

10 Views of the Civil Aviation Authority, the Department for Transport and other bodies

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Introduction

10.1. This chapter contains the views of the CAA, the DfT, the North West Development Agency and the CAA's panel of advisers.

The CAA

10.2. The CAA undertook an extensive period of consultation beginning in July 2000 before making this reference. The progress of that consultation was published on the CAA's web site (www.caa.co.uk) and is summarized in paragraphs 3.44 to 3.49, as are the CAA's proposals which were submitted with the reference. These were based on the dual-till approach, which it termed the RRCB.

10.3. The following summary is an indication of the main points made by the CAA through written submissions and at hearings during the inquiry.

10.4. The CAA said that its recommendations followed its statutory objectives set out in section 39(2) of the Airports Act. These are that the CAA shall perform its functions in the manner which it considers is best calculated:

- (a) to further the reasonable interests of users of airports within the UK;
- (b) to promote the efficient, economic and profitable operations of such airports;
- (c) to encourage investment in new facilities at airports in time to satisfy anticipated demands 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.

In addition, section 39(3) of the Airports Act requires that in performing those functions, the CAA shall take into account such of the international obligations of the UK as may be notified to it by the Secretary of State for the purposes of this section (see paragraph 3.18).

10.5. The Airports Act did not provide any guidance on the interpretation of these objectives and did not set out how trade-offs, if any, between the objectives should be judged. The CAA, however, believed that trade-offs between the objectives should be judged against the criterion that, where there were potential gainers and losers between airport users and airports from different regulatory options, the aim should be to choose the policy that was expected to maximize net gains to users and airports combined.

10.6. It stated that its proposals, based on the RRCB approach, would be likely to result in a shift of economic rents to Manchester compared with a continuation of the current single-till framework. It noted that one of its statutory objectives was to further the reasonable interests of users, but it did not believe that the reasonable interests of users extended to an automatic claim on locational rents.

The CAA's general approach

10.7. During the course of the present inquiry, the CAA told us that it had been saying publicly that it would like to implement our recommendations, but it would also have to be sure that it was operating consistently with the Airports Act in doing so. The CAA urged us to be very clear in explaining the framework used in developing our recommendations.

10.8. The CAA would have to make a final decision on the future price cap for Manchester that it considered best calculated to achieve the objectives set out in section 39 of the Airports Act. Our report would, of course, be a major input to that and in developing its own proposals the CAA would have full regard to our recommendations. There was no appeal against the CAA's final decision (short of judicial review) and the Human Rights Act was a new factor since the last review. Because of this, the CAA would want to give very careful consideration to our recommendations and the analysis and reasons that underlay them, but its objectives and responsibilities under the Airports Act were clear.

10.9. The CAA was also asked for a view on what its recommendations would be on aspects of the regulatory framework if the single till were to be retained. It replied that the package of recommendations it had put to us in February 2002 was the result of a lengthy process of analysis and external consultation. It did not, therefore, believe it would be appropriate to make further comment on individual aspects until it saw the report.

10.10. The CAA said that its aim had been to develop proposals that were expected to lead to users being better off in aggregate over time. It acknowledged that some users had expressed doubt whether the CAA's approach best met the statutory requirement to take account of the 'reasonable' interests of users, and it accepted that regulatory policy translated into a price cap might have different effects for different categories of users. It believed, however, that the user objective in section 39 of the Airports Act was satisfied because its proposals afforded protection to users against monopoly pricing by airports while reducing the distortion caused by economic regulation.

10.11. The CAA said that it had considered whether the Airports Act obliged it to set a 'binding' price cap. The Airports Act, which did not give discretion not to set a cap, required the CAA to meet its statutory objectives. A 'non-binding' price cap could protect users from the possibility of excessive charges. The purpose of the scheme of regulation was to protect users from the exploitation of Manchester's monopoly position. That requirement did not necessarily imply the setting of a tight price cap. At Stansted in 1997, the then MMC had recommended a 'non-binding' price cap. The CAA was clear that its recommended policy ensured that users were protected from prices in excess of the costs of monopoly services.

The economic regulation of Manchester Airport

10.12. On the economic regulation of Manchester, the CAA made the following points:

- (a) Manchester had capacity available due to the recent completion of a second runway. Its policy appeared to have been to invest to meet unconstrained demand; and so it was likely to continue to have incentives to keep prices relatively low.
- (b) Manchester was in local government ownership, and currently appeared to have different objectives from those of BAA. It was not primarily a profit maximizer, but aimed to develop services at the airport for the benefit of the region. This had meant that it had invested in capacity primarily to meet a highly peaked demand, so that the airport was characterized by underutilized capacity rather than excess demand. Manchester was subject to greater competition than either Heathrow or Gatwick, but its market share in its catchment area was high enough to indicate that it still had significant local market power. Its incentive to exploit its market power was reduced given its current ownership status and objectives. Therefore the CAA's objective in regulating Manchester was to provide protection for users while minimizing the regulatory distortions and burden. It noted that the ownership position and Manchester's objectives could change within the quinquennium.
- (c) The CA 98 provided a constraint on the behaviour of dominant firms. In the case of Manchester, this needed to be taken into account in setting a price cap that best met the objectives of the CA 98. It could be used, in particular, to control any possible abuse of market power in Manchester's commercial activities, which, under the dual-till proposal, would cease to be subject to any form of price regulation under the Airports Act and provided a policy framework within which Manchester could offer more flexible pricing.
- (d) Manchester's place in the competition spectrum was somewhat short of the point where one was dealing with a monopoly for which there was no prospect of competition. It would be more accurate to characterize Manchester currently as a dominant firm which was subject to some competition, albeit more in some areas than in others; and one where there was potential for greater competition and where, in some areas at least, there were available substitutes. In that context, therefore, the CAA took the view that a relatively light regulatory touch was appropriate. The Airports Act itself, together with the tradition of relatively light-handed oversight of capital expenditure and operating expenditure in the past, were consistent with this view.

