

11 Conclusions

The reference

11.1. Under the reference made by the Civil Aviation Authority (CAA) on 9 December 1991 (see Appendix 1.1), we are required to investigate and report on the maximum amounts that should be capable of being levied by Manchester Airport PLC (MA PLC) by way of airport charges at Manchester Airport during the period of five years beginning on 1 April 1993 (the reference quinquennium). We are also required to consider whether MA PLC has at any time during the period from 29 May 1987 until the date of the current reference pursued a course of conduct which has operated or might be expected to operate against the public interest, in relation to any airport charges levied by it at the airport, to any operational activities carried on by it and relating to the airport, or to the granting of a right by which any operational activities relating to the airport may be carried on by any other person or persons.

11.2. The CAA specified its view that the maximum level of airport charges should continue to be determined by a condition which has as its basis changes in the Retail Price Index (RPI) and is expressed in the form of RPI-X. It had not, however, reached any view on the appropriate value of X.

11.3. The CAA did provide us, however, with a background paper and additional information relevant to the current inquiry. The MMC also recently concluded a report into the level of charges at the BAA plc (BAA) South-East airports (the BAA report) for the five years from 1 April 1992:¹ the CAA told us that many of the general issues discussed in its background document to the BAA inquiry and its decision on that report applied equally to Manchester. We have taken full account of the information provided by the CAA in carrying out our investigation.

The legislative background

11.4. This is the second reference of MA PLC required by the Airports Act 1986 (the Airports Act); the previous reference, on which the MMC reported in December 1987, concerned the level of charges for the five years 1 April 1988 to 31 March 1993² (the 1987 report). In considering the legislative background to the Airports Act references, it is useful to draw on the summary of the legislative position in the recent BAA report.

11.5. The Airports Act distinguishes various categories of activities at airports and charges made for those activities:

- (a) '*Airport charges*' are charges levied on operators of aircraft in connection with the landing, parking or taking off of aircraft at the airport, and passenger charges.
- (b) '*Operational activities*' refers to any activities carried on wholly or mainly for the benefit of users of the airport or the revenues from which are wholly or mainly attributable to payments by such

¹ Monopolies and Mergers Commission: *BAA plc: a report on the economic regulation of the South-East airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd)*, published by the Civil Aviation Authority, MMC 2, July 1991.

² Monopolies and Mergers Commission: *Manchester Airport plc: a report on the economic regulation of the airport*, published by the Civil Aviation Authority, MMC 1, December 1987.

users: in addition to activities financed by airport charges the term includes 'commercial activities' carried out at the airport, by the airport company operator itself and by its concessionaires, licensees and tenants.

- (c) The Airports Act also distinguishes a third category, *relevant activities*. These include the activities covered by airport charges in (a), but also activities in relation to the servicing of aircraft and the handling of passengers and their baggage or cargo (which are also included in operational activities). The CAA is entitled to impose 'discretionary conditions' to remedy what it may regard as adverse effects of any course of conduct by the airport operator in relation to relevant activities carried on by the airport operator or the granting of rights by virtue of which these may be carried on at an airport. We refer below to an inquiry carried out by the CAA under this provision into arrangements for ground handling at Manchester.

'Users' are defined in the Airports Act to mean both persons for whom any 'relevant activities' are provided, and persons using any of the air transport services operating from the airport.

11.6. In considering whether any course of conduct has operated, or might be expected to operate, against the public interest, we are required to have regard to various objectives of the CAA specified by the Airports Act. The CAA is required to perform its functions in the manner which it considers is best calculated:

- (a) to further the reasonable interests of users of airports within the United Kingdom;
- (b) to promote the efficient, economic and profitable operation of such airports;
- (c) to encourage investment in new facilities at airports in time to satisfy anticipated demand by the users of such airports; and
- (d) to impose the minimum restrictions that are consistent with the performance by the CAA of its functions.

There is no statutory obligation on the MMC to take such objectives into account in considering the maximum level of airport charges but, since the CAA is required to do so in considering our recommendations, it would seem appropriate that we should also consider these objectives in the context of airport charges. The MMC are also required, in the case of a matter relating to the granting of rights to carry on operational activities at the airport, to have regard to the furtherance of the reasonable interests of persons granted those rights.

11.7. In performing its functions, the CAA is also required to take into account such of the international obligations of the United Kingdom as may be notified to it by the Secretary of State. While again there is no statutory obligation on the MMC also to do this, it would seem sensible for us to do so, so far as these are relevant to our investigation; extracts from the main international agreements are reproduced in Appendices 2.2 to 2.4. We are, however, aware of a recent arbitration between the United Kingdom and United States Governments, the result of which is still awaited.

11.8. The Airports Act also specifies that conditions for regulating the maximum level of airport charges over a five-year period may provide for an overall limit to airport charges at the airport, for limits to particular categories of charges, or for a combination of such limits. The charging condition may operate to restrict increases in charges, or require reduction in them, whether by reference to a formula or otherwise; or provide for different limits to apply in relation to different periods of time within the five-year period.

11.9. The Airports Act provides for regulation only of airport charges. In 1991/92 these accounted for somewhat over 50 per cent of the income of MA PLC but a significantly lower proportion, some 30 per cent, of its operating profits (see Table 5.1). The point was made to us (as in the recent BAA inquiry) that the scope of regulation should be wider, but it would be open to us to consider extending price regulation to cover other activities only if we had identified this as an appropriate remedy to a course of conduct which we had found to be adverse to the public interest. Nevertheless, in setting the maximum level of airport charges it is necessary to take into account projections for other commercial and non-operational

income and hence the projected profitability of all activities at each airport. The use of commercial activities to limit the level of airport charges is widely referred to as the 'single till', and we understand that this is a common basis for airport pricing throughout the world. The quinquennial review therefore involves us in considering the contribution from MA PLC's commercial activities, as well as the level of airport charges.

Manchester Airport PLC

11.10. MA PLC was established as a public limited company in April 1986. 55 per cent of its shares are owned by Manchester City Council (the City Council), with nine other local authorities in the Manchester area each holding 5 per cent of shares. As MA PLC is publicly owned, its borrowings are subject to government restrictions (see Appendix 3.2). For reasons of public expenditure control, there can be no commitment to allow borrowings for more than one year ahead, and no certainty that approval will be given for all of MA PLC's borrowing requirement. To date, however, MA PLC has not had difficulty in raising loan capital to meet its development needs, and its borrowings, from the Public Works Loans Board, tend to be at interest rates somewhat below those that would be paid by commercial companies. We were told that government policy is to encourage local authority airports to seek private sector capital, but the Government is also considering the case for the compulsory privatisation of such airports. The local authorities have seen significant benefits from ownership of MA PLC.

11.11. Manchester is the third largest airport in the United Kingdom, after Heathrow and Gatwick, and among the top 20 airports internationally in terms of international passenger numbers. In 1991 it was used by some 10.1 million passengers (compared with 40.2 million at Heathrow and 18.7 million at Gatwick), about 80 per cent of whom were on international flights, the balance on domestic flights. Traffic grew rapidly throughout the 1980s, the number of passengers more than doubling from that in 1981 (4.7 million), an annual rate of growth of almost 8 per cent per year, compared with about 5 per cent for United Kingdom airports as a whole. Manchester Airport also handled some 65,000 tonnes of cargo in 1991 (considerably below that passing through Heathrow, 650,000 tonnes, and Gatwick, 200,000 tonnes). Freight traffic also more than doubled over the previous ten years, with an annual growth of about 9 per cent. We were told that the airport was the main economic growth point in the North-West, and that its continuing success was essential to the development and promotion of the region.

11.12. MA PLC forecasts that growth will continue, expecting the airport to handle almost 20 million passengers by the year 2000. It also expects a change in the mix of traffic. Over 50 per cent of passengers at Manchester Airport currently use charter flights: MA PLC projects a decline in this proportion to as little as one-third over the next 10 to 15 years. A key objective is to develop the airport as a 'world hub', particularly for connections between domestic and international flights.

11.13. Manchester Airport currently has one runway and one passenger terminal divided into a domestic and an international section (Terminals 1A and 1B). Growth in traffic has been accommodated by continued development of capacity. Since the 1987 report, completion of Terminal 1A has increased the passenger capacity of the airport to a limit variously put at 11.5 or 12 million passengers per annum (mppa), a level of traffic which MA PLC expects to be exceeded in 1993/94. It is currently constructing a second terminal to be used only for international flights, the first phase of which, with a capacity of 6 mppa, is to be operational by April 1993. The second phase, with a further 6 mppa capacity, is planned to be finished by the late 1990s, and by about 2005 a third terminal may be necessary to meet current forecasts of demand (see Figure 7.1). MA PLC is also planning the construction of a second runway, which it believes will be necessary to meet demand by the late 1990s at the latest.

11.14. Manchester Airport has achieved its rate of growth in part by attracting traffic from other airports. The development of long-haul services, for example, has enabled passengers to fly directly to and from the North-West without having to travel through the London area airports: and the development of feeder services into the airport may also attract passengers who would otherwise have used the London area or overseas airports. Airlines indeed spoke highly of MA PLC's marketing and development strategies. MA PLC's forecasts of traffic growth partly depend on airlines winning further concessions under bilateral agreements that currently limit the number of carriers and frequency of international services from the United Kingdom.

11.15. As is apparent from Tables 2.4 and 2.5, Manchester is by a considerable margin the main airport for passengers travelling to or from the North-West or Yorkshire and Humberside, and it is considerably larger than other airports outside London. Its facilities—due to the developments it has undertaken—are superior to those of other regional airports, many of which have shorter runway lengths, as well more limited passenger facilities. We were also told that some other regional airports have more restricted operating hours than Manchester. Both passengers and airlines themselves would be severely inconvenienced should they have to use other airports. As shown in Table 4.5 and Appendix 5.1, MA PLC's airport charges tend to be below those of other regional airports, but above those of the London airports.

11.16. In our view, therefore, Manchester Airport's dominant position in the travel industry, particularly in the North-West, requires as stringent a system of regulation as that applied to the BAA South-East airports. A five-yearly review of charges would seem essential for the accountability of an undertaking in such a strong market position, although the current process, with neither ourselves nor the CAA able to bind our successors to any underlying principles on which charges should be set, also introduces a degree of uncertainty to an industry, such as airports, which makes large investments with pay-off periods often far in excess of five years.

The 1987 report

11.17. The MMC's 1987 report recommended that airport charges over the five years from 1 April 1988 should increase by no more than the increase in the RPI less 1 per cent (generally referred to as 'RPI-1'); the company had suggested a formula of RPI plus 2 per cent. The MMC's recommendation was adopted by the CAA, although the CAA, after further representation from MA PLC, applied a somewhat different form of regulation to that put forward by the MMC. The MMC had favoured the use of a 'tariff basket' approach, in which the RPI-1 formula would be applied to an average price, derived by weighting each element of the airport's charging structure (for example, the passenger charge, and the landing charge) by its share of revenue. The CAA adopted a 'revenue yield' approach: revenue per passenger from airport charges was required to increase by no more than the RPI less 1 per cent. This distinction is further discussed in paragraphs 11.37 and 11.38.

