercial pressures; however, the CAA correctly identifies the difficulty in defining the boundary between legacy and new assets – and the competition concerns this raises. It goes on to suggest setting a RAB-based price cap for legacy assets and a precautionary (or loose) price cap for new assets, and that the outcome would be below that required to fund major investment – specifically SG2.
109. easyJet considers that this would only be the case where investment could not be delivered cost-efficiently and in accordance with the needs of users – and that the CAA wrongly assumes that new capacity could only be delivered at a higher price to users. In competitive industries, companies are constantly seeking ways to deliver capacity at lower than current costs. In any case, companies are generally unable to charge for infrastructure that is yet to be delivered; however, this is exactly what BAA seeks to do.
110. Nevertheless, a legacy price cap approach leaves open the possibility that a situation will be arrived at wherein:
- airport capacity is constrained; and
 - BAA is unable or unwilling to deliver new capacity at existing prices; and
 - incumbent airlines are unwilling to pay higher prices; and
 - new entrants are consequently denied access to the market – or are unable to effectively compete with incumbents, whilst enduring a higher cost base.
111. This would in turn place additional emphasis on (and pressure for) a requirement for genuine negotiation between airlines and the airport, where interests in new capacity are able to be aligned. However, where agreement is not realised, the competition concerns raised by the CAA – that incumbent airlines might be unwilling to pay for capacity expansion, so preventing new entrants - might be realised.
112. So whilst easyJet considers that a legacy price cap has a number of immediate attractions – not least the removal of distortions to investment decisions identified by the CAA, the situation at STN means that the need for regulatory intervention would likely simply be postponed.
113. Nevertheless, the CAA's comment is interesting, in light of its stated position that STN does not enjoy significant market power. It said, *'Overall, the CAA considered that Option 2 had some intuitive appeal. Users of existing infrastructure would continue to be afforded the protection of a price cap, removing risk of exploitation from any inability on their part to switch away from the airport, whilst new capacity is treated much like a new airport, and would be allowed to earn a return free from such regulation.'*⁵⁵

⁵³ Table 8-10.

⁵⁴ Table 8-11.

⁵⁵ Paragraph 9.5.

114. Whilst the CAA made comparisons of the breakdown of shared and terminal-specific costs (using BAA and STN ACC projected costs), it did not translate these into indicative price caps.⁵⁶

Options 4 and 5: Market-Led Price Cap (MLPC) and Precautionary Price Cap (PPC)

115. An MLPC and a PPC are variants of the same approach, with an MLPC being set at some approximation of LRAIC and a PPC set to a level to preclude what the CAA describes as *'an airport operator increasing charges to an excessive level.'*⁵⁷ The CAA goes on to describe this as being set at an *'appropriate margin [above] LRAIC.'*⁵⁸

116. Both represent a *'loose price cap'* and as such, easyJet has considered them together.

117. easyJet's main concerns with the CAA's approach were outlined earlier, in particular that it is unclear why one regulated airport should be priced at LRAIC, while the others continue to be regulated using RAB.

118. It is also unclear how such price caps would be arrived at for STN. Despite first suggesting this approach in December 2006 the CAA has not provided any detailed description of how it proposes to take this forward. Its January 2008 consultation simply uses the costs set out by BAA, and applies an arbitrary reduction to these, to arrive at an indicative cost range. It seems clear that the only way in which the CAA could arrive at a robust estimate of LRAIC at STN would be for it to carry out its own detailed work on both the costs of the new runway and terminals, work that it has described as being onerous and a serious disadvantage to any regulatory approach.

119. easyJet considers that given the CAA's view that STN does not possess market power, and its initial view that the price cap should be based on LRAIC, the CAA's only consistent position would be to take forward a PPC. That said, the CAA seems to contradict this, in stating that, *'The underlying rationale for the MLPC approach is to set a single price cap by reference to a judgement of the relative risks of setting it too high or too low, considered in the context of the CAA's statutory duties. In particular, the price cap would be set sufficiently high so as to remove the risk of serious distortions to investment decisions and to competition, but would also have regard to the degree of risk faced by users that the airport might abuse its market position.'*⁵⁹

120. It subsequently states that:

- *'One of the key considerations when assessing the relative benefits of this approach will be, therefore, the degree of competition likely to be faced by Stansted and the degree of confidence that exists about the evidence of the current and prospective degree of competition.*⁶⁰
- *'If airport competition does not appear to deliver significant benefits then the MLPC might not be the appropriate approach.*⁶¹

121. The CAA is clearly basing its support for a MLPC on its view that STN does not have significant market power, but then usefully points out that this would be inappropriate if its view turns out to be wrong.

122. easyJet supports neither a MLPC nor a PPC and sees no clear rationale for the use of LRAIC. This approach does not take account of the actual price paths that airports exhibit in competitive markets and would allow STN to make significant profits over the first few years, profits significantly in excess of those seen at LHR or LGW.

⁵⁶ Tables 9-1, 9-2 and 9-3.

⁵⁷ Paragraph 12.18

⁵⁸ Paragraph 12.23.

⁵⁹ Paragraph 11.57.

⁶⁰ Paragraph 11.97

⁶¹ Paragraph 11.98

123. Finally, easyJet does not see how the CAA can come to a decision on the LRAIC at STN without carrying out at least as much detailed work as would be required under RAB regulation - and in fact, it might need to carry out more, as its decision will set the price cap for a much longer period of time. This would place even more responsibility on the CAA, to ensure that it comes to the right conclusions.
124. Subsequent to its consultation of January 2008, the CAA made has suggested no further indicative price caps; indeed, its illustrations are noticeably devoid of such indications.⁶²

⁶² Figures 11-1, 11-2, 11-3, 11-4, 12-1 and 12-2.