The single till or dual till/RRCB

10.13. On the question of the single or dual till/RRCB, the CAA took the view that although the case for the dual-till approach was less strong at Manchester than at more congested airports such as Heathrow and Gatwick, it still recommended the RRCB approach for Manchester. The CAA argued that a move away from the single till might not necessarily reduce efficiency by causing a loss in outputs. This was because Manchester had demonstrated an ability to price differentiate, which, if applied efficiently, could increase output. Also, one of Manchester's objectives was to maximize growth, while operating profitably. More generally the dual till would provide a long-term dynamic to maximize passenger throughput. Together, the CAA believed, these factors should ensure that any loss in output resulting from a move away from the single till would be small. It was possible that Manchester would not price up to the dual-till cap. The CAA also believed that the distortions caused by widening the scope of regulation to include the commercial business by retaining the single till would impose a greater loss of output than any minor losses arising from charges being slightly higher than they would otherwise have been.

10.14. It submitted that it was also arguable that over time the incentives provided by the RRCB to increase profits on commercial activities would enhance further Manchester's incentives to ensure that passenger volumes were increased. To the extent that passenger volumes were elastic in respect of airport charges, this could result in the airport setting lower charges to ensure that passenger volumes were increased.

10.15. Commenting on the effect of the single-till approach on investment incentives, the CAA submitted that in theory, the single-till approach offered the prospect that all investment would eventually be remunerated in aggregate provided that there was reasonable regulatory certainty. This did not in itself provide good incentives for airports to invest optimally. Airports might be prepared to undertake some investments that did not deliver any, let alone the optimal, value to users, since the airport would earn a return on investments in any event. In the CAA's view, this was a distortion; and the single till, by widening the scope of regulation, widened the scope of projects subject to this distortion.

10.16. Charges resulting from the single till might be lower than they would be if a dual-till approach were adopted, but the CAA submitted that, if charges were higher, users would have more incentive to challenge airports' investment plans with possible improvements to investment decision-making generally. Separately, the CAA did not necessarily view as a bad thing the possibility that there might be disputes on investment plans between airlines and airports, as this could reinforce oversight of the system and add to the quality of the investment decisions. As to development of Manchester's commercial activities, this was distorted to the detriment of users under the single-till approach, because the single till in effect exacted a 100 per cent levy on expected commercial returns in excess of the airport's regulated cost of capital and because it implied that their commercial investments were in effect insured by the regulatory framework.

10.17. The CAA listed a number of potential benefits that would arise from moving to a dual-till/RRCB approach. These were:

- (a) The scope of regulation would be reduced to the core airport aeronautical activities where the airport had a clear monopoly in relation to its users. This was highly desirable in itself and consistent with developments in the regulation of utilities in the UK more generally.
- (b) If prices were set in relation to aeronautical activities alone, there might be a clearer focus by the airport on promoting those activities. The CAA accepted, however, that since effective returns would also be increased on commercial activities, it was unclear whether the airport would be more likely to use substitutable space in the terminals for aeronautical or commercial activities. It also acknowledged that a move to a dual-till system would entail detailed cost and asset allocations. The CAA believed that the single till also required contentious issues of this type to be resolved and that the single till added to the complexity of regulation since it required detailed forecasting of costs, investment and demand for commercial activities.
- (c) Under a dual till, the CAA expected that increasing profitability of investments would result in the likelihood of more investment in the future in aeronautical infrastructure than under a single till. It recognized, however, that at Manchester the level of investment had not been a primary

concern of users, given Manchester's history of investment in infrastructure, which had been ahead of user requirements as a result of its growth objective; but believed that regulatory policy needed to be seen to be long term.

- (d) The CAA submitted that in the past, under the single-till regime, Manchester had made sub-optimal investment decisions without proper consideration of user requirements. It instanced R2 in this respect.

10.18. As to evidence of distortion among the effects of the single till in the past, it was not possible to assess what would have occurred had the regulatory regime been different. Generally, however, the CAA had the impression that commercial investment had not been carried out on a strictly commercial basis and that decisions were made with an eye to the short term. The single till was, thus, not without its own potential for gaming—planning commercial investments with a view to maximizing short-term returns between quinquennial reviews. If a dual-till approach were to be adopted, the approach towards investment was likely to be more long-sighted and more sharply focused.

10.19. Asked further what had changed since the last regulatory review, when it had not argued for the dual-till approach, the CAA responded that, in its view, the dual-till approach would provide optimal airport development over the long term, and maximize the benefits for consumers and producers in a more effective manner than did the single-till approach. The CAA also considered that competition to Manchester was intensifying. The impact of the single till was to impose increasingly tight price caps on Manchester with the likely effect of dampening this emerging competition and putting greater pressure on service quality.

10.20. Another advantage of the dual till, affecting Liverpool, arose from the fact that its growth in the market had had a beneficial impact on the dynamics of airport competition in the North-West and other adjacent regions. If regulation continued with a relatively light touch—as it would under a dual-till approach—on the one hand users at Manchester would be protected while in due course other regional airports were likely to be able to take increasing business. By contrast, one of the airports at issue here had told the CAA that it would be concerned if the result of this review were a single-till outcome that drove Manchester's charges down. The CAA pointed out that the airport charges at these other airports were not regulated and that it was not aware that single-till pricing was the norm for such airports, some of which might well be pricing at below single-till levels and some above them. There were increasing numbers and examples of airports in other countries that were adopting some form of dual-till approach.

10.21. The CAA was asked to consider a number of other arguments which had been put to us:

- (a) Commercial revenues at Manchester could not be generated without aeronautical facilities. By reducing airport charges, the single till gave airlines and their passengers a share in the profits. Airlines had also made some contribution (through the charges in previous years) to the costs of developing the terminals where the commercial operations were located. It was thus not unreasonable that they should share in the benefits of these operations.
- (a) If airport charges were to be higher at Manchester under a dual-till regime than under the single till, this could have adverse implications for passengers and the fares they paid for flights.
- (b) Manchester was relatively underutilized, and the dual till, on the face of it, provided no incentive to increase utilization because it provided for no real-term price cuts over the Q4 period. It relied instead on a very indirect mechanism—on high returns on commercial activity to drive through the aeronautical investments and stimulate more passengers. The single till, by acting on landing and passenger charges, provided a much more direct means of driving up utilization. How, therefore, could the indirect dual-till mechanism be much more efficacious than the direct single-till mechanism?
- (c) There was no evidence that the single till had led, or would lead, to underinvestment in aeronautical facilities at the airport.
- (d) If there were a need to encourage investment in particular facilities at Manchester, this could be done under the single till by, for example, allowing different rates of return on specific assets or categories of assets, provided that this reflected differential risks.