11.18. The MMC did not in the earlier inquiry find any course of conduct which operated, or might be expected to operate, against the public interest. They did, however, identify a number of areas of concern. In the course of the current inquiry we have considered whether those issues still give rise to concern, namely: the system of matching manpower to workload (paragraphs 11.26 to 11.31), the structure of charges (paragraphs 11.80 to 11.82), the provision of information on quality of service (paragraph 11.88), the functional costing system (paragraphs 11.90 to 11.94), the agreement with the City Council (paragraph 11.98), and arrangements for ground handling at the airport (paragraphs 11.99 to 11.121).

MA PLC's performance under the current regulatory formula

11.19. We discuss in Chapter 3 MA PLC's performance in the current quinquennium. Our assessment has had to be based on actual performance in the first three years of the quinquennium only, on unaudited figures for 1991/92 (although audited figures will shortly be available to the CAA), and on forecast performance in 1992/93. (We note that the CAA will also be in a position to consider any revision to these forecasts before it takes the final decision on charges.)

11.20. We regard comparisons of actual and projected performance as an important aspect of each quinquennial review, in order to assess both how well the RPI-X form of regulation has worked, and whether there should be any 'clawback' of excess profits in the reference quinquennium. If, for example, MA PLC has done significantly better than expected over the current quinquennium, we should consider whether profits should be reduced over the reference quinquennium. There can, however, be no presumption of such clawback. It is an objective of the RPI-X approach that an industry should have an incentive to improve its performance, and such an incentive would be much diminished if any such gains were to be offset automatically in low returns for the next five-year period. On the other hand, clawback of profits would need to be considered if actual performance showed any significant error in the assumptions or the information on which charges had been set.

11.21. MA PLC argued that over the first four years of the current quinquennium performance was likely to be close to that originally forecast. Our analysis of actual and projected performance (including forecasts for 1992/93) is given in more detail in Chapter 3. The comparison is not straightforward, due to differences in the accounting basis of the figures. The 1987 report quoted figures relating to assets revalued in 1987 and projected forward revenue and costs at constant 1987 prices. MA PLC's Report and Accounts are on a historic cost basis (subject to revaluation in 1987 and 1991) and cannot be compared directly with the 1987 figures. We have therefore had to adjust figures in the 1987 report to actual prices for purposes of comparison.

11.22. We are indeed concerned that similar problems may arise in monitoring performance over the reference quinquennium for which we have taken into account returns on the basis of the replacement cost of fixed assets, rather than on historic cost with infrequent revaluations as in the Report and Accounts. We believe users should also be able to compare actual against projected performance throughout the quinquennium. To do so, we suggested to MA PLC that its Report and Accounts should include a statement showing capital employed with fixed assets at current replacement cost values and the impact on the profit and loss account of the consequent change to the annual depreciation charge, with a restatement of the return on capital employed (ROCE) on the replacement cost basis. MA PLC saw no difficulty in our proposal: failure to publish such information could by the time of the next quinquennial review be regarded as a matter contrary to the public interest.

11.23. Figures for estimated ROCE (at historic cost, before interest and tax) are summarised in Table 11.1.

TABLE 11.1 Return on capital employed at historic cost

	<i>per cent</i>					
	1988/89	1989/90	1990/91	1991/92*	1992/93†	Average
1987 report (historic cost, 1987 prices)	17.7	15.8	15.1	14.3	9.0	14.4
1987 report (historic cost adjusted to actual prices)	19.2	18.7	19.2	18.4	12.4	17.6
Actual (historic cost)	30.3	26.6	17.5	13.3	9.5	19.4

Source: MMC study.

*Provisional.

†Forecast.

11.24. The present RPI-1 target assumed initially high but declining ROCEs. In the first two years of the current quinquennium, financial performance was significantly better than forecast due to higher than expected traffic levels. In later years it fell somewhat below forecast, when traffic was lower than had been projected due to the impact on air travel of the Gulf War and the recession. Over the quinquennium as a whole, ROCEs were better than expected although the airport handled less traffic than forecast and there was under-recovery of airport charges by some 4 to 5 per cent over the period as a whole (implying charges increasing at almost 2.5 per cent per annum below the RPI). The strong performance in profitability mainly reflected fast growth in commercial income. The extent to which performance has been better than expected is not, however, sufficient to justify any clawback of profits in the reference quinquennium.

11.25. We noted in Chapter 3 two other aspects of MA PLC's financial performance. Dividends were significantly higher than expected, but mainly because profits (after interest and tax, rather than before interest and tax, the measure relevant to assessing ROCE) have also been higher. Consequently, we do not regard dividend payments at that level as unreasonable. We also noted that MA PLC has drawn down loans earlier than required and has reinvested the funds in the money markets at a higher rate of interest. MA PLC argued that this was necessary, since, if borrowings are not taken in the year they are approved, there is no assurance that they will be available in future years when required, and to do otherwise may indeed affect future claims. We are surprised that there is scope to draw down and use loans in this way, a further factor which improved MA PLC's profits after interest and tax.

Matching manpower to workload

11.26. One particular aspect of past performance, productivity, is relevant to assessing both the future level of airport charges and possible public interest concerns. In this latter respect, the 1987 report stated that 'it was not in the public interest that a company in the position of MA PLC should fail to operate an effective manpower planning system, to carry out procedures for matching manpower to workload, or to maintain adequate control of overtime'. Given, however, that the company had recognised the deficiency and had started to take remedial action, there was no adverse public interest finding, although the report said that 'all the matters mentioned above must be followed up and checked at the next review, when the MMC would expect to find appropriate controls and procedures well established'.

11.27. MA PLC told us that 'productivity improvement is a major objective for Manchester Airport, and the company has made considerable efforts in this area'. It referred, for example, to three deals with Handling Services Division each delivering considerable improvements; the multi-skilling agreement in the Engineering Division; new efficient rosters and use of part-time employees in security; cut-back in overtime working in car parks; and restructuring of administration and management, with reduction of up to 50 posts.

11.28. We raised with MA PLC a number of continuing apparent deficiencies in its approach to raising productivity. These include lack of work measurement, no performance-related bonuses or incentive payments for the majority of employees, continued high overtime and lack of sectional productivity measures. MA PLC argued that the main deficiencies highlighted were not relevant in the airport context: it believed its procedures were fully adequate in matching staffing to workload, particularly in the use of part-time staff to cover peaks. MA PLC also claimed a productivity level comparable with that of Gatwick if allowance was made for differences in functions.

11.29. It is, however, disappointing that despite MA PLC's enthusiasm for what it claims to have achieved, the effects of these improvements have yet to show up in the overall productivity figures; passengers per employee, excluding security, declined by about 10 per cent between 1988/89 and 1990/91. We also noted in paragraph 6.49 a decline in productivity of all but one of the separate sections of the workforce since 1988/89, although this poor performance may at least in part be attributable to taking on more work in-house, development of new businesses and additional employment associated with Terminal 1A.

11.30. MA PLC forecasts an increase in passengers per employee of some 6 per cent per annum after 1992/93 (see Table 6.17) despite the opening of Terminal 2, as a result of economies of scale as traffic increases. Additionally, MA PLC's financial projections assume a 1 per cent per annum productivity improvement over and above the effects of economies of scale incorporated in the model. The recent process of tendering for ground handling operations in Terminal 1 (discussed in more detail in paragraphs 11.104 to 11.107) showed scope for productivity improvements beyond those achieved over the last five years. MA PLC accepted that there may well be similar room to improve productivity in other airport activities, but believed it 'imprudent' to aim to achieve improvements beyond those assumed in the model, as this would put standards of service at risk.

11.31. On balance, the importance MA PLC attaches to improvements in productivity and the measures it has adopted since the previous report persuade us that there are insufficient grounds for an adverse public interest finding on productivity. Past performance has, however, been somewhat disappointing. The achievement of increases in productivity assumed in MA PLC's financial projections would represent an improvement on past trends. However, as in the 1987 report, we consider that the possibility of yet better performance exists. We have taken this into account in evaluating the level of airport charges for the reference quinquennium so as to present a challenge to MA PLC to achieve this better performance.

The form of regulation for the next quinquennium

11.32. As mentioned in paragraph 11.17, the condition for airport charges for the current quinquennium is that average revenue per passenger should not increase by more than the actual increase in the RPI of each charging year (for which the figure in September was specified), less 1 per cent. This is subject to two qualifications:

- (a) *A correction factor.* When charges are determined, there is uncertainty both as to average revenue per passenger that will result (which depends on the mix of traffic, for example the relative number of passengers and aircraft movements, and the balance between international and domestic and between peak and off-peak passengers), and as to the increase in the RPI in September of the charging year as specified in the formula. Charges are therefore set-in, for example, autumn of 1989-having regard to the maximum revenue yield for 1990/91, on the basis of forecast traffic mix and the forecast of the RPI for September 1990. Only after the end of the 1990/91 charging year will it be known whether revenue yield has differed from forecast: hence there is allowance for correction of over- or under-recovery of airport charges for that year. By that stage charges for 1991/92 have already been set and will indeed be in operation. The correction factor, therefore, is applied to the charges set in autumn 1991 for the following year, 1992/93: that is, with a two-year delay.
- (b) *Additional security costs.* Standards of security are established by the Department of Transport (DTp). Changes in standards can represent a significant and unexpected cost element for the airport: there is, therefore, allowance for 75 per cent of the costs associated with additional security requirements to be recovered in the charging year two years after the year in which the additional standards are introduced. MA PLC would, for example, be permitted in 1992/93 to recover 75 per cent of the costs associated with additional security requirements introduced in 1990/91.

11.33. For the reference quinquennium (1993/94 to 1997/98) MA PLC has proposed:

- (a) retention of the existing RPI-X form of regulation, applied to revenue yield and still based on the RPI of the charging year, with X as zero (the size of X is discussed in paragraphs 11.56 to 11.78);
- (b) a modification of the form of regulation, in particular of the correction factor;
- (c) a change in the treatment of security costs; and
- (d) the starting point of the formula for the quinquennium to be based on the forecast yield in 1992/93.

We have carefully considered MA PLC's comments on each of these points.

The RPI-X form of regulation

11.34. We have discussed in Chapter 4 the advantages and disadvantages of regulating airport charges by reference to an RPI-X form of condition rather than by reference to the rate of return (ROR) earned by an airport in any single year. As was also discussed in the BAA report, the RPI-X form of regulation has been preferred in the United Kingdom in order to provide a greater incentive for an enterprise to reduce costs. The ROR expected from a particular level of charges is an important reference point in applying the RPI-X form of control. Hence over the long term, and by means of five-yearly reviews of charges, the approach can still be regarded as relating prices to costs, as well as a means of providing an incentive to reduce costs and improve efficiency by enabling an airport for a period to retain the benefits of improved profitability. An ROR form of regulation, by contrast, although more directly based on costs and ensuring that no more nor less than an adequate rate of profit is earned in any one year, either allows increases in operating or capital costs to be passed on fully to users, with little incentive to control costs, or it requires continual regulatory scrutiny of charges and the cost base. This would, in our view, provide over time a less efficient means of control.

11.35. On the other hand, there are also drawbacks associated with the RPI-X form of regulation. There is a risk that costs be reduced by deterioration in quality of service, or that an industry invests less than it forecast it would do, highlighting the need to consider whether an airport has operated against the public interest in these respects. Uncertainty over the future value of X may itself inhibit investment. We have, however, no evidence that this form of control has had such adverse effects to date. Finally, the mechanics of setting X require forecasts of future profitability and financial position over a five-year period, which are inherently subject to significant margins of uncertainty (although an ROR control would also be based on forecast costs and revenues in any charging year). MA PLC's performance over the last five years illustrates that uncertainty-profits adversely affected towards the end of the period by lower than expected traffic, a development more than offset by higher than forecast commercial revenues. Nonetheless there are insufficient grounds to change the current approach. We consider, therefore, as does MA PLC, that the RPI-X form of control should be retained for the reference quinquennium.

