

11 Views of Manchester Airport

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Introduction

11.1. This chapter contains the views of Manchester concerning the regulation of Manchester Airport, as put forward in written submissions and at hearings. Manchester had taken part in the CAA's consultation exercise in the period leading up to the reference, and its submissions to the CAA were published on the CAA web site (www.caa.co.uk). Manchester's formal written submission to ourselves in April 2002 was published on our web site (www.competition-commission.org.uk).

11.2. The following summary is an indication of additional points made to us through further written submissions and at hearings. Some of the main points made by Manchester are repeated in a summary form in order to convey the sense of its position generally.

The economic regulation of Manchester Airport

General strategy

11.3. Manchester submitted that the shareholders had reviewed the long-term business strategy of MAG, and had identified Manchester Airport as having considerable scope for further growth and substantial opportunity to increase competitiveness and value. Manchester's key strategic objectives for the airport were to:

- (a) increase passenger traffic by developing domestic, short-haul and long-haul international point-to-point scheduled services, and by protecting and increasing its share of the inclusive tour and charter market;
- (b) reduce operating costs and charges to airlines to levels more reflective of those at other competing airports;
- (c) increase revenue derived from retail, car parking and other concessionaire activities;
- (d) develop new revenue streams through new business opportunities; and
- (e) improve utilization of capital assets by controlling more effectively future levels of capital investment.

11.4. Manchester described to us the rationale for moving to a new Group structure, which is outlined in paragraph 3.9. It said that change had been dictated by the growing complexity of the business; the need to improve corporate governance issues; and the requirement for shareholders to challenge management effectively. The MAG structure was designed to be more responsive to the marketplace; to ensure quicker and more appropriate decision-making; and to empower the implementation of a radical change agenda. Manchester's business strategy was fundamentally based on its need to respond to competition in order to develop profitably. Manchester said it hoped that the regulatory review would provide appropriate incentives to drive the business forward for the benefit of all its stakeholders, including passengers, airlines and shareholders. It also hoped that the result would be consistent with light-handed regulation rather than any heavy-handed approach and, with some specific reservations, had supported the framework proposed by the CAA in its recommendations put to us in February 2002.

11.5. Manchester had not waited for the result of the review before embarking on a radical review of its business and it believed it needed to take radical steps to improve its competitive position. Currently, it was well invested, but in several of its key market segments it was underperforming, particularly in relation to the extent of the scope and depth of its European network. Long-haul connections were still fragile. As to the charter and leisure segments, MA had seen some loss of market share over the last five years and therefore it aimed to try to maintain and improve its position. It considered that there was scope to improve commercial revenues and reduce costs.

11.6. We asked Manchester about the potential for Manchester Airport becoming a hub airport. Manchester said that at the moment it did not have the volume of transfer traffic required to become a hub airport and previous initiatives in this direction had not enjoyed lasting success. Manchester provided us with a copy of a study by Roland Berger which examined the conditions under which airports

could become hubs and concluded that Manchester Airport was unlikely to fulfil these conditions at the present time. Manchester argued that a hub airport needed to offer over half its slots to airlines offering services to transfer passengers and said that by that criterion even Heathrow was not a hub, as only about one-third of passengers were transfer passengers.

11.7. We asked Manchester how it expected to grow its passenger traffic. It said that currently it held about 27 per cent of the UK inclusive tour and charter market; it aimed to try and sustain this share. It expected its share of the charter market to decline in overall terms relative to the scheduled market; it planned, for scheduled flights, to increase the range of destinations and frequency of services.

11.8. We asked Manchester why the no-frills airlines were not to be found at Manchester Airport. It said that it was not able to offer the no-frills airlines prices that they would accept. We asked why the no-frills airlines were found at Gatwick where discounts were not available; Manchester said that the airlines were able to pay full charges at Gatwick because the market was stronger and the airlines were able to obtain higher yields from flights.

11.9. Manchester said that generally, the aviation market was volatile; it was not possible to predict what would happen to the traditional inclusive tour market. The distinctions between the scheduled and the charter markets had become increasingly blurred. The low-cost or no-frills carriers were forcing competitiveness into both sectors; BA, for example, was responding to this by offering lower fares. That said, it was not easy for Manchester to facilitate having low-cost carriers at Manchester Airport at the present time, although increasing its current limited off-peak incentive scheme might alter that situation.