- (e) The dual till might lead to a greater emphasis on commercial investments, as commercial returns were typically higher than those from spending on aeronautical assets. This could lead to possible detriment to aeronautical facilities, for example in the event of capital rationing, where aeronautical spending could be deferred in favour of more profitable commercial investments; or if terminals became cluttered with commercial facilities, which could impede the efficient throughput of passengers.
- (f) Manchester was likely, in any event, to be subject to continued pressure from its shareholders to expand airport capacity. In the past, it had done so ahead of growth in demand. R2 and T3 were examples. There was therefore little evidence of a need for stronger incentives for Manchester to invest in aeronautical facilities; and hence little likelihood that the airport would become congested if the single till were retained.
- (g) A dual till would create an artificially rigid dichotomy between commercial and aeronautical facilities by giving insufficient recognition to the fact that some commercial and ground transport facilities were necessary for the proper operation of an airport.
- (h) The dual-till proposal could also lead to difficulties in allocating current, and future, assets and costs between the tills—a process that, in itself, could create an unnecessary regulatory burden and foster a conflict of interest between the airport and its users as further incremental investments were made.
- (i) Introducing a dual till at Manchester on the grounds of regulatory consistency with Heathrow and Gatwick did not seem to be compatible with ICAO guidelines that each airport should be looked at on its merits.
- (j) No useful parallels could be drawn from the overseas airports that used the dual till in whole or in part, as their circumstances were not comparable with Manchester's. For example, the shift to a dual till at Sydney had taken place as the airport was being prepared for privatization, and although some US airports operated a dual till, under federal law they were said to be required to retain all revenues for reinvestment in the airport.
- (k) It was not at all clear that the CA 98, which, the CAA had suggested, was an adequate safeguard against excess commercial profits at Manchester arising under the dual till, would prove suitable to deal with rates of return on commercial investments which were deemed excessive. Action could be taken only if there were a breach of Chapter II, which prohibited abuse of a monopoly position. It was questionable whether levying rents that represented—because of the locational advantages of an airport—a high return on investment would amount to such a breach.
- (l) Manchester was a relatively high-cost airport and a dual till which set a high and, in all probability, non-binding cap that provided very few incentives for the airport to drive down its costs and increase its operating efficiency.

10.22. Responding to these arguments, the CAA said:

- (a) It was not clear why it followed that airlines should automatically share in the benefits of commercial revenues. They did not own any part of the commercial infrastructure. The CAA did not accept that regulation should be used so that airlines had any intrinsic rights over net commercial revenues generated at the airport. It took the view that continued extension of the regulatory regime to commercial activities, as distinct from core airport services, was in itself undesirable given section 39(2)(d) of the Airports Act, which required the CAA to perform its functions in the manner which it considered was best calculated to impose minimum restrictions compatible with its obligations. Regulation carried costs and distortions of its own and the continuation of the single till was undesirable on the grounds of excessively extending the regulatory regime. Moreover the single till did not imply 'sharing' of commercial rents; it was assumed that all of these rents were passed to users through lower airport charges.
- (b) CAA modelling indicated that airport charges were likely to continue at roughly their present levels under a dual-till regime. All that would be lost from the abandonment of the single till would be a decline in charges that might otherwise have been passed on to passengers. But that would have been, the CAA suspected, de minimis and not really noticeable to the passengers concerned, particularly if Manchester differentiated its prices to avoid output loss. The change in charges at issue was very small in relation to the total cost of air fares.

- (c) Although the dual till might be considered an indirect mechanism to encourage greater utilization of Manchester Airport, it did provide incentives over the longer term to increase use and secure growth in output and, in the CAA's view, it would probably do so better than the single till.
- (d) It accepted that there was no evidence that the single till had led to underinvestment in its use during the 15-year currency of the present regulatory system. However, investment issues were anyway less intense at Manchester, not having the capacity hurdles facing airports in the South-East. In addition, since the single-till system was a standard RAB approach, it did not permit an accurate assessment of whether there had been too much investment, too little, or whether it had been just right.
- (e) The idea of allowing different rates of return presupposed detailed regulatory intervention and the regulator taking a view as to which rate of return to allow on which assets depending on how desirable the regulator considered them. A dual-till system would avoid such intervention and address investment in a particularly beneficial way.
- (f) In the CAA's view the dual-till system would, if anything, moderate the incentive to overcrowd the airport with commercial development, which might reduce outputs. And capital rationing was unlikely to be a major problem under a dual-till regime, whereas with the single till it could be.
- (g) The CAA accepted that Manchester did not need any short-term (the next five years) incentives to invest ahead of demand. Over the longer term, however, this might well become more of an issue; and with long-lived infrastructural assets, the long-term signals mattered. A further argument in favour of a move to a dual till at Manchester followed the CAA's conclusion that the dual till was the appropriate basis for setting the price cap at more congested airports. The CAA argued that if prices were not to be set on a dual-till basis at Manchester, the airport would have an incentive not to alleviate congestion, in order that it could avoid a single-till approach in future.
- (h) The CAA agreed that some level of commercial activity was essential for an airport, but once this got beyond a certain basic level it was not clear what passengers actually wanted, and the CAA would disagree that there were links beyond this level such that commercial and aeronautical activity should be considered a joint product. The CAA saw commercial activities as being clearly separate from aeronautical activities. Most passengers, for example, would agree that there was a distinction between buying goods and services in airport shops and going on a flight.
- (i) Users were clearly going to have a close oversight of the till boundaries and the CAA did not think there were any major disbenefits arising from that process.
- (j) As to regulatory consistency and the ICAO guidelines, the CAA was driven more by the duties in the Airports Act, including taking account of advised international obligations, than by these guidelines. In any case, however, the CAA did not read these guidelines as necessarily requiring the CAA to take a different view of Manchester from that taken of the three BAA designated airports. One strong argument in favour of using the same framework at all the designated airports was that while a dual till could be justified at Heathrow and Gatwick on the grounds that their congestion would justify the higher user charges consequent on the dual till, not to apply the same approach at Manchester could create a perverse incentive for the latter to encourage congestion.
- (k) On the parallels with overseas airports, in Australia many of the same arguments as here had been debated before a decision to go for a dual-till system at Sydney was taken. An important precedent had been set by the move of Sydney Airport to the dual till; and the CAA agreed with the analysis of Australia's Productivity Commission on the review of airport pricing.
- (l) The CAA considered that, under its proposed cap, prices could not exceed the costs of monopoly services. There were also the safeguards in the CA 98 to address concerns over excessive commercial prices. Its point here was that the types of problems that people foresaw arising on commercial profits at airports under a dual-till system were no different from those occurring in