11.36. One source of uncertainty in setting the level of airport charges is the volume of traffic over a five-year period. Given the high proportion of fixed costs in an airport's operation, profitability is highly sensitive to growth in traffic. One option to reduce this degree of uncertainty would be to incorporate a volume factor into the formula which would allow higher charges in years of low growth, and lower charges in years of high growth. The BAA report pointed to a number of disadvantages of this approach which we also discuss in Chapter 4: it would require considerably higher charges to offset lower than expected traffic growth, which would be imposed on airlines at a time when they themselves would be in a weaker financial position; it would add to the instability of charges; and in view of the difficulty in forecasting traffic growth, it would add to the correction factor in subsequent years. There is also the risk that it could deter an airport company from endeavouring to adjust costs to traffic growth or act as a disincentive to seek to increase traffic. MA PLC did not favour the adoption of a volume term in the formula and we agree that there would be insufficient benefits to justify doing so.

Revenue yield or tariff basket

11.37. As mentioned in paragraph 11.17, the 1987 report recommended that the RPI-1 formula proposed be applied to an average price, derived by weighting each element of the airport charging structure by its share of revenue (referred to as the 'tariff basket' approach) rather than to average revenue per passenger (the 'revenue yield' approach). The revenue yield approach gives an incentive to the airport to maximise the number of passengers by lowering the passenger charge and raising landing charges. In the circumstances of the 1987 report, when MA PLC was about to commence construction of a second terminal, the MMC believed that this could distort the airport's pricing structure. The revenue yield approach has the further disadvantage that passengers represent only one element of an airport's output, and there is a disincentive to develop other businesses such as freight movements. The tariff basket approach, on the other hand, encourages the airport to concentrate increases in charges on those elements of demand which are growing more strongly-passengers rather than movements-which would have been justified at the time of the 1987 report, and provides a more comprehensive measure of airport charges and output.

11.38. In practice, however, there is no evidence that the revenue yield form of control has distorted the airport's pricing structure. MA PLC has indeed actively encouraged all categories of traffic, especially movements of smaller, feeder aircraft, as part of its development as a 'hub'. Moreover the circumstances of the airport have changed, with the runway also now becoming fully utilised at peak periods and with MA PLC planning the provision of additional runway as well as terminal capacity. The revenue yield approach, although still subject to some disadvantages, would no longer lead to the distortion feared in 1987; hence there is currently insufficient reason to change from the method of regulation adopted over the last five years. The MMC did indeed recommend continuation of the revenue yield approach for regulation of BAA over the 1992/93 to 1996/97 quinquennium.

The correction factor and the appropriate RPI

11.39. MA PLC made a number of criticisms of the way the correction factor is currently applied. The particular points were as follows:

- (a) MA PLC argued against the use of the interest rate ruling in the year that revenue is over- or under-recovered. This fails to allow for changes in interest rates before the correction is made, but is necessitated in part by the difficulty at the time of setting charges in forecasting interest rates for the year in which the correction is to be implemented.
- (b) MA PLC also criticised calculation of the correction factor with reference to over- or under-recovery per passenger, with this factor subsequently applied to the greater (or, more rarely, lesser) number of passengers in the year the correction is made. This is also necessary in practice since recovery of a particular total sum of money by adjusting the passenger or landing charges requires accurate forecasts of the number of passengers or movements in the year the correction is implemented.
- (c) Finally, MA PLC objected to the two-year lag in the system. This is also necessary under the present formula since an error in charges in, for example, 1990/91 is only fully apparent in 1991/92, at the time charges are proposed to come into force in 1992/93.

The interest rate factor could have either beneficial or detrimental effects. The effect of passenger growth on the correction factor (see (b) above) would be to an airport's disadvantage should it over-recover charges, since traffic is more likely to grow rather than decline but, as shown in paragraph 4.62, in practice the penalty has not been significant (considerably less than £0.25 million in 1990/91). Indeed the correction factor would be to the benefit of the airport if charges were initially under-recovered.

11.40. To overcome its objections, MA PLC proposed a two-stage, or 'rolling', correction factor. In setting tariffs for 1996/97, for example, an assessment would be made the previous autumn of the extent to which a correction factor was necessary as regards 1995/96: since that assessment will be subject to error (as will be the attempt at implementation, depending as it will on the volume of traffic in 1996/97), during 1996/97 a further assessment would be made of a correction factor to be applied in 1997/98. MA PLC believed such an approach would be more efficient, reducing the current two-year delay between any error in applying the formula and the correction for that error, and relating charges in any one year more directly to costs in that year, rather than factors relevant up to two years earlier.

11.41. The system proposed by MA PLC is attractive but would, in our view, be considerably more complicated than the present approach. We are also not convinced that it would have significant benefits. It relies heavily on forecasts and, since these forecasts will remain subject to error, the system may prove no more efficient than at present, and the period over which the correction factor is applied may indeed prove longer than the current two years. MA PLC has not, moreover, established any substantial detriment from the way the current formula works. In our view, therefore, there are insufficient grounds for amending the correction factor.

11.42. Nevertheless we believe that the operation of the correction factor could be simplified. The need for the correction factor arises partly because the charging formula is based on the RPI in the charging year: hence, as explained above, it is necessary to forecast the RPI at the time charges are set, and subsequently apply a correction factor when, as commonly happens, the change in the RPI differs from that predicted. In the BAA report the MMC recommended that actual RPI at or about the time charges are set should be substituted for the RPI of the charging year; the MMC recommended use of the RPI in the January before each charging year (initial proposals to airlines could, it was suggested, be based on the RPI as at September, but final charges on the later figure), but the CAA, while broadly accepting the recommendation, preferred to adopt the figure for the September before each charging year.

11.43. MA PLC argued strongly against adopting such a system, stating that it would be inefficient that charges should reflect some previous rate of inflation, rather than inflation in the charging year. In our view, however, use of a forecast RPI would prove more efficient than use of a historic RPI only if forecasts were reliable. As shown in paragraph 4.53, actual inflation in September of each year of the current quinquennium is expected to differ from forecast by on average some 2.2 per cent, but differed from

inflation the previous January by broadly the same amount. There is therefore very little advantage in using forecast as opposed to historic inflation: the effect of the present approach is mainly to require correction in subsequent years. Use of an actual inflation rate at the time charges are set reduces the need for a subsequent correction factor (although some correction will still be necessary because of the difficulty of forecasting yield). MA PLC may be disadvantaged at times when inflation is rapidly rising but it would be advantaged at times when the rate of inflation is declining.

11.44. We recommend, therefore, that the current formula be amended to substitute actual RPI at the time charges are set for the RPI in the charging year. In our view, the formula should specify as late a figure for the RPI as MA PLC wishes (but to be the same for each year): that for January before each charging year if it so chose, although in discussion with us MA PLC suggested an earlier figure may be necessary.

Security costs

11.45. Security costs are estimated to have amounted in 1990/91 to some £14 million of which those attributable to additional security requirements imposed during the current quinquennium are put at £4.4 million. The total includes £4.7 million of Greater Manchester Police costs (of which some £0.8 million related to additional security requirements).

11.46. The current charging formula, as explained in paragraph 11.32, allows MA PLC to recover 75 per cent of the costs of meeting additional security requirements, in order to give an incentive to control such costs, but with a delay of two years before any such charge can first be levied. Major new requirements could therefore impose a significant cost penalty on an airport for the remaining period of the quinquennium. In the BAA report, the MMC recommended that 85 per cent of additional costs be recovered after a one-year delay. The CAA decided to allow 95 per cent recovery after a one-year delay. Airlines were sympathetic to increasing the proportion of additional costs that could be recovered. In our view, MA PLC should be entitled to a treatment of additional security costs similar to that now permitted for BAA, the element of costs to be borne by the airport still providing an incentive to contain extra costs.

11.47. A further aspect of the present system which the MMC noted in the BAA report is that the existing formula is based on additional costs estimated at the time new requirements are introduced. There is no apparent need to validate that the costs are actually incurred.

11.48. MA PLC's proposals went some way beyond those adopted for BAA, namely that all security costs-*ie* all expenditures incurred by the airport in meeting all existing security requirements as well as any new requirements introduced by DTp-be separately identified and recovered in full. Initially MA PLC had proposed that some three-quarters of such costs be separately identified and recovered in full, representing the share of security costs attributable to the airlines, the balance being subsumed within the overall RPI-X formula. It subsequently suggested that, in presenting the charge to airlines, those costs associated with the airport and concessionaires would be shown separately but would together be fully recovered in the separate security charge.

11.49. MA PLC argued that security costs should be treated separately, since security requirements were determined by DTp and there was less scope to reduce costs or improve efficiency without putting standards or quality of service at risk. One main element of those costs-payments to Greater Manchester Police-were outside MA PLC's control, the level and costs of policing being determined by the Chief Constable: MA PLC believed the present level of policing costs, and proposals to increase these costs, were excessive. There is provision under the Aviation Security Act for arbitration by the Home Office and DTp in the event of any dispute. MA PLC has not to date resorted to arbitration believing that this procedure could work to its disadvantage, but we understand that Greater Manchester Police is itself currently considering going to arbitration.

11.50. MA PLC argued that, should its proposals be adopted, it would still be under commercial pressure to control costs and charges. It also suggested that wage levels in security would reflect trends elsewhere in the airport, and hence be subject to the discipline of the RPI-X formula on other airport activities, but it also proposed that the CAA should both validate the costs incurred and undertake efficiency audits of those costs.

11.51. We are not convinced that security costs, other than those associated with additional requirements imposed by DTp, should be treated differently from any other of MA PLC's costs. In our view, the RPI-X approach provides a much stronger incentive to control costs-by, for example, employing part-time staff-than any system that requires an external efficiency audit. The RPI-X form of control would indeed be much weakened if such a substantial proportion of costs were to be excluded from the formula. To the extent that there is less scope to reduce costs in security than in other activities, this is reflected in the financial projections and our judgment as to the value of X: we acknowledge less scope for a high value of X should MA PLC's proposals for security costs not be adopted.

11.52. We considered whether there was a case for separate treatment of Greater Manchester Police costs, about which MA PLC is particularly concerned. There is, however, no evidence that such costs have risen by more than expected at the time of the 1987 report, while the incentive for MA PLC to challenge the level of policing costs would itself seem a benefit of the present system. MA PLC is, in our view, in a far better position to resist any unreasonable level of policing costs than the airlines would be were such costs to be passed on automatically in airport charges: it has the incentive and an established disputes procedure to do so.

11.53. We therefore recommend that MA PLC be permitted to recover 95 per cent of the costs of any additional security requirements brought into effect after the date of our report, and that it be allowed to introduce such charges in the year following the date of implementation of such additional security requirements. We also recommend, as in the BAA inquiry, that there should be provision for validating the estimate of costs on which recovery is to be based and correcting for any errors in those estimates.