Cost reductions and projected revenue increases

11.10. We asked Manchester about its policy of reducing operating costs and charges to airlines. Manchester said that it was trying to reduce its pay bill in order to reduce charges to be competitive. It was benchmarking its provision of labour against the market generally. In 1986, when Manchester Airport had become a PLC, it had been run as a local authority entity with local authority rules and culture. Manchester had had to institute a fundamental culture change within the organization, and it was aiming gradually to introduce the concept of market pay for security, fire and other services. Its cost reductions were more ambitious than had been allowed for at the last regulatory review in 1997, and it had under-recovered on airport charges. Manchester added that, if the abolition of duty-free sales within the EC in 1999 were ignored, the cost reduction demanded following the last regulatory review amounted to RPI-12 rather than the CAA-determined figure of RPI-5.

11.11. We asked Manchester about increases in non-regulated charges, which a number of airlines had stated had been equivalent to the amount by which Manchester had not priced up to the cap. Manchester said that it had told the MMC at the 1997 review that it intended to increase non-regulated charges for use of the baggage systems, check-in desks and staff parking, to the extent that these charges needed to reflect better the actual costs of the facilities. MA said that it had voluntarily not priced up to the cap; it could have done so and also increased the unregulated charges, but it had chosen not to do so. Further detail on unregulated charges is given in paragraphs 4.38 to 4.48 and paragraphs 7.55 to 7.59. Manchester told us that the under-recovery on the regulated charges had been due mainly, but not entirely, to the cost-related increases of the baggage system charges and the check-in desk rent charges. A further factor had been the transfer of responsibilities for airbridge driving, which had been given up by Manchester during Q3, and was now dealt with by handling agents. Staff parking charges were also increased during Q3 to reflect costs, but the increase was used to support public transport rather than to reduce regulated charges.

11.12. We asked Manchester about its aim of increasing retail revenues. It said that it had been difficult to invest in terminals based upon current passenger profiles, because airline requirements and alliances kept changing; the challenge was to change that situation. Retailers needed to understand passenger mix and expected throughput; the retail offering also needed to be made as attractive as possible. Further detail on Manchester's retail strategy is in paragraphs 7.74 to 7.94.

11.13. We asked Manchester how it proposed to improve the utilization of capital assets at the airport. Manchester said that currently it used its full airport capacity only at peak times; following CAA encouragement, it had introduced off-peak discounts in the hope of attracting airlines to use the airport at the times when capacity was under-used. We put it to Manchester that possibly the investment in R2 had

generated too much capacity; Manchester replied that it had started planning R2 12 years ago with the support of all its users. The case for such capacity had been argued extensively, with airline support, at the public inquiry for R2, and had been accepted, not only by the inquiry inspector, but also by the Secretary of State.

Competitiveness and market power

11.14. Manchester argued that high market share was not necessarily equivalent to market power which, it said, was the ability persistently to raise prices above competitive levels, which it could not do. It said that it disagreed with the analysis of the CAA, which had claimed that Manchester Airport had substantial market power. Manchester put forward the following arguments:

- (a) Manchester accepted that it did have a considerable market share of the passenger traffic arising in the North-West region, but said that this was not the relevant geographic market. Furthermore, the CAA's subdivisions of the product market were not correct; charter services competed with low-cost scheduled services and the low-cost scheduled services competed with full-service scheduled services. Finally, Manchester Airport's first-line customers were the airlines, which exercised considerable buyer power. Passengers chose between services operated by airlines rather than between airports. Manchester argued that the issue of market power needed to be assessed under different geographic and product market definitions in terms of whether Manchester would be able to raise prices to first-line customers, ie airlines.
- (b) Manchester submitted that a key test should be whether competitive market forces were operating on Manchester Airport, nationally and internationally as well as locally. Manchester Airport had a growing role as the leading regional alternative to Heathrow for many regionally originating journeys, resulting in a significantly wider catchment area overlapping with many other airports, including those of Heathrow and Gatwick. Competitive market forces did not just apply at the North-West regional level, but at the national level; Manchester Airport had a vital role in competing with Heathrow and Gatwick to attract airlines to operate long-haul services which would otherwise be available only from the London airports. As a result, Manchester said it had a powerful incentive to keep prices to airlines 'below those charged by the London airports' and to maintain competitive service quality levels. In determining its price and quality offering, Manchester also had to have regard to competitor airports overseas which were also seeking to attract the same global airlines in terms of the allocation of routes and equipment.
- (c) Manchester went on to say that competitive pressures were particularly strong with regard to Manchester Airport's strategic role as a developing complementary hub for regional travellers, giving some relief to congestion in the South-East. To that end, the competitive position of the airport was different in respect of short-haul scheduled and charter services, as distinct from long-haul and transfer traffic. The airport met local demand, but its users were also able and willing, if there were an appropriate price differential, to use the London airports or other European hubs; this situation was not an indication of market power.
- (d) Many airports lay within Manchester Airport's catchment area. Details are given in paragraphs 7.7 to 7.30. Manchester said that the other airports within its catchment area were increasingly attracting airlines, particularly in short-haul markets, to offer the same services as Manchester Airport; there was therefore direct competition for passengers related to air fares and flight frequencies. In general, other airports in the region were not capacity constrained and could attract considerably more passengers and airlines if Manchester's prices were to become uncompetitive.
- (e) Manchester said that in any event it would challenge the view that a simple consideration of an airport's penetration of its catchment area market was the primary criterion for considering whether an airport operated in a competitive market. The key measure was the competitiveness of an airport in attracting airlines to commence or maintain services and whether the airport could profitably raise prices. Manchester stated that the fact that an airport handled the majority of passengers from a particular geographical area on a particular type of service did not mean that it was not subject to full competitive pressures from other neighbouring airports seeking to attract the airlines to operate services from them as well as or instead of from Manchester. By definition, Manchester Airport's market penetration was less and the influence of competition

greater when airlines and passengers further from its location were considered; therefore, any attempt to raise prices to all passengers would result in a significant loss of passengers from these peripheral regions, potentially making such a price rise unprofitable.

- (f) Manchester argued that it was often the case that narrow geographic market definitions would show high market shares, even in the most competitive markets. If competition resulted in identical price and service offerings by all suppliers of a product, then customers would normally choose the supplier nearest to them. Such a supplier might have a 100 per cent market share of customers living very locally, but would price competitively because of the need to attract marginal customers. Neither airports nor airlines could charge discriminatory prices based upon a passenger's location. Any attempt to raise prices to airlines offering services to very local passengers would result in prices rising to marginal passengers from further afield, who would face attractive alternative offers from airlines operating from competing airports. A rise in Manchester's prices would give rise to a loss of business, to such an extent that the price rise would not be profitable.
- (g) In addition, Manchester argued that airlines had significant buyer power or 'countervailing power'.
- (h) Fundamentally, Manchester's objective was to develop the network of services at Manchester Airport to meet the needs of passengers and business within its wider catchment area, with specific reference to relieving the burden of regional travellers on the London system in line with government policy. For new destinations, Manchester Airport was often competing primarily with London to attract airlines to commence services which would be new to the regions overall. Whilst all market segments were important, competition for new long- and short-haul scheduled services was particularly critical. In line with its objectives to develop its range of services for the benefit of the region, consistent with national airports policy, Manchester regarded passengers and the wider community as fundamental components of its customer base. It could only achieve the objective of broadening the range of services available to regional travellers if it could attract airlines to initiate services; it was at this level that competition with other airports was most intense.
- (i) Manchester said that the key 'product market' of an airport could be defined as the supply of infrastructure and services to airlines and tour operators wishing to serve the passenger market. In respect of this core product market, Manchester argued that price competition was real and that Manchester Airport had to respond to this price competition if it were to achieve its core objective of enhancing the range of air services offered to regional consumers. This price competition was very much a result of the increasingly liberal air service regime in Europe and beyond, which allowed airlines to commence services where and when they wished. Manchester supported liberalization as essential to allowing airlines to develop services to meet regional needs. However, the implications of liberal frameworks on airport competition needed to be taken into account fully in assessing the appropriateness of regulatory frameworks put in place prior to liberalization in Europe and elsewhere taking hold from the early 1990s.
- (j) Manchester said that whereas previously airlines, particularly those offering scheduled services, would have had limited options in terms of where they could operate, governed by bilateral air service agreements, airlines were now free to choose in most markets. Airlines and tour operators had many route development options open to them. They did not simply consider service to a single city or catchment area, but evaluated whether there was sufficient demand within the catchment area of any airport to make a service viable, having regard to competing services offered. Airlines were constantly re-evaluating the performance of their route network. For example, as stated in paragraph 7.19, in 2000 Manchester Airport saw services lost by Delta Airways to New York, as the airline's membership of the SkyTeam alliance led by Air France resulted in a refocusing on routes to Paris, and frequencies reduced to Amsterdam, Geneva and Madrid. In the case of Geneva and Madrid, services were lost as a direct result of competition from easyJet at Liverpool on the same routes. Manchester Airport could not regard its existing customers or routes as captive.
- (k) Manchester submitted that it was no longer relevant to define a geographical monopoly by saying that if an airline wished to serve Manchester, it had no choice but to use Manchester Airport. The airline could serve that market from a neighbouring airport or it might choose not to serve the