various other areas of the economy. The CAA did not accept that high profits on commercial activities were necessarily excessive since they were likely to reflect locational rents. Neither did the CAA believe that ensuring that commercial profits were limited to some specified level was an objective that followed from the CA 98.

- (m) The CAA believed that a dual-till regime would provide appropriate incentives to cut costs. Using the single-till regime to impose a tough price cap with the objective of forcing cost reductions could have an effect on a lot of other things besides costs. The primary problem lay in governance and the CAA was not currently persuaded that the single or dual till would really make a major difference in respect of cost efficiency.

Service quality

10.23. As part of its policy package, the CAA had not proposed a service quality term in the price cap for Manchester, as it had for Heathrow and Gatwick. In response to representations made by both Manchester and airlines in the period prior to the CAA's presenting its proposals to us, the CAA stated that focus on quality was likely to be blunted if there were no financial sanctions, should the airport fail to perform to the appropriate standards. It went on to say that it would like to see some type of binding undertaking on service quality and that that undertaking should be linked to the charges condition in such a way that it would be clear that any departure would be taken into account when the price cap was set in five years' time.

10.24. In its view a Q factor was less important where the price cap was unlikely to be tightly binding. Manchester had priced below the cap under the single till in Q3, and the CAA anticipated that it would continue to price below cap under its dual-till proposals. The CAA suggested that the issue of service standards should be built around the information disclosure approach, which would require specification of service quality. It added that Manchester was committed to that approach, and that, should the price cap be set on the basis of the dual till, one sanction on Manchester might be a return to the single till at the next review if service quality were not dealt with satisfactorily. It had not, however, really seen service quality as a core problem at Manchester which was regarded as a relatively high-quality high-cost airport. It also noted that Manchester had reported that it had received little, sometimes no, airline interest in service quality arrangements, and it appeared to the CAA that airlines did not seem to be overly concerned about service quality or about consultation on service quality. Certainly the CAA's own view was that the focus for quality should be on the improvements in consultation arrangements which it had recently been negotiating with Manchester—arrangements which covered capex as well as other aspects of the business plan activities.

10.25. Asked to comment on the suggestion that one way of giving force to agreed service quality standards with financial compensation, in the event of the airport not complying with a standard, would be for it to incorporate the standards as conditions in the Permission to Levy Charges, the CAA commented that the Permission was not the equivalent of the licence held by other regulated entities. For example, the circumstances in which the CAA could attach conditions to a permission were tightly prescribed by the Airports Act. These were: (a) following a CAA investigation that concluded that an airport was pursuing one of the courses of conduct described in section 41 of the Airports Act; and (b) following a public interest recommendation from us at a quinquennial review. An investigation under section 41 would normally result from a detailed complaint submitted by a party directly affected by the alleged course of conduct. The CAA had, however, received no such complaints about service quality at Manchester, although it acknowledged that it would have to act if we were to make a public interest finding in this area.

10.26. On the enforcement of conditions attached to a permission, the CAA said that under section 39(1) of the Airports Act, an airport had to comply with any conditions and that these were enforceable in accordance with sections 48 to 50, through the making of compliance orders. As to the question of how any service quality undertakings by Manchester might be made binding, the CAA reiterated that it considered that any undertaking given by the airport could be made binding in the sense that any departure by Manchester from its undertaking would be taken into account at the subsequent review. On the suggestion that a public interest finding might be that the absence of published standards, with an enforceable scale of discounts when these standards were not met, operated or might be expected to

operate against the public interest, the CAA acknowledged that matters at Manchester had fallen short of perfection but said that, broadly speaking, there was not a major service quality issue crying out for remedy. There was a question whether such a finding was necessary when it had not been applied in the past. On the consultation side, given its more recent discussions with Manchester, the CAA felt reasonably comfortable. It was also aware that Manchester was close to agreement with the airlines on almost all of the first batch of SLAs—covering inbound and outbound baggage system, security systems, air-bridge availability, stand availability, FEGP and bussing operations. The CAA considered that the rebate system under discussion—for service quality failings—was more appropriate than a system of penalties.

10.27. The CAA also considered that it was right to be concerned at the possibility that the necessary SLAs, or some of them, might not be agreed within a reasonable timetable. But while there was undoubtedly pressure on airports to conclude these SLAs expeditiously, a binding requirement to do so might make an airport's engagement less constructive. The CAA hoped, as far as any proposal for binding arbitration was concerned, that Manchester and its users could jointly agree on an arbitration system. It would not want to act as the arbiter of first instance as there was a risk of it being drawn in too early and too often.