The starting point for the formula

11.54. MA PLC proposed-as indeed the MMC recommended for BAA-that the starting point for the formula for the reference quinquennium should be based on the *forecast* level of yield in the last year of the current quinquennium, ie 1992/93, with no need for an adjustment in subsequent years should actual yield differ from forecast. Were the RPI-X formula to be based on the *actual* level of yield in 1992/93, the maximum level of charges per passenger throughout the subsequent quinquennium-and the ROCE implied-would be unpredictable, depending on the final out-turn in 1992/93. We therefore agree that the forecast level of airport charges per passenger in 1992/93 (£7.84 including current security recovery-see Table 4.7) should be the base for the permitted yield in the subsequent years. Had there been a risk that MA PLC could recover a higher yield than the formula allows in 1992/93, there would have been a case for a subsequent one-off correction for any over-recovery, which would not affect permitted yields throughout the reference quinquennium: but given that MA PLC expects to recover significantly less than the permitted amount in 1992/93, there would seem to be no need to provide for any such correction. Current projections are based on 4.5 per cent increase in the RPI in 1992/93. Should the RPI differ from that assumption, the CAA may need to adjust the formula in the first year of the reference quinquennium or charges would be higher or lower than expected in real terms throughout the five-year period.

11.55. Finally, MA PLC told us that the CAA was proposing to charge users direct for an element of the airport navigation services currently included in MA PLC's airport charges. Such charges levied by the CAA are excluded from the scope of the Airports Act. MA PLC agreed that there should be provision for an appropriate adjustment to the airport charge formula, to remove this amount of charges, should the CAA implement this proposal.

The assessment of X

11.56. MA PLC, on the basis of financial projections of income, expenditure and capital employed for the reference quinquennium, proposed that airport charges should be allowed to increase at the rate of inflation of the RPI (RPI-0). It argued that such a condition was necessary if it was to earn an adequate ROCE (which it believed should be within the range of 8 to 9 per cent) and meet other financial objectives, to provide adequate return to its shareholders, and to be able to invest to meet the growth in traffic. We have considered these arguments in turn.

The financial projections

11.57. The financial projections are discussed in more detail in Chapter 7. The financial model used by MA PLC is considerably more sophisticated than at the time of the 1987 report, but was further amended by MA PLC to meet various points we raised during the course of our inquiry. In effect, the model is based on forecast traffic growth, to which various options for airport charges can be applied. Assumptions are made as to the level of commercial income to be earned and the level of operating costs. Capital employed is calculated with reference to the existing asset base and the rate of future investment. The model provides a basis on which to consider the implications of different values of X, but any such projections depend on the assumptions adopted and must be regarded as subject to a considerable degree of uncertainty (as indicated by the comparisons with the 1987 projections).

11.58. The number of passengers at Manchester Airport is expected to grow at about 7.5 per cent per annum over the quinquennium. This is a significantly higher rate of growth than that experienced over the last three years, when traffic has suffered from the effects of the Gulf War and economic recession. It is, however, broadly in line with historic trends. It is also based on an assumption that MA PLC succeeds in attracting a large element of 'interline' traffic: passengers changing aircraft at Manchester. We have no reason to regard the growth assumptions as unduly pessimistic, or understating potential returns; lower growth would be expected to result in significantly poorer performance.

11.59. In examining the impact of airport charges on profitability, it is necessary to consider commercial income excluded from the scope of airport charges. Over the last ten years, commercial income has grown at about 1 per cent per annum above the RPI, and over the last five years in particular it grew more than predicted at the time of the 1987 report. MA PLC has assumed that commercial income per passenger will be broadly unchanged in real terms for the next five years: an increase in concession income per passenger would be offset by a reduction in other commercial income per passenger. In our view, this assumption would appear somewhat pessimistic: we have therefore adopted the assumptions suggested by the CAA (see Table 7.8), which show an increase in commercial income per head broadly consistent with past trends. There may indeed be scope to do still better than this: we have, for example, noted in paragraph 7.32 that commercial income performance in 1991/92 was significantly better than expected, compared with which the projections for 1992/93 now look somewhat conservative, which would affect forecasts throughout the reference quinquennium. The recent decision to maintain the concession on sale of duty-free goods to passengers travelling within the European Community until 1999 has removed one main uncertainty as to the level of commercial income: abolition of this concession would have required a significant increase in airport charges in the quinquennium under review.

11.60. A major factor in the financial projections is the expected increase in operating costs associated with the opening of Terminal 2 in April 1993. The employment costs in Terminal 2 itself are partly offset by limited reductions in employment costs in Terminal 1 but there are significant increases in depreciation and other costs. MA PLC's costs in part reflect the depreciation policy adopted. There is a large increase in the annual depreciation charge from the time the terminal becomes operational, even though there is little additional throughput at the airport. MA PLC argued that there was little scope to adjust the depreciation charge, to reflect the build-up of traffic associated with the second terminal. We agree that in this case it would be difficult to depart from the generally accepted accounting conventions previously adopted by MA PLC.

11.61. Productivity is a further important factor in the projections. The forecasts assume that productivity increases at 1 per cent per annum, aside from the effects of economies of scale from handling more passengers and the increase in employment from opening Terminal 2. As discussed in paragraph 11.31, the forecast increase in productivity would itself represent an improvement on past trends, but we believe that there is somewhat more scope for productivity improvements than MA PLC has assumed.

11.62. The level of investment planned by MA PLC is relevant both to projections of depreciation, and hence operating profit, and also to the value of capital employed. As shown in Table 7.4, capital expenditure is expected to total about £450 million over the reference quinquennium (in current prices). Projects for the period under review include the second phase of Terminal 2, the second runway (with expenditure due to start in 1995/96), construction of a fixed link between the terminals and the railway station, refurbishment of Pier B, and cargo and office developments. In general, we have no reason to call into question MA PLC's investment forecasts, but there may be a degree of uncertainty about the second runway for which planning permission has still to be sought. During our inquiry, we have been made aware of considerable local opposition to the development: on the other hand the CAA, DTP and the airlines all acknowledged the need for a second runway, although some airlines believed the requirement would come later rather than sooner. MA PLC may indeed be able to meet some of the concern expressed by helping to reduce the environmental impact of the airport, for example by increasing its contribution to noise insulation. It will, however, need to consider whether the present weight-related landing charge of the airport (a charge which attracts smaller aircraft) may require the runway to be developed earlier than would otherwise be necessary. MA PLC estimated that a flat-rate runway charge would reduce traffic by 30 per cent, but believed the attraction of smaller aircraft to be essential to the airport's development as a hub and hence to developing international services. In its view, the second runway may be needed earlier than currently planned, before the end of the period under review. Inclusion of the second runway in the capital programme reduces ROCE by almost 0.5 per cent (see Table 7.20).

11.63. On other aspects of the model, we noted in Chapter 7 the assumption of increases in land rentals, paid to the City Council at a rate [*Details omitted. See note on page iv.*]. The level of rentals is still subject to negotiation with the City Council, or to arbitration should no agreement be reached. Increases beyond the rise in the RPI reduce the ROCE achievable by MA PLC and thus the dividends payable to its shareholders, without diminishing the yield to those shareholders. This is a factor which needs to be taken into account in considering the value of X. There may be scope for more limited increases than assumed by MA PLC if, for example, there were to be somewhat slower growth in the profitability of the airport than MA PLC currently assumes. Its shareholders may also have to consider the extent to which rent increases may affect the ability of MA PLC to finance future developments out of retained earnings.

Reasonable financial return

11.64. The financial projections (although themselves subject to a significant degree of uncertainty) need to be considered against a criterion of an appropriate financial return for the airport. In the case of BAA's South-East airports, the MMC suggested that an 8 per cent ROCE on a current cost basis would be reasonable given particularly the risks associated with BAA's longer-term investment projects, as well as the shorter-term risks of falling short of its desired financial performance. The CAA initially proposed 7 per cent, and its final decision, although avoiding any attempt to be over-precise, was consistent with an ROR of 7.5 per cent. MA PLC has argued for a ROCE of 8 to 9 per cent, stating, *inter alia*, that it is open to more competition than BAA, more dependent on leisure and charter traffic and subject to a greater degree of risk. Airlines to which we spoke were sceptical about this suggestion, and the British Air Transport Association referred to returns of about one-half of those sought by MA PLC.

11.65. As acknowledged in the BAA report, there is no fully satisfactory method of establishing a 'reasonable' ROR. Comparisons of RORs with other companies, or the economy generally, are themselves not straightforward, being affected by differences in asset lives and accounting policies. It is difficult to find any other companies within the United Kingdom with which an airport can be compared, while overseas airports are financed very differently from those in the United Kingdom.

11.66. MA PLC, like BAA, faces, in our view, relatively little risk from competition, but its investment projects are long-term and susceptible to uncertain trends in demand. The risk associated with the regulation of airport charges over the lifetime of an investment is offset by the probability that regulators would protect the airport should its viability be threatened. The risk of outright failure is very low but the possibility of earnings and profits falling short of expectations rather greater. For this reason we do not regard the very low RORs suggested by some airlines as justifiable.

11.67. We nevertheless find it difficult to accept MA PLC's arguments that it is in a significantly more competitive position than the BAA South-East airports. Nor do we regard MA PLC as exposed to a significantly higher degree of risk compared, for example, with the risks associated with the recent development of Stansted as London's third airport, which faces a period of significant losses while it remains relatively underutilised. On balance, we would regard MA PLC-as the MMC did BAA-as subject to less competition and less risk than the economy generally. An adequate ROR would therefore be less than that of the economy generally (below, for example, the 8.7 per cent over the last five years for all industrial and commercial companies, excluding North Sea, or the 9.3 per cent for service companies, shown in Table 7.21).

11.68. We also considered whether a lower ROR would be appropriate for MA PLC because it is a public sector body with access to borrowings at relatively low rates of interest. Public sector bodies are, however, required to operate commercially. As was noted in the BAA report, the Government has set a required minimum ROR for investment by nationalised industries and certain other public sector bodies financed by public sector borrowing of 8 per cent, 'based on average returns on assets achieved in the private sector for activities with low cyclical year-by-year variability' (although in some circumstances an ROR as low as 6 per cent is specified in the public sector); an 8 per cent return on new investment does not necessarily imply a similar return on existing assets. We note an 8 per cent ROCE has been set as the financial target for certain activities of the CAA, and is specified as an average financial ROR for central government trading activities selling commercially into private markets.

11.69. Regulators for some of the privatised utilities (see Appendix 7.2) have regarded returns on assets somewhat lower than some of the figures specified for the public sector as appropriate in setting charges. Apart from the fact that these utilities are also subject to an RPI-X regime, they are not, however, obvious comparators to MA PLC.

11.70. Although the CAA decision for BAA suggested that a return below 8 per cent for a particular quinquennium could still be sufficient to encourage investment in airports, on balance we consider that an ROR of up to 8 per cent would be reasonable over a succession of quinquennia, for a company in MA PLC's position. A higher or lower return could, however, be appropriate in particular five-year periods; a higher return might, for example, be justified if the company had been particularly successful in raising efficiency.

11.71. A return on replacement cost of assets of about 16 per cent is expected for the current quinquennium, but profitability over this period has been somewhat above that assumed by the MMC in recommending RPI-1 for that period (see paragraph 11.23). The financial model, however, also suggests very high returns for the subsequent quinquennium (of at least 15 per cent at RPI-0, as favoured by MA PLC) as airport capacity again becomes fully utilised. The high returns currently projected after 1997/98 are subject to a significantly greater degree of uncertainty (there is, for example, no allowance for construction of a third terminal), but also suggest scope for a much greater reduction of airport charges in real terms in that period. We believe there is a strong case for a somewhat lower ROR in the period in which a major tranche of new capacity such as Terminal 2 is opened, to be offset by the prospect of a somewhat higher return later when capacity again becomes fully utilised, although the extent to which this approach can be followed is limited by the inability of ourselves and the CAA to bind our successors. Looking beyond the reference quinquennium also permits a degree of smoothing of charges over the longer term, the direction of charges in the quinquennium reflecting the scope for a more substantial reduction in unit costs and charges thereafter.