10.28. Commenting on the possibilities that our report might recommend 1 February as the date by which Manchester should have in place its proposed SLA regime; that the CAA might step in to impose the necessary measures in default of a timely agreement and act as backing for any dispute arbitration system; and that the CAA's two conditions imposed following the 1997 MMC report (see paragraphs 10.29 and 10.30 below) might be extended into Q4, the CAA said:

- (a) The date, 1 February, to implement a regime of SLAs might be difficult to impose by way of a condition because the process following our report was to some extent fixed by the Airports Act and was unlikely, in practice, to be less than three months. If the CC decided to make a public interest finding in this area, therefore, the CAA would prefer to see some flexibility, possibly allowing the CAA to determine the date on which any remedy would become active.
- (b) On the suggestion that part of the remedy might be that the CAA be empowered to step in and itself impose the necessary measures, in default of timely agreement by Manchester and the airlines, the CAA said that it already had the necessary legal powers to impose such measures within the scope of such a public interest finding. While it might agree with this idea as a remedy to a finding under section 41 of the Airports Act, for the requirements of that section to be fulfilled would involve a time-consuming process.
- (c) In respect of arbitration, the CAA would view third party independent arbitration as helpful if this could be agreed by the parties. It saw some difficulties, however, in the CAA acting as an arbiter given its quasi-judicial role under section 41 of the Airports Act. In addition it did not see how arbitration could be backed up by section 48 other than through a formal process under section 41.
- (d) Finally, in respect of the possible extension of the current public interest conditions, the CAA pointed out that these were intended to remedy shortcomings in the process of consultation rather than to achieve the outcome of effective SLAs. Going forward, this would seem to be a suitable remedy only if the public interest finding were once again on this basis.

10.29. Commenting specifically on this last aspect, the CAA said that conditions imposed by the CAA to remedy the adverse effects of a course of conduct identified by us at a quinquennial review were not strictly linked to the timing of the next charge control period. Section 51 of the Airports Act required the CAA to specify whether or not a condition (other than a price cap condition) expired on a specific date. At the last review the CAA had decided that the two conditions at issue in this case should expire at the end of the current price control period (that is, on 31 March 2003) so that they could be considered afresh as part of the current review. Section 51(2) allowed the CAA to extend the period of an existing condition, which would otherwise expire. In the light of a possible recommendation that the CAA could use its powers under section 51(2), not relying on an explicit public interest finding, the CAA saw no difficulty in principle with the condition relating to cost information being extended subject to possibly seeking external views on whether the condition should be retained in its present form or modified taking account of section 51(6).

10.30. The second condition, however, which related to consultation, presented some difficulty. The condition followed very closely the recommendation from the MMC dealing with the airport's arrangements for consulting users in a number of areas. Manchester had complied fully with the terms of the condition and had made some changes to its procedures at the CAA's request following external consultation. The CAA had recently been discussing with Manchester the enhanced disclosure of information as a basis for consultation with its customers. With this agreed—and with appropriate user input—the CAA might envisage these arrangements as in effect superseding or at least supplementing those now in place. The final decision on this would be for the panel of the CAA board appointed for the purpose of the airport reviews.

Dropping the S factor

10.31. As part of its package, the CAA argued that the S factor should be abolished. Following the 1997 review, Manchester was allowed to pass through to customers 95 per cent of the costs of new government security requirements, one year in arrears. The CAA noted that the final decision on whether to allow expenditure to be passed through was to be taken by the CAA. It said that problems had arisen in assessing the validity and amount of claims. Furthermore, work on revised security standards was sometimes combined with work to bring about other desirable improvements, and therefore it was difficult to separate out the incremental costs of meeting additional security requirements.

10.32. A cost pass-through was justified only if (a) the regulated firm had little or no control over costs; (b) costs were subject to significant forecasting uncertainty over the review period; and (c) the uncertainty was better imposed on customers than on the firm itself. In its view the costs of the additional government security requirements did not meet these criteria.

10.33. The CAA accepted, however, that the events of 11 September could have far-reaching consequences for airport security in the UK. The costs of any additional security proposals were uncertain at the time that the CAA had submitted its proposals for the price cap. It acknowledged, therefore, that if further information did not become available by November 2002, it might need to revisit the question.

10.34. Even if the picture remained unclear, however, the S approach might not be the best one. Alternatives such as a one-off contingency arrangement might provide a better alternative.

10.35. In its view the airport should bear the additional security risks in view of the fact that it was the primary supplier, and ought to be responsible for meeting the required standards in the most cost-effective manner. The CAA argued that the absence of any ability to pass through costs would ensure that subsequent security requirements were implemented efficiently. It also believed that the greater flexibility which it foresaw resulting from the proposed move to a dual till should enable Manchester to meet any new requirements cost effectively, without resort to pass-through. The CAA added that, although it had made its proposal on the S factor with a dual-till regime in mind, it believed that a single-till environment would point to the same conclusions. It did not believe that there was anything particularly different about security costs which would suggest that they should in principle be treated differently from other costs. If airports did suddenly face major new costs which it was clear needed to be taken into account, the regulator could address this eventuality as it arose.

Peak pricing

10.36. The CAA endorsed movements by Manchester to a peak pricing structure. It considered that a move to a peak pricing structure had potential to promote efficient use of existing capacity and to provide signals of where and when additional capacity was required. The CAA said that it did not propose formally to impose a peak pricing structure on the airport, but considered that the revenue yield approach to setting the cap, combined with the dual till, would provide good incentives to move to appropriate price structures.

10.37. Asked if there was any danger that a peak pricing regime would lead to unjustified discrimination between airlines, the CAA replied that, in its view, the CA 98 provided a powerful framework within which the issue of potential price discrimination could be addressed, if necessary. Complaints could also be made under section 41 of the Airports Act. The CAA said it hoped that we would offer general encouragement, in our report, for peak pricing.

Discounts

10.38. The CAA pointed out that at Manchester, the price cap was calculated as if users were paying the published charges, unlike at the BAA London airports. The CAA did not wish this position to change. If an airport offered unpublished discounts to an airline, it should not be able to benefit from an increased cap to raise charges to other airlines to compensate; it therefore continued to believe that the price cap should be calculated at all the designated airports as if airlines were paying the published charges. It had received a number of approaches suggesting that this approach be adopted at the BAA airports too, and agreed with them. On unpublished discounts the CAA's view, broadly, was that the airports should be left to make their own decisions with the CA 98 as a fall-back guarantor of competitive behaviour plus the CAA's own powers under section 41 of the Airports Act. It would, therefore, prefer a case-by-case approach to one that set ex ante constraints. Although it believed that there should be no absolute limit on the amount Manchester could spend, a £6 million limit of the kind under consideration for inclusion in the till might not be unreasonable and would be consistent with the notion that the price cap was set as though published prices were being paid. There might nonetheless be question marks over whether some unpublished spending might circumvent that policy.

Non-passenger flights

10.39. Concerning non-passenger flights, the CAA said that at Manchester, the revenue from non-passenger flights was removed before calculation of the price cap, unlike the position at the designated BAA airports. The CAA wished to extend this approach to these airports. The effect of its proposal would be a separate price cap for non-passenger flights, but with a condition that the charges for non-passenger flights should be no higher than the published charges for passenger flights. The CAA added that in its view, Manchester did not appear to have market power as far as non-passenger flights were concerned.

Volume term

10.40. It was not in favour of a volume term, under which the price cap would be reduced if outputs were higher than forecast and increased if outputs were lower than forecast. The CAA recognized that 11 September might mean that the medium-term outlook for Manchester would remain unclear, but believed that the solution was not to introduce a volume term. The CAA stated that it believed that the correct answer to the danger of basing the price caps on over-conservative demand forecasts was a thorough analysis and challenge to the forecasts during the review.

The default price cap

10.41. The CAA introduced the concept of the default price cap by saying that a mechanism that facilitated greater direct contracting between users and airports could have significant benefits in terms of better use of existing airport facilities, and in providing better incentives to ensure that airports invested in the new facilities actually wanted by users. The concept of the regulated price cap acting as a 'default price cap' which users could opt for as an alternative to direct contracting, could provide a better basis for those objectives to be achieved.

10.42. Since, under the CAA's proposals, Manchester was unlikely to set prices at the maximum level allowed by the cap, it would have scope to contract directly with users without the need for special regulatory provisions. In any event, the use of published charges to determine the yield for the price cap formula provided a partial framework for direct contracting.

The revenue yield and tariff basket approaches

10.43. The CAA stated that since 1986 all the price caps at designated airports had been set on a revenue-yield basis. Under the revenue-yield approach, a cap was placed on the airport's revenue from

airport charges per passenger handled. The alternative approach, known as the tariff-basket approach, required the airport's actual charges each year to be restricted to meet the price cap such that the weighted average revenue from the charges adopted could not be more than the weighted average of such charges in the previous year, plus or minus the X factor.

10.44. The CAA did not recommend the tariff-basket approach at MA. Asked why not and whether the CAA felt that a 'Ramsey pricing' approach might be appropriate (whereby prices were increased on services with inelastic demand and reduced on services with elastic demand), the CAA said that the response all round to its consultation process had been strongly in favour of the status quo. Second, peak pricing, which MA had just introduced, was one form of Ramsey pricing, and added that it had not proposed a tariff-basket approach for Manchester because no support for it was expressed during consultations and because it did not believe that the price cap was likely to be binding. Moreover, the revenue-yield approach provided incentives to move towards Ramsey pricing—the main criticism of the approach was that it went too far in this respect, not that it fell short.

Till definition

10.45. As to till definition, and the single-till approach in particular, the CAA believed that there was in principle no difficulty in regarding activities in or in close proximity to the airport as falling within the till. On the balance of MAAS's business, for example, much more of it fell within that category than outside it. The CAA would, therefore, be content to see it included as long as RHS (which was subject to competition) was excluded from the till.

Passenger forecasts

10.46. The way in which passenger numbers were likely to recover from 11 September, which had been a very large shock to the industry, was slightly unpredictable. However, the CAA's latest views on numbers growth was now closer to Manchester's than it had been at the outset of this review. Its latest forecasts were also independent of whether the regulatory approach was dual-till or single-till—the CAA had not seen any evidence to show that either would result in substantial differences in passenger numbers.

Cost of capital

10.47. While Manchester was a local-government-owned enterprise, the CAA considered that the standard cost of capital framework was appropriate, as the opportunity cost of resources invested in Manchester by its owners had the usual opportunity costs in terms of forgone consumption and investment. In line with standard practice, the CAA had based its cost of capital calculations on the framework provided by the CAPM. The CAPM and WACC required market data as inputs. Due to the fact that no firm-specific market data (that is, beta and debt premium) was available for Manchester as it was local-government-owned, the CAA had relied on BAA data to come to a conclusion on Manchester's firm-specific parameters, whilst taking into account the airport-specific factors such as its size, traffic mix and throughput. Having taken account of Manchester's arguments, and given the uncertainties in estimating the cost of capital, the CAA considered that a 7.5 per cent real pre-tax cost of capital for Manchester was appropriate.

Unregulated charges

10.48. The CAA was aware that Manchester had told us that it had no intention of introducing any new charges or of increasing any existing unregulated charges beyond changes in the RPI during Q4. The question was: should that statement be regarded as sufficient or should we recommend some further conditions to ensure that this came about. The CAA said that, given the definition of airport charges, this had been a potential issue at previous reviews. It said that Manchester's behaviour in the present quinquennium (Q3) had been reassuring—it had adjusted its regulated cap to accommodate changes in unregulated charges. There was, therefore, no need for something in addition to Manchester's assurances—the subject could always be revisited, if necessary, at the next review.

Air traffic services

10.49. The DfT had asked the CAA to review the way in which air traffic services were charged and to advise whether the direct charging of airlines by NATS for these services should be extended to all airports (including Manchester, which was not designated under the Transport Act 2000 (the Transport Act) and therefore currently recouped the cost of the services through the airport charges) or whether it should be discontinued. The CAA had published a consultation paper. It was not aware of a specific proposal from Manchester to be designated under the Transport Act; but said that without prejudice to the conclusion of the consultation process it could see a strong argument that air traffic services could be subject to more effective regulation under the Airports Act, as exemplified by the current situation at Manchester. Issues of transparency in this context were separate and could be dealt with without requiring separate charges for these services or airline payments being made direct to NATS rather than to Manchester.