11.72. As well as ROCE, MA PLC has referred to other aspects of financial performance including historic cost gearing of below [*] (but with ratios in excess of this acceptable for short periods if

*Figures omitted. See note on page iv.

major capital expenditure is being undertaken) and current cost gearing in excess of [†]; interest cover approaching [†] (but below [†] in periods of heavy investment); and current cost dividend cover in excess of [†], or [†] on a historic cost basis. These measures, in our view, are of less relevance to a company still in the public sector. Indeed MA PLC's financial projections, even using its own preferred proposals and value of X, tend to fall short of all these targets in the period under review. Such financial ratios are also in part under MA PLC's control were it to consider use of additional equity. MA PLC has not had difficulty to date in borrowing to meet its requirements and the scope for borrowing may be all the easier, although possibly more expensive, were private sector finance to be sought.

The value of X

11.73. Financial projections for MA PLC, for different values of X, and on different assumptions as to security cost recovery and commercial income are summarised in Table 11.2. A condition of RPI-0, as proposed by MA PLC, and on MA PLC's assumptions including its proposed treatment of security costs, produces what MA PLC regarded as a reasonable ROR of 8.7 per cent. MA PLC also argued that on a priori grounds there was a good case for RPI-0: to maintain prices in line with the RPI was not unreasonable for a company with little scope for technological change, with no other obvious way to cut costs, and in a less dominant position than, say, the BAA airports. Its financial projections, however, do show falling unit cost and the benefit of scale economies after the opening of the second terminal, and it has in practice managed to reduce its charges by over 2 per cent below the rate of inflation over the current quinquennium.

TABLE 11.2 MA PLC financial results for different values of X

	CAA ROCE					Average		per cent	
	1993/94	1994/95	1995/96	1996/97	1997/98	1993/94-1997/98	1998/99-2002/03	Gearing (HC) 1993/94-1997/98	Interest cover (HC) 1993/94-1997/98
<i>MA PLC assumptions</i>									
RPI-0	4.9	7.6	9.5	10.1	11.5	8.7	15.6	[[
RPI-1	4.7	7.2	8.9	9.3	10.6	8.2	14.0		
RPI-2	4.6	6.9	8.3	8.5	9.7	7.6	12.5		
RPI-3	4.4	6.6	7.7	7.8	8.9	7.1	11.1		
RPI-4	4.3	6.2	7.2	7.1	8.1	6.6	9.8		
RPI-5	4.1	5.9	6.7	6.4	7.3	6.1	8.6		
<i>MMC assumptions</i>									
-existing security recovery*								†	†
-CAA commercial income assumptions									
RPI-0	4.0	7.2	9.1	10.0	11.8	8.4	16.7		
RPI-1	3.9	6.7	8.3	9.0	10.7	7.7	14.7		
RPI-2	3.7	6.3	7.7	8.1	9.6	7.1	12.9		
RPI-3	3.5	5.9	7.0	7.2	8.5	6.4	11.2		
RPI-4	3.3	5.5	6.4	6.4	7.5	5.8	9.5		
RPI-5	3.1	5.1	5.7	5.6	6.6	5.2	8.1]]

Source: MMC study of information provided by MA PLC.

*As long as DTp regulations about security requirements remain as at present, this would also apply to 95 per cent additional security cost recovery and one-year delay in recovery. Given the uncertainty about what future security requirements may be introduced, the effects of less than 100 per cent additional security cost recovery cannot be predicted.

11.74. On the figures above, and on the basis of existing security recovery and the CAA commercial income assumptions, the model indicates that a condition of RPI-3 would produce an average ROCE of about 6.5 per cent, but with significantly higher returns towards the end of the quinquennium, of 8.5 per cent in 1997/98. These projections must, however, be regarded as uncertain. MA PLC may well, in our view, do better than this were, for example, greater increases in commercial income or productivity to be achieved (see paragraphs 11.59 and 11.61), rental payments to the City Council to increase by less than assumed (see paragraph 11.63) or construction of the second runway to be delayed.

11.75. MA PLC argued that any tighter regime than RPI-0 would cause it to scale back or defer capital expenditure, with adverse effects on development of the business. It argued that for every additional point on X, capital expenditure (other than on the key projects-phase 2 and the multi-storey car park of Terminal 2, the second runway and the Pier B development) would need to be reduced by 20 per cent in order to maintain what it regards as an acceptable ROR of about 8.5 per cent. MA PLC also believed gearing would be excessive if a tighter X was to be imposed. Service standards would also be at risk.

11.76. We believe that MA PLC has exaggerated the adverse effects of adopting a charging condition less favourable than that which it has proposed. In our view, a condition of RPI-3 may well be expected to produce an ROR for the reference quinquennium greater than the 6.5 per cent indicated above; even on the current projections, the ROR would increase to over 8 per cent by 1997/98, and a relatively high return may be justifiable in the subsequent quinquennium as terminal capacity again becomes fully utilised. With the prospects of such RORs there is no reason to doubt that MA PLC could earn an adequate return on new investment, or have sufficient incentive to invest, particularly if it were prepared to meet more challenging targets for generation of commercial income and improvements to productivity, and given also its relatively low cost of borrowings. We have not seen sufficient reason to believe that the additional borrowing required at such a level of charges would not be forthcoming. Failure to invest at such an ROR or any deterioration of service standards would, in our view, raise serious public interest concerns that would need to be examined as part of the next quinquennial review, or by the CAA in the interim.

11.77. A further option we considered, as with the CAA decision for BAA, is of a 'profiled' value of X (for example, RPI-0 for two years, followed by RPI-5), reflecting, in the case of MA PLC, the initial increase in operating costs with the opening of Terminal 2 and the subsequent economies of scale as increased capacity becomes fully utilised. A profiled value of X would therefore reflect the relatively high returns which are projected for the end of the quinquennium and for the reference quinquennium, which imply scope for a substantial reduction in prices relative to inflation after 1997/98 if returns are to be kept within reasonable bounds; hence it could reduce the need for a significant tightening of the regulatory formula at the next quinquennial review. In our view, such an approach attempts to be too precise given the degree of uncertainty in the financial projections, particularly in the traffic forecasts. Rapid growth at the beginning of the period could even out returns; alternatively, the sudden reduction in charges may coincide with a period of low growth and falling profitability. The extent to which real airport charges may need to decline in the subsequent quinquennium is also highly uncertain, and attempts to reflect the longer-term direction of charges in those at the end of the current quinquennium may prove mistaken. Taking all these factors into account, we consider that the case is not made out for a profiled value of X.

11.78. In summary, the purpose of the RPI-X formula is, as previously mentioned, to encourage efficient management. To this end it must be neither so tight that future investment is unreasonably delayed, nor such that it fails to present a challenge to MA PLC to improve its performance. We recommend that airport charges for the five years from 1 April 1993 be permitted to increase by no more than the increase in the RPI less 3 per cent. This is a value for X greater than MA PLC maintained was necessary to meet its desired ROCE. We believe, however, that it offers a challenge to MA PLC to reduce costs below those currently assumed-by means of an increase of productivity beyond that currently planned, as well as, for example, rentals to the City Council lower than those assumed-and an incentive to develop commercial and other revenues. In short MA PLC has the opportunity to achieve higher RORs.

Public interest issues

11.79. We considered a number of aspects of operational activities at the airport about which the MMC expressed concern in the 1987 report or which gave rise to complaint during the current inquiry.

Structure of airport charges

11.80. In the 1987 report, the MMC stated 'We do, however, think that it is important that each charge should reflect the economic costs of providing the corresponding service ... we would expect that, with major capital expenditure on Terminal 2 under consideration, the company would move toward a charging structure with greater differential between peak and off-peak charges than it has at present'. MA PLC believes it has moved some way in this direction since the 1987 report, and there has been some widening of the peak/off-peak differential. Various aspects of the charging structure, about which we received complaints, do, however, seem difficult to justify with reference to any economic cost. The tonnage-related landing charge about which some charter operators complained may become increasingly anomalous given MA PLC's plans to build an additional runway. On the other hand, the existing runway may not yet be under sufficient pressure of demand to justify a flat-rate charge, which would impact severely on operators of smaller aircraft and raise wider civil aviation issues. Our attention was also drawn to various other elements of the pricing structure designed to attract particular categories of traffic, for example favouring aircraft under 25 tonnes and propeller aircraft.

11.81. In our view, in the period up to the date of reference, the effects of the charging structure were not sufficient to justify an adverse public interest finding, although we think that the airport should move closer towards a structure of charges related to the structure of costs. Some airlines suggested (as they did during the BAA review) that the charging formula for the reference quinquennium should ensure no differential increase in charges to individual airlines; but this could prove an inflexible approach, particularly were MA PLC to decide that any element of rebalancing could be desirable. There are powers for airlines to object to the CAA about any discrimination in pricing structure. In view of the implications of the structure of airport charges for the airline industry in general we believe, as in the recent BAA inquiry, that these issues would be better resolved by the CAA.

11.82. Complaints were also made about MA PLC's procedures for consultation on airport charges, including late submissions of documents. MA PLC referred to a number of instances where it had amended its proposals to take into account the views of airlines, and it believed that recent changes in its procedures would remedy many of the problems raised. We would expect to examine the consultative procedures closely during the course of the next review to ensure that these improvements have been adequately carried out.

Quality of service

11.83. Quality of service is discussed in Chapter 6. Generally MA PLC's standards are similar to those of BAA. We noted, however, that MA PLC adopts different service standards for provision of check-in desks for charter and scheduled passengers (for charter a minimum of one desk per 130 passengers, for scheduled sufficient to allow handling agents to offer a multi-class service): MA PLC told us that this reflects airlines' own required use of desks. The standard for provision of check-in desks for scheduled passengers also varies for peak and off-peak periods (less than three minutes for 95 per cent of passengers, but at peak periods less than five minutes for 80 per cent of passengers): there is also a similar differential in peak/off-peak standards for security queues. We find it difficult, however, to regard this differential in standards as unreasonable.

11.84. Generally we received relatively few criticisms of quality of service to passengers. MA PLC has, however, only recently instituted customer surveys, which it now intends to undertake on a regular basis. We also noted the absence of prepaid postcards for comments and complaints which would enable passengers to make their views known on current performance and any need for new services, not covered by the survey.

11.85. MA PLC's own studies show excessive security queues at peak periods last summer: but MA PLC appears determined to remedy the situation through, for example, more use of part-time staff. We also noted that MA PLC currently provides staff for separate security checks for business class passengers without additional charge.

11.86. Of the complaints made by airlines, British Airways argued that MA PLC should be required to develop Pier B of Terminal 1 to the standards of other piers at its own expense: MA PLC told us that it intended to do this (although it saw some scope for joint funding). Criticism was also made of the lack of a fixed link between Terminal 1, Terminal 2 and the new railway station: MA PLC is planning to install such a link within the next five years.