Capex consultation

10.50. The CAA had confidence that consultation on capex would improve following the agreement on enhanced information disclosure it had recently been negotiating with Manchester. Up to now, however, Manchester had not produced comprehensive and clear business planning information on the range of options it faced, in any given investment situation, and the key drivers relating to them.

The Competition Act 1998 and section 41 of the Airports Act 1986

10.51. Asked to comment further on the use of the CA 98 and section 41 of the Airports Act, the CAA said that when it had referred to the existence of the CA 98, it was drawing attention to an additional legal mechanism to address issues of airport conduct. Airports, in common with other sectors of the economy, were subject to the two prohibitions in the CA 98 and these could be enforced by the Office of Fair Trading (OFT) at any time. The CAA also noted that the existence of section 41 of the Airports Act did not relieve us of our obligation to deal with public interest matters in accordance with the statutory terms of the reference.

The CAA's comments on NERA advice

10.52. Commenting on advice which NERA had given us on the question of the dual till (NERA had stated that airports appeared to have market power in commercial activities, where supernormal profits were made), the CAA said that NERA's analysis was not focused on the definition of the regulatory till for the purposes of setting airport charges, but instead on the case for ex ante regulation of non-aeronautical activities. The question whether commercial activities at airports should be regulated was not a question that should be addressed as part of the current review. That was a matter for the Government and Parliament.

10.53. The CAA also made the following points on the NERA analysis:

- (a) NERA had stated that the returns on commercial activities were supernormal. But while the accounting returns were indeed high, this did not necessarily point to supernormal profits in an economic sense if there were locational rents. Assets could have been undervalued.
- (b) NERA had asserted that the accounting returns indicated the ineffectiveness of competition law. However, the CAA said that it had not seen any evidence of widespread abuse and that such abuse could in principle be remedied by the Fair Trading Act 1973 and the CA 98, if necessary. The Airports Act made provision only for the direct price regulation of airport charges, not commercial activities. This indicated that when the Airports Act was passed commercial activities were not seen as good candidates for direct economic regulation.

The CAA's other responses on the issues

10.54. The CAA's further responses on a variety of issues, many raised by us in the earlier stages of the inquiry, are summarized at Appendix 10.1.

Department for Transport

10.55. The DfT (formerly, at the time it initially gave evidence, the DTLR said that it agreed with the CAA that Manchester's objectives were not focused on profit maximization and included growth objectives which the local authority shareholders saw as having the longer-term goal of developing the regional economy. For example, the DfT recognized that wider costs and benefits to the regional economy were relevant to the timing of Manchester's decision to build a second runway. The DfT also agreed with the CAA that Manchester had significant local market power but that its incentive to exploit this was reduced by its current ownership status and objectives.

10.56. Manchester's strategy had identified as a key priority the rapid development of the network of services provided at the airport to enhance the level of air services provided to customers in the North-West and to reduce unnecessary journeys via the London airports. Its pricing proposals had been aimed at incentivizing growth in the use of the airport by all airlines. Its Millennium Prices proposal issued in September 1999 had been targeted at increasing services to unserved destinations. A differential pricing scheme, including peak and off-peak differentials, had been due to be implemented in April 2002.

10.57. The DfT said that the principal economic benefits from the provision of additional airport infrastructure arose in the additional journeys facilitated by the reduced cost of air travel through the relieving of capacity constraints. Direct international services became possible as routes reached a financially viable critical mass and as existing services were able to operate at increased frequencies. The scope for achieving these effects would increase as regional demand grew. Manchester as a regional airport also provided feeder services to both UK and Continental hubs. All of these constituted welfare gains to the economy.

10.58. In addition, economic benefits could arise at the local and regional levels from the beneficial impact of airports on employment, and airports could play a part in generating clusters of economic activity and could help to attract inward investment to the UK. There was, for example, strong anecdotal evidence that proximity to regional airports was an important factor in the location of investment decisions by both domestic and foreign-owned enterprises.

10.59. Regional airports, like Manchester, could also act as a focus for local economic development and regeneration, helping to boost economic and employment opportunities in rundown areas. The scale of the impact depended on the size of the airport and the presence of deprived areas nearby. Several of the local government wards to the north of the airport were deprived areas and would benefit from the additional employment opportunities that growth might provide. For example, Benchill ranked as Great Britain's most deprived ward, while the wards of Baguley, Sharston and Woodhouse Park fell within the bottom 5 per cent. The extra low-skilled jobs created by the expansion of the airport should contribute to improving the economic and social position of these wards.

10.60. During much of the 1990s only small amounts of supplementary credit approvals were made available for investment in local-authority-owned airports. So these airport companies had had to rely on internally generated financial resources or alternatively to look to the private sector to finance major airport expansions. Manchester had taken the first route in financing R2. The relaxation of borrowing controls meant that local authority airports no longer needed to accumulate funds from internal resources before undertaking large investments, and Manchester had chosen the most appropriate financing mix for each project, in the same way as a private sector company would have done.

10.61. To date, the main effect of the easing of borrowing constraints on local authorities had been to facilitate Manchester's acquisition strategy. The DfT pointed out that the CAA had noted that Manchester's group debt seemed to be related to the financing of the acquisition of new airports. In July 2000, MA's board had approved a business strategy which included the following objective: 'Manchester Airport plc aims to be a long-term owner and operator of quality airports with the objective of maximizing shareholder value by acquiring significant equity stakes in a mixed portfolio of airports across the UK, exploiting the Manchester brand, maximizing growth and profitability, and so consolidating our position as a long-term investor in the airports industry'. This objective had been approved by the local authority shareholders subject to the need to grow and improve the profitability of the core business at Manchester Airport itself.