11.87. The allocation of piers and remote stands was a source of complaint from charter airlines. MA PLC said that it now intends to adopt new procedures to ensure more even-handed treatment. We were surprised that there is no discount for use of remote stands, although this involves extra costs in crew transport, and passenger inconvenience. Airlines were not keen on such a rebate, preferring to eliminate the present apparent discrimination in allocation of remote stands. We are also aware of criticisms on the standard of passenger coaching, which could clearly be improved.

11.88. We asked MA PLC how widely its quality of service standards and information on its performance were publicised. They are not (contrary to the MMC's suggestion in the 1987 report) published in the annual Report and Accounts. We consider that MA PLC should publish its targets and performance including the results of its customer surveys in its annual Report and Accounts, and in any other forms readily available to the public (such as its airport newspaper). MA PLC saw no problem with this suggestion. We were told that airlines are provided with details of service standards and performance, but airlines' requests to us for firm, acceptable levels of service to be agreed with the Airline Operators Committee (AOC) and subsequently published suggest scope for improvement.

11.89. On balance (and apart from the particular context of baggage handling which we discuss below), we find insufficient grounds to regard any aspect of quality of service as suggesting a course of conduct against the public interest. We would, however, at the time of the next review wish to see evidence that charter and scheduled airlines are being treated fairly in the allocation of stands; that quality of service standards and information as to MA PLC's performance against these standards are being published more widely; and that improved monitoring of passenger views and complaints are leading to better information and appropriate action.

Functional costing system and transparency of non-airport charges

11.90. In the 1987 report, the MMC commented that the lack of transparency in MA PLC's business and its inability to relate increases in charges to the costs of providing services were serious shortcomings which might amount to a practice contrary to the public interest. The MMC concluded on this issue that they would have decided that the absence of a functional costing system was against the public interest were it not for the work currently in progress and the plans to have such a system in operation from July 1988. MA PLC refuted the suggestion that there had been any subsequent delay in installing such a system, although, as discussed in Chapter 3, there have recently been a number of changes to the system and it is still not fully disaggregated into individual income streams.

11.91. As in the recent BAA inquiry, we received complaints mainly from airlines about the lack of information supplied to users on the relationship between charges and costs for facilities which are essential for airlines to operate on the airport but which are excluded from the airport charges formula and not therefore subject to the formal system of regulation. Such charges are those for check-in desks and baggage systems, other desk licences, staff car parking, staff ID cards, fixed electrical ground power, hydrant refuelling, airside licences, cable routing, and maintenance, heating and utility services. In the absence of such information, airlines argued that it was difficult to judge whether MA PLC was exploiting its position or acting unreasonably.

11.92. Income from these services amounts to some £6 million per annum. Some of these charges have increased considerably in excess of inflation (eg the fuel levy, and check-in desk rentals, which have risen significantly since the reference began, the latter offset by reduction in the passenger service charge). This confirms that MA PLC is in a position to impose charges for such services unrelated to costs.

11.93. MA PLC acknowledged that little information was provided to users about the costs of individual services. In our view, users of facilities necessary for their operation at the airport should have available to them information on costs relevant to each category of charges excluded from the airport

charges formula, so that they are in a position to judge the reasonableness of such charges and whether a complaint should be made to the regulatory authorities for an investigation. In the absence of transparent records there are difficulties in supporting or contradicting airlines' complaints that to date MA PLC had or had not exploited its dominant position with respect to these services. However, the failure to provide such information might be expected to have the effects adverse to the public interest that MA PLC is able to impose charges for these facilities that are not related to costs, and increases in charges not related to increases in costs. We also believe that MA PLC might be expected to take advantage of this position, and impose charges unrelated to and in excess of costs, particularly if subject to a more demanding airport charges formula. The provision to users of inadequate information on the costs of the services and facilities for airlines, tenants and licensees listed at paragraph 11.91 is a course of conduct relating to operational activities carried out by the airport, and to the granting of rights by which operational activities may be carried on at the airport. We have concluded that this course of conduct in the period specified up to the date of the reference might be expected to operate against the public interest with the effects adverse to the public interest specified earlier in this paragraph.

11.94. In order to remedy the adverse effects, we recommend that a similar condition be imposed upon MA PLC as upon BAA following the MMC's earlier report, a suggestion made to us by a number of airlines, namely that MA PLC be required:

- (a) by 31 December 1992 (and by 31 December in each subsequent year) to inform the CAA of the system for allocating costs to non-airport charges and make any amendments to its cost allocation system if requested by the CAA; and to provide the CAA with detailed assumptions on which prices are set for the current period with appropriate supporting information;
- (b) by 31 December 1992 (and by 31 December in each subsequent year) to produce to the CAA statements of actual costs and revenues for the immediately preceding charging period (for example, the year to 31 March);
- (c) annually, or at the time of each price change, to provide to users or organisations representing users of the services and facilities specified a statement of pricing principles for each item charged;
- (d) annually, or on the occasion of each price change, to supply to users or their representatives and the CAA the assumptions and relevant cost information adequate to verify that the charges derive from the application of the cost principles;
- (e) where costs stated in connection with a particular charging item vary from those provided in the costing reports supplied to the CAA, to provide a reconciliation to the CAA and users or their representatives with detailed reasons for the difference; and
- (f) where charges are not related to costs, but subject to demand pressure, to provide users with a statement of the principles on the basis of which the charges have been set, with full background information as to the calculation of such charges including statements of any comparables used.

These provisions should be applied to each of the services specified in paragraph 11.91. MA PLC did not in principle object to this recommendation although it did have reservations on grounds of confidentiality, and also suggested that it should initially have until 31 March 1993 to provide the first information to the CAA. We feel that, as a less complex organisation, MA PLC should have no difficulty in fulfilling the requirements now imposed on BAA.

Rental income

11.95. Information provided by MA PLC confirms rents above local levels, as tends to be the case with other airports. Over five years, the increase in rents has been broadly similar to that of the city centre: over the first two years of the current quinquennium they increased considerably less, over the last three years considerably more. We appreciate the concern of airlines and other tenants about the level of rents but given the limited supply of office accommodation at airports there would seem little alternative to using rents as a means of allocating available capacity. The volume of accommodation having increased at Manchester Airport, there is no evidence that MA PLC has artificially restricted supply. Tenants have the

right to go to arbitration under the Landlord and Tenant Act but have not done so to date. As the MMC commented in the BAA report, only if there was evidence that the use of that Act had failed to ameliorate any problem which had been shown to exist would we think it appropriate for us to become involved in an area where there is already statutory provision for protection.

The engine test facility

11.96. We received a considerable volume of complaint about problems with the engine test facility, the charges for which are excluded from the airport's charging formula. The background to this facility is given in paragraphs 5.95 to 5.105. Complaints from users included the installation of the facility without consultation, the subsequent problems when using the facility, users' inability to comply with maintenance manual procedures, the absence of lighting and power, the level of charges and the imposition of charges for engine testing on the apron when it proved dangerous to use the facility. While pointing to the significant environmental benefits from its use MA PLC acknowledged errors in the construction of the facility and is endeavouring to remedy the problems. Temporary lighting, for example, was installed towards the end of our inquiry with a permanent scheme planned. The charging for engine testing on the apron even when the facility cannot be used is a source of concern, but MA PLC believes that to do other than charge would deter use of the facility, and loss of its environmental benefits. The revenue from engine testing on the apron has, from the figures we have seen, been very limited so far.

11.97. In our view MA PLC acted unwisely in constructing such a facility without adequate consultation with users and then proved insufficiently responsive for too long a period to users' complaints. The detriments that have occurred would be sufficient to justify a finding of a course of conduct against the public interest were it not for the efforts being made by MA PLC to resolve these problems. If, however, problems persist there may well be a case for further investigation by the CAA.

Manchester City Council contract

11.98. A further issue identified in the 1987 report was the contract with the City Council for the provision of services to the airport. The report commented that continuation of the guarantee to the City Council of a minimum workload would not be desirable. The current contract with the City Council, for the three years from 1 June 1989, contains no such guarantee, and provides for MA PLC to invite competition for all large projects while reserving the right to seek competitive tender for smaller projects. Some contracts have been awarded to the City Architect and City Engineer on a sole tender basis but with MA PLC free to seek tenders should it choose to do so, and there has been active and effective competition for direct works contracts. As the contract has lapsed, it is unnecessary to make any finding, but in our view there would be no commercial benefit in its renewal. We believe it would also be appropriate for MA PLC to include in its annual Report and Accounts a statement of the contracts entered into with the City Council with a description of the work carried out and the contract value.

Ground handling

11.99. The main concern of virtually all airlines from which we heard related to the arrangements for ground handling at Manchester. Ground handling in this context includes the loading and unloading of passengers' baggage, and its movement between the aircraft and the baggage-sorting system, the movement of freight, steps and catering supplies, airside coaching of passengers, services for disabled passengers, and collection and delivery of passenger baggage trolleys. Arrangements for ground handling at Manchester are summarised in Chapter 5. They differ from those at Heathrow or Gatwick (but are in line with those at many of the smaller United Kingdom airports) in that the handling agents (appointed by the airlines and responsible for check-in of passengers, supervision of aircraft loading and turnaround, aircraft cleaning and various other activities on the ramp) are not permitted to undertake a number of ground handling activities. At the date of the reference (the date up to which we have to consider whether MA PLC has pursued any course of conduct against the public interest) the ground handling activities listed above were carried out by the Handling Services Division of MA PLC. As from 1 April 1992, the bulk of these functions were undertaken by Ringway Handling Services Ltd (RHSL), a wholly-owned subsidiary of MA PLC, but with some other changes in the arrangements. Catering loading is now provided by aircraft catering companies and there is a provision for RHSL to sign loading instructions (previously carried out by handling agents) and to supply as well as move steps (the supply of steps being currently the responsibility of handling agents) should airlines so choose; also for handling agents to move and position steps, previously the sole prerogative of the ground handler.

11.100. The MMC had received many complaints about arrangements for ground handling at the time of their previous report (see paragraphs 5.47 to 5.49). MA PLC argued at the time that, due to lack of space on the apron and in the baggage hall, it was necessary to restrict competition in ground handling, to ensure the best use was made of equipment and reduce congestion and the risk to safety. In their conclusions in the 1987 report, the MMC acknowledged that not all members took the same view on safety but, in the face of MA PLC's views and views expressed by local representatives of the CAA and the Health and Safety Executive (HSE), they were 'not prepared to say on this occasion that the company's policy on baggage handling has hitherto been contrary to the public interest'. The MMC did, however, state that they were not satisfied that that must always be the position, and they expected the company to take advantage of the opportunity to reorganise the use of the apron and design the second terminal to allow for the activities of competing baggage handlers in case it was decided to introduce this. The report added that when the next reference was made, the MMC might take the view that considerations of efficiency and choice called for some competition in baggage handling. 'In the interim, the company needs to ensure that the baggage handling service provides the best possible value for money. To this end it should consider putting the existing service it provides out to competitive tender.'

11.101. MA PLC told us that it had taken action to put into effect the MMC's recommendation to seek competitive tenders. In 1990, however, the AOC complained formally to the CAA about the continuing monopoly of ground handling. The CAA inquiry (see paragraphs 5.50 to 5.56) concluded that MA PLC was pursuing a course of conduct which unreasonably limited the number of rights it granted in the case of ground handling at Manchester Airport.

11.102. In reaching this decision, the CAA took the view that it was not able to base its decision on safety matters, its duties on safety arising not under the Airports Act, but under the Civil Aviation Act 1982. The key issue was still the effect of multiple handling on congestion on the apron and in the baggage halls: the CAA was not, however, convinced that multiple handling would lead to an increase in apron congestion on the scale feared by MA PLC since the main determinant of vehicle movements would continue to be the number and size of aircraft; nor was it convinced that congestion in the baggage hall would become acute by industry standards, or that competing handlers would be unable to take effective steps to minimise it. The CAA therefore concluded that the congestion arguments were not so compelling as to override the presumption in favour of competition and choice. The CAA saw no evidence that the standard of service was worse at Manchester than at other airports, and believed MA PLC was offering a high level of service; nor did it find evidence of major cost savings or efficiency increases which would inevitably follow if competition were to be introduced, 'although it was difficult to escape the conclusion that some such benefits would result'. The CAA also did not consider that there were any industrial relations issues which of themselves would lead it to disturb the handling monopoly. The main issue, however, which led the CAA to determine its decision was that of competition and choice. The CAA was required by the Airports Act to further the reasonable interests of users of airports, and to promote the

efficient economic and profitable operation of the airport. The CAA believed the 'reasonable needs' of airports and airlines were more likely to be met by competition than by monopoly or oligopoly.

11.103. The CAA concluded that it should impose conditions on MA PLC which would require it to put the ground handling contracts to tender, with a minimum of three handlers to be appointed and with MA PLC itself being allowed to tender. MA PLC subsequently argued that, whether or not it was itself one of the three handlers, there would be large redundancies among its staff and a major reorganisation of its management and operational structure which would cause a reduction in its efficiency and performance, and a diminution in the quality of service to users in the period leading up to the introduction of competition. The CAA was therefore persuaded that 'the effects on the operation of the airport were it to impose a condition ... would not be consistent with its general duties under section 39 of the Act'. A further consideration was that if MA PLC refused to accept the condition, there would have been a further delay while the matter was investigated by the MMC. MA PLC volunteered, and the CAA therefore accepted undertakings (see Appendix 5.4) requiring a single competitive tender of ground handling at Terminal 1, for a five-year period from 1 April 1992, for which MA PLC would itself be allowed to tender provided a separate limited company was formed for that purpose. MA PLC also agreed to permit at least three ground handlers to operate at Terminal 2, and to give catering companies the right to undertake catering loading at all terminals if they so wished. MA PLC subsequently decided that the ground handler appointed at Terminal 1 would also be allowed to compete for business at Terminal 2.

11.104. The tendering process is described in some detail in paragraphs 5.57 to 5.85. Twelve companies originally expressed an interest in tendering for the Terminal 1 ground handling contract. Seven of these companies subsequently submitted a Prequalification Questionnaire, following which four companies were short-listed. We received considerable criticism about the exclusion of two companies from the short-list on the grounds that they 'had no relevant experience of baggage and freight handling', although they were associated with groups which had extensive experience at other airports. MA PLC told us that one of these companies, although notified by post that it was excluded because of lack of experience, was actually eliminated because it operated as a passenger handling agent at the airport; MA PLC did not think it desirable that one of the three passenger handling agents should be a monopoly provider of ground handling services to the other passenger handlers.

11.105. The tender documents, with a technical specification running to some 500 pages, were sent to the four short-listed companies at the beginning of October, for return within six working weeks. The specification of the contract included minimum service times for baggage delivery and other services, and provision for liquidated damages should these standards not be met. There was also a requirement to lease the fixed equipment and the baggage fleet owned by MA PLC and judged by MA PLC to be in 'good' or 'fair' condition, which the contractor would be responsible for maintaining. MA PLC told us that this was to maintain a level playing field between tenderers since its own subsidiary would have been unfairly advantaged by owning a fleet, when other bidders would have to demonstrate that they could procure one during the start-up period. MA PLC also felt that it should not have to lose the value of its investment in ground handling equipment. Had any of the tenderers complained about this arrangement, MA PLC told us it would have considered the matter further: none of them, however, had raised it as a problem.

11.106. As well as the charges for use of this equipment, there was an initial licence fee, plus a turnover-related fee to cover accommodation and maintenance costs of the baggage system, and a turnover-related charge regarded as analogous to the arrangements with other concessionaires. The annual fee amounted to some 15 per cent of gross turnover. The tender documents required a considerable volume of information to be submitted in order that MA PLC be able to evaluate tenders according to the criteria agreed with the CAA, namely detailed pricing schedules and pricing policies, resource plans, business plans, details of operations and procedures, personnel policies, and details of premises required.

11.107. Two companies subsequently chose not to tender, one referring to the amount of work required to complete the document, and to the delay in issuing it; the other to various features of the tender specification including the requirement to lease equipment which it regarded as undesirable. Only two tenders were therefore received, one of which did not contain any business plans or other details, and could not therefore be evaluated, the remaining tender being that of RHSL, the former Handling Services Division of MA PLC, now a wholly-owned subsidiary. RHSL fulfilled virtually all the requirements of the tender, although one aspect of the bid—the charges for supply of various services to the airport—is still under discussion; it was also noted that the business plan for the second and subsequent years would need to be

reviewed and revised. RHSL's bid implied a significant reduction in employment (mainly through redeployment to other activities) and in other costs compared with the previous situation, due in part to its no longer undertaking catering loading. However, after allowing for catering loading, the RHSL tender still involved a reduction in costs of almost £3 million from the previous level and a reduction in charges to airlines of £1.8 million (see paragraph 5.83).

The public interest

11.108. We have considered whether MA PLC in the period up to the date of the reference to us has pursued a course of conduct, in relation to the granting of a right by virtue of which operational activities may be carried on, which has operated or might be expected to operate against the public interest. MA PLC expressed an understandable degree of frustration at our close scrutiny of ground handling, given that the issue had been examined by the CAA, that undertakings had been agreed with the CAA following that inquiry, and that MA PLC had, in its view, subsequently fully carried out these undertakings in consultation with the CAA, and without the CAA subsequently referring any aspect of its performance specifically to us. We consider that the CAA inquiry does not affect our duty to examine this issue, to the extent that a course of conduct within the period specified in the terms of reference may be involved. That the CAA did not in our terms of reference choose to specify any aspect of the tendering procedure in no way affects this duty or presents any impediment to our examining that procedure. Indeed we believe we have to take our own view on the issue, although in so doing, particularly in considering whether any course of conduct 'might be expected' to operate against the public interest, we clearly have to have regard to the CAA's decision, the change in arrangements agreed by the CAA, the developments subsequent to the CAA decision up to the date of the reference to us, and MA PLC's arguments on the issue (as summarised in Chapter 10).

11.109. Virtually all airlines from which we have heard have criticised the ground handling monopoly at Manchester. The information they have provided to us points to significant weaknesses in the arrangements. The evidence we have seen suggests costs higher than would otherwise be the case. Various organisations, for example, have said that they could carry out the activities at up to 25 per cent less cost than MA PLC before the tendering process (see, for example, paragraphs 5.60, 5.78 and 5.90), although we accept that such claims have not been supported by any detailed cost analyses. Comparisons with other airports also suggest costs were relatively high before the recent tendering procedure (see also paragraph 5.90) although these comparisons are generally with smaller airports which may not be comparable with Manchester Airport and in part reflect differences in activities carried out, notably catering loading. The savings resulting from the tendering process, referred to in paragraph 11.107, have, however, clearly demonstrated that there was scope to reduce the costs of ground handling at the airport, and that the previous situation of a single ground handler led to a higher level of costs than necessary in the period we have to consider.

11.110. We accept that in many respects MA PLC has achieved high standards of service which have indeed in some respects (notably baggage delivery performance) improved since the time of the 1987 report, but we have also been given many examples of weaknesses in performance particularly in mishandling of baggage (see Appendix 5.6). Responsibility for poor performance may not always be with MA PLC's handling staff, and shortcomings on the part of handling agents may be in part blame, MA PLC claiming that the contracted duty of the handling agent to supervise loading and reconcile bag numbers has fallen into disuse. Nevertheless, weaknesses in performance would seem endemic to an arrangement where there is a split of responsibility between passenger handling agent and ground handling agent. MA PLC itself (see paragraph 5.56) acknowledged that the benefits from an integrated passenger and ground handling service were such that RHSL would be unable to compete effectively in either terminal were the passenger handling agents allowed to provide ground handling.

11.111. The single supplier situation prevailing up to the date of the reference in our view therefore deprived the airlines of competition and choice, an adverse effect also specified by the CAA with which we are in full agreement. On the evidence we have seen, however, as summarised in paragraphs 11.109 and 11.110, we also believe that the absence of competition and choice led to higher costs and poorer service standards than would be expected in a more competitive situation.

11.112. Against that, however, MA PLC has continued to argue that multiple handlers at Terminal 1 would increase congestion given the limited space available on the apron and in the baggage hall, with risk to efficiency and safety: hence, on balance, that the existing arrangements are in the public interest. The airlines and handling agents from which we heard all disputed the argument. We have also noted that the CAA was not convinced that there would be an increase in apron congestion on the scale feared by MA PLC, or that congestion in the baggage hall would become acute by industry standards. None of the evidence we have seen indicates that the problem of congestion could not in time be overcome, particularly with the transfer of traffic from Terminal 1 to Terminal 2 in April 1993, which will provide at the least a temporary breathing space to introduce multiple handlers, and enable them to adapt their operations to resolve any problem that may arise. Indeed, MA PLC drew our attention to the present level of accidents under the current arrangements, a further factor which suggests to us that it has overstated the extent to which a single handler reduces the risk of accidents. The CAA believed it could realistically consider the question of safety to aircraft, in the context of its duties under the Civil Aviation Act, only at the stage when an airport has been asked to implement a particular decision, and has made specific practical arrangements to give effect to it, at which point it would need to submit proposals to the Safety Regulation Group of the CAA for approval. In our view it is not for us or for MA PLC to prejudge the ability of other ground handlers to devise procedures which would enable MA PLC to satisfy the CAA as regards aircraft safety on the apron or which would be acceptable to the HSE mainly as regards safety in the baggage hall. We believe that multiple handlers may well be able to adopt working methods as they do at other airports that would ensure no significant threat to safety, particularly after the opening of Terminal 2. Even in so far as the scope to do so is limited by physical constraints in the baggage hall or on the apron, we believe the opportunity can and should be taken as part of the developments planned by the airport—for example, the refurbishment of Terminal 1 and the replacement of the baggage sorting equipment—to undertake the capital expenditure necessary to remove those constraints: we return to this further in paragraph 11.121.

11.113. We conclude, therefore, that, in the period from 29 May 1987 up to the date of the reference, MA PLC has pursued a course of conduct relating to the granting of rights by which operational activities may be carried out at the airport which, in restricting the operation of ground handling at the airport to a single supplier, has operated against the public interest, with the adverse effects identified in paragraph 11.111.

11.114. We also, however, have to consider whether that course of conduct 'might be expected' to operate against the public interest in future, and, if so, whether the adverse effects identified could be remedied or prevented by the imposition or modification of any conditions in relation to the airport. In order to do so, we clearly have to take into account the CAA inquiry, discussed above, and the extent to which the undertakings proposed by MA PLC and agreed by the CAA have of themselves fundamentally changed the previous course of conduct, or its effects.