10.62. In February 2001, the Secretary of State had approved Manchester's purchase from National Express of the East Midlands and Bournemouth Airports subject to OFT approval. This acquisition had

been judged to fit within the criteria set out in Manchester's acquisition strategy and to have limited adverse consequences for competition.

10.63. The DfT said that it was concerned about the proposal to remove the S factor arrangement for Manchester. Following 11 September, the aviation security regime in the UK had been reviewed and extra requirements had been quickly laid upon airports. These had resulted in considerable extra costs, although final costs remained unclear.

10.64. Given the additional security requirements already imposed on the UK industry, as well as those in the pipeline, it could not agree with the CAA that the requirements, or indeed their costs, would be known before the price cap was finalized. Furthermore, given the current environment, any further incidents or apparent security breaches would be likely to lead to a requirement for yet further security enhancements with increased costs as a result.

10.65. In more general terms, if the S factor cost pass-through arrangement were to be withdrawn, this could result in Manchester doing the bare legal minimum to meet the security requirement. Such action could have serious consequences. Although the CAA had argued that airports would still be legally obliged to meet all security standards, this was true only as regards security measures set down in directions under the Aviation Security Act 1982 (as amended). Airports were not legally obliged to follow the many other security recommended practices contained in the National Aviation Security Programme.

10.66. If our report took the view that the S factor was anomalous, the DfT would argue for a reduction as opposed to total removal. A compromise option might be for a reversion to an earlier level of 75 per cent of costs being recoverable.

10.67. The CAA had given four reasons why a move away from the single till might not have harmful effects on Manchester, namely: price differentiation could be used to limit any loss in output from setting a higher price cap; more passengers generated additional commercial revenues and therefore a move away from the single till would give Manchester stronger incentives to deliver more passengers; Manchester had, historically, priced below the price cap and so the higher price cap resulting from a move away from the single till would have little or no effect on actual prices charged; and finally, Manchester might become congested in the future so that any possible loss of output would be small and short term. However, in the DfT's view, despite these CAA arguments, the case for removing the single till now at Manchester seemed weak.

10.68. The CAA had argued that if the single till were retained at Manchester, this might have the effect of discouraging investment at the airport in order to bring forward congestion and encourage a move away from the single till with the associated prospect of higher returns from regulated assets. The DfT considered that it would be undesirable to switch to and from the single till over time depending on whether the airport was congested or not. However, the case for first moving away from the single till well before an airport became congested seemed more difficult to justify. It was unclear that Manchester, given its history of investment, possibly in advance of user requirements, and its growth objective, would have an incentive to withhold investment.

10.69. The Exchange of Notes under Bermuda 2 between the UK and the USA meant that the UK Government was no longer under a legal obligation to apply or retain the single till, since the 1994 wording indicating 'no current intention to depart' from the single till (at Heathrow) did not constrain the CAA making proposals to change this almost ten years later. However, the DfT said that the CAA did need to take account of guidelines which followed the ICAO's Conference on the Economics of Airports and Air Navigation Services (ANSCConf 2000) and subsequent ICAO guidance which recognized that a range of approaches might be appropriate given that circumstances differed between airports. The DfT said that the CAA acknowledged that ICAO policy now took a more flexible view. This ICAO policy was not prescriptive, implying that arguments for moving away from the single till should be considered at the airport level based on the position of individual airports, and not across the board.

10.70. The DfT said that it agreed with the CAA that airlines should not be asked to subsidize surface access projects where there was no clear evidence of benefits to users, but noted that there might be some schemes which, though economically worthwhile, were possibly financially unviable, because the net benefits could not be fully captured by users of the services provided. The DfT considered that there was a case for including surface access projects within the aeronautical till where, despite the fact that they were commercially unviable, they had the support of airlines.

Northwest Development Agency

10.71. The Northwest Development Agency (NWDA) said that Manchester Airport was by far the largest airport in the UK regions. The airport had a major economic influence across the North-West and beyond, and a significant role in helping to underpin the competitiveness of the North-West and much of northern England.

10.72. Manchester Airport's second runway had been completed in February 2001 and its growth forecasts indicated that the airport could be handling 40 million passengers by 2015, all accommodated within the boundaries of the current site. The airport's ability to grow and support the regional economy had been (and to an extent still was) constrained by government and regulatory policies. These included:

- (a) the system of international air route licensing agreements by which the Government continued to constrain the growth of scheduled international flights: this was the key to attracting new investment and supporting economic growth;
- (b) the legal restrictions (vires) on the airport's local authority owners, which limited the type of business opportunities and partnerships in which the airport could be involved (for example, Manchester would not be able to acquire an overseas airport); and
- (c) the existing framework of regulation, which did not recognize the need to invest in facilities like public transport.

10.73. The NWDA would continue to lobby the Government to relax these constraints and support the continued growth of the airport as a means of stimulating growth in the northern regions and reducing inflationary pressures and environmental impact in the South-East and East Anglia. The NWDA told us that it did not consider that there was any significant competition for scheduled flights between Manchester and the other airports in the region, including Liverpool. Liverpool had developed a complementary role to Manchester by concentrating on the budget traffic market.

The CAA panel of advisers

10.74. The CAA panel of advisers (Professor Martin Cave, Mr Brian Pomeroy and Professor Ralph Turvey) said that since 2000 it had acted as a panel of advisers to the CAA on the process, analysis and conclusions of the reviews of the regulated airports. It thought it useful to write to us independently.

10.75. The panel largely supported the CAA's approach and process. It considered the emphasis on economic efficiency, with less concern about rent distribution, to be sound.

10.76. The panel thought that the CAA proposal to give greater flexibility to Manchester in its proposed price cap was sensible. Manchester's public ownership situation made it an unusual candidate for price cap regulation. In addition, in the panel's view, competition to Manchester would be undermined by a 'tight' price cap. The panel believed that the dual-till approach would give adequate protection to Manchester's users from monopoly power by limiting price control to the costs of aeronautical activities. The panel also believed that it would be inappropriate to adopt a different policy on till definition for different regulated airports.