11.115. The undertakings required MA PLC to allow competing baggage handlers in Terminal 2, to put to tender a contract to provide all ground handling operations in Terminal 1, and to allow catering companies to load aircraft. The situation as regards catering loading has clearly been changed by these undertakings. The situation as regards other ground handling activities will evidently be improved for the airlines moving to Terminal 2, but, given constraints of space, airlines are not free to choose from which terminal they can operate. Those airlines remaining in Terminal 1 would therefore be at a disadvantage without the choice of ground handlers available for airlines at Terminal 2, and without the option to choose an integrated passenger and ground handler. We do not accept that charges in Terminal 2 would provide an effective constraint on charges in Terminal 1. Moreover, passenger handling agents for airlines transferring from Terminal 1 to Terminal 2 would only be able to provide ground handling for those airlines at Terminal 2: this would prevent them pooling their equipment between the two terminals, and thus could increase their costs. In our view the course of conduct, restricting the operation of ground handling to a single supplier, is thus broadly unchanged by these undertakings as regards the existing terminal, although there clearly has been a revision of the arrangements under which such a single supplier operates. We have therefore also to consider whether the effects of that course of conduct may be changed by the undertakings agreed between MA PLC and the CAA.

11.116. The agreement to tender ground handling in Terminal 1 could not itself provide competition or choice for airlines remaining at the terminal. Nevertheless, some benefits may be expected to arise from the change in arrangements as part of the tendering process. There is, for example, a commitment to provide minimum standards of service, and provision for some reallocation of responsibilities between handling

agents and the ground handler, such as allowing the handling agent to move steps, and the ground handler to take on more responsibility for supervision of loading. Effective competition for the tender would, however, be a means to ensure that the ground handling operation was carried out at a minimum cost consistent with the specified service standards, reducing the disadvantages of maintaining a single handler.

11.117. In our view the tendering procedure did not prove sufficiently effective in eliminating the adverse effects of restricting the number of ground handlers at the existing terminal. Only one company-RHSL-submitted a full tender. Some of the main potential competitors for the contract told us that they did not bid because they believed a contract to operate in effect as a regulated monopoly to be unattractive. At least one other company which might be regarded as well qualified to bid was excluded on the grounds that it was a passenger handling agent. One company said that it was deterred by the tender documents and the time-scale in which the bid had to be submitted, another mentioned other aspects of the tender, such as the requirement to lease equipment. We did consider whether the tender process itself could be regarded as seriously at fault. MA PLC, on the other hand, said that it had done everything it could to encourage competition, including a degree of flexibility in the date for submission of the tenders, and would have done more to meet any particular objection raised by potential bidders. In our view, the evidence put to us does not justify a conclusion that the tender process itself was conducted in a manner adverse to the public interest but for a number of reasons that process failed to produce effective competition for the tender.

11.118. We considered carefully MA PLC's arguments that it was too soon to judge how well the revised arrangements will work in practice. In our view, however, the undertakings agreed between the CAA and MA PLC have not fundamentally changed the course of conduct identified in paragraph 11.113 or sufficiently remedied the effects of that course of conduct on users. There remains no competition or choice for airlines remaining at Terminal 1 which will be at a significant disadvantage to those airlines allowed to move to Terminal 2. Although some cost savings resulted, the tender process did not produce sufficiently effective competition to ensure that the service was to be provided within the service standards stipulated and at minimum cost. Although the tender process introduced some change in the existing arrangements, for example the scope for RHSL to take more responsibility for supervision of ground handling, some airlines are reluctant to allow RHSL to carry out such duties, and there remains a division of responsibility between ground handler and passenger handling agent which may be expected to have adverse effects on service and costs: for this reason, indeed, MA PLC believed RHSL would not be able to compete effectively to provide ground handling in Terminal 2 against the passenger handling agents. In our view, therefore, although some reduction in cost and improvement in service has resulted from the tender process, competition between ground handlers at Terminal 1 is the only effective means to ensure lower costs and high standards of service. MA PLC drew our attention to our duty, in considering the public interest (referred to also in paragraph 11.6), to have regard to the reasonable interests of persons granted rights to carry out ground handling, namely RHSL; this we have done, but we also have to have regard to the reasonable interests of users of airports, and the promotion of the efficient, economic and profitable operation of airports: restricting the operation of ground handling at Terminal 1 to a single supplier is, in our view, against the public interest. We conclude therefore that the course of conduct we have identified might be expected to operate against the public interest by reason of the adverse effects identified in paragraph 11.111.

Recommendations

11.119. We considered whether such adverse effects could be remedied by a requirement to introduce an additional one, two or three ground handlers at Terminal 1. MA PLC argued that this could not be done without either putting safety at risk, or reducing the capacity of the terminal by a significant margin, or by incurring substantial investment expenditures particularly in the baggage area to allow multiple handlers to operate without jeopardising safety or increasing congestion. MA PLC has thus adhered to its rejection of multiple baggage handling in Terminal 1 as unacceptable on grounds of congestion and its potential effect on safety. We consider that it has been reluctant to look positively for ways to introduce competition in ground handling without compromising safety. We recognise the responsibility of the airport for safety but there is a potential conflict of interest with MA PLC wishing to preserve a monopoly of ground handling under its control and a perhaps natural aversion to incurring additional expenditure to find a solution.

11.120. We recognise the efforts being made by the management of RHSL to provide an efficient, commercial service to its customers and we have no reason to think it could not hold its own in competition with others operating solely as ground handlers. It does not, however, have experience of passenger handling and MA PLC did admit the advantages of the integrated passenger/baggage-handling services: RHSL would therefore on its own be almost inevitably at a disadvantage against the passenger handling agents. MA PLC has by appointing RHSL as one of the baggage handlers in Terminal 2 accepted the problems associated with competing with its own customers. It would not seem too great a further step for RHSL to acquire the necessary passenger handling expertise in order to compete on the basis of an integrated service. Certainly we would regard it as preferable that RHSL should compete across the board at both terminals rather than being the only baggage handler able to deploy its baggage-handling equipment and personnel over both terminals, enjoying a monopoly at Terminal 1, and leaving its competitors at Terminal 2 to rely on the advantage they may derive from their ability to offer an integrated passenger/baggage-handling service in that terminal alone.

11.121. Whether or not RHSL seeks to expand its range of activities into passenger handling, in our view, it is unacceptable for MA PLC to envisage a future which does not include effective competition among ground handling agents in Terminal 1. We believe it should include in its plans for the airport firm proposals to undertake the development necessary to allow such competition. The opening of Terminal 2 next year with the immediate transfer to the new terminal of a substantial part of present capacity represents one window of opportunity for MA PLC to produce an improvement to the problems of congestion at Terminal 1: further opportunities may arise as part of the continual process of development of the terminal—for example, in the course of the refurbishment already planned there, and when the existing baggage system needs to be replaced. Some additional expenditure may also be required: MA PLC estimated, for example, that reconfiguration of the baggage system, to provide separate areas for competing handlers, would cost about £6 million. Further expenditure may be necessary to minimise the effect on congestion. It is for MA PLC to plan to provide facilities to allow competition, at reasonable cost, in consultation with the airlines and handling agents, and a requirement to introduce competition should in our view allow them sufficient time to undertake any development necessary. We recommend therefore that the CAA should impose conditions to require MA PLC to allow a minimum of three ground handlers to operate in Terminal 1 as soon as possible and in any event no later than the end of the current RHSL contract (1 April 1997). Possible applicants could include RHSL and existing passenger handling agents. It is also clearly necessary for MA PLC to maintain the undertaking to allow multiple handling in Terminal 2.

Airbridges

11.122. A further complaint made to us concerned the existing arrangements for the operation of airbridges. Unlike arrangements at a number of other airports, handling agents are not allowed to move airbridges although, we were told, their staff would be able to do so at no extra cost since they are required to be present at the arrival and departure of the aircraft. Airbridges are currently operated by marshallers, although there is now less requirement for marshalling of aircraft than previously, except for smaller planes and aircraft capable of manoeuvring on the apron under their own power.

11.123. Airlines argued that the need to employ marshallers unnecessarily added to costs. They also pointed to instances of delay, or of the airbridges not being operated at all due to absence of staff. MA PLC told us that marshallers were still employed on a range of other duties: there would, therefore, be only a very limited reduction in the number of staff employed if they were no longer to operate airbridges. Its main argument, however, was that the current arrangements were to ensure safety, and minimise the risk of damage to its equipment or to planes: service, it argued, was generally good with only isolated examples of poor performance. On balance, we feel that there could be scope for more flexible arrangements (such as the training of airline and handling agent personnel to operate airbridges should marshallers not be available), to reduce the risk of the minor delays that may arise at present. We have not sufficient evidence, however, to suggest that the current situation represents a course of conduct against the public interest. Nonetheless, we would hope that by the time of the next quinquennial review, MA PLC may itself have decided that it was in its own interests to adopt the arrangements prevailing at other airports.

Summary and recommendations

Airport charges

11.124. As to the maximum level of airport charges at Manchester for the five years from 1 April 1993, we recommend that:

- (a) The maximum level of airport charges should continue to be based on a formula of RPI-X applied to average revenue per passenger (paragraphs 11.35 and 11.38).
- (b) In the formula limiting increases in income from airport charges per passenger to RPI-X, actual RPI at the time charges are set should be substituted for RPI of the charging year as used at present (paragraph 11.44).
- (c) MA PLC should be permitted to recover 95 per cent of the costs of meeting additional security requirements, as from the charging year following the implementation of any such additional requirement, but with validation of the estimates of the costs on which recovery is based and correction for any errors in those estimates (paragraph 11.53).
- (d) The starting point for the formula should be the forecast average revenue per passenger from airport charges in 1992/93, of £7.84 (paragraph 11.54).
- (e) There should be provision for the airport charge formula to be adjusted to exclude from airport charges any element of airport navigation services that is in future charged directly by the CAA (paragraph 11.55).
- (f) The increase in airport charges per passenger at Manchester Airport should not exceed the annual increase in the RPI less three percentage points (paragraph 11.78).

We believe that these recommendations are fully consistent with the need to encourage investment at the airport, while giving MA PLC the incentive to improve productivity and efficiency, and to achieve any higher ROR at which it may wish to aim.

The public interest

11.125. We are also asked to consider whether MA PLC has, in the period from 29 May 1987 until the date of the reference, pursued a course of conduct specified in the reference which has operated or might be expected to operate against the public interest. We have concluded that the provision of inadequate information to users on the costs of a number of services and facilities to airlines might be expected to operate against the public interest (paragraph 11.93); we have recommended that a condition be imposed on MA PLC, similar to that recently imposed on BAA, requiring it to provide on an annual basis or at the time of each price increase information to the CAA and to users on the detailed costs or other factors on which such charges are based (paragraph 11.94).

11.126. The main issue concerning the public interest raised with us was that of arrangements for ground handling. We have concluded that the course of conduct of MA PLC, in the period from 29 May 1987 up to the date of the reference, of restricting the operation of ground handling at the airport to a single supplier has operated and might be expected to operate against the public interest (paragraphs 11.113 and 11.118). We do not believe that the undertakings agreed with the CAA and the subsequent process of tendering the ground handling operation at Terminal 1 has fundamentally changed this course of conduct or remedied these adverse effects. We have therefore recommended that conditions be imposed to require MA PLC to allow a minimum of three ground handling agents in Terminal 1 as soon as possible and in any event no later than 1 April 1997 (paragraph 11.121).

H H LIESNER (*Chairman*)

K S CARMICHAEL

J D KEIR

P K R MANN

B C OWENS

S N BURBRIDGE (*Secretary*)

8 June 1992