market at all, preferring another more profitable opportunity. Manchester Airport did serve its local market but, based upon the density of local demand, it had been able to support services not previously available from other neighbouring regional airports. However, as the market overall had grown, more airports were able to attract airlines to those same destinations and thus compete directly with Manchester Airport.

- (l) As to short-haul scheduled and charter services, Manchester Airport's competitors were largely its neighbouring airports which had local markets able to sustain and support such services. Even within the North-West and the Yorkshire and Humber region, Manchester Airport's market share, allowing for those passengers transferring between flights at Heathrow and Gatwick, was less than 64 per cent, with 11 per cent of passengers still using Heathrow and Gatwick to connect to short-haul flights. Liverpool's share of north-west traffic had been nearly 15 per cent in 1999; the impact would have been greater in 2000. Levels of competition were greater still in Yorkshire and the Humber region, with Leeds Bradford handling 27 per cent of passengers. In Cumbria, there was competition from Newcastle and the Scottish airports. To the south, competition from Birmingham was intense.
- (m) Manchester said that even some of its short-haul traffic was in effect secured in the face of competition from Heathrow and Gatwick.
- (n) At an initial stage in the inquiry, Manchester said that in respect of competition from local airports, as a regulated airport it was restricted in its ability to differentiate its tariffs to encourage airlines with high growth prospects to use Manchester rather than other regional airports. Manchester said that neighbouring regional airports did not operate under such regulatory restraints and offered individual discount packages to airlines designed to attract them to base aircraft and operate services from those neighbouring airports in preference to Manchester. For scheduled carriers, deals offered by neighbouring airports comprised long-term rebates or discounted charges for all services, whether to new destinations or not. Neighbouring airports often charged below cost and offered heavy, and sometimes long-term, discounts to the published charges but, in the absence of regulation, were free to pass on the burden of cost to other users. This illustrated the aggressive price competition affecting this element of the market in which Manchester Airport operated.
- (o) For long-haul scheduled services, Manchester Airport experienced substantial competition from Heathrow and Gatwick, with 53 per cent of passengers in the core of Manchester Airport's catchment area still using the London airports. That analysis excluded the sizeable number of passengers who travelled from regional airports via European hubs, particularly Amsterdam. A key strategic objective of Manchester Airport was to claw these passengers back to direct regional services.
- (p) Manchester said that the lower charges at the London airports, in part secured through regulation, created their own competitive pressures on Manchester Airport's pricing. Manchester Airport operated in competition with the London airports to attract additional frequency or aircraft resources. For example, Continental Airlines had decided in 2001 to start flying to Stansted rather than start a second daily flight to Manchester. Airlines were often captive to serving the London market, but did not have the same level of commitment to retaining service to Manchester; consequently Manchester's business had a higher risk profile than the London airports.
- (q) As to the charter market, Manchester said that charter airlines were highly price sensitive; they were also subject to competition from low-cost scheduled airlines, particularly the easyJet operation at Liverpool.
- (r) Manchester said that competition with other modes of transport was relevant in respect of domestic air travel. Manchester Airport would be faced with increased competition from the upgraded West Coast mainline from about 2007 when work was complete. The last upgrading of the line, in the 1960s, had led to a marked reduction in the traffic to Heathrow.
- (s) In the light of its analysis on competition, Manchester asserted that Manchester Airport operated in a competitive environment such that Manchester continued to question the need for full regulatory scrutiny of its activity.

11.15. Manchester said, in response to questions from us about competitiveness, that the airport's growth rate had been below the national average for regional airports and therefore it clearly needed to be more competitive. It added that airlines were not necessarily attracted only by airport charges; route profitability was the most important driver.

11.16. We asked Manchester further about the CAA's requirements for it to take account of discounts for the purposes of economic regulation. Manchester said that it was required by the CAA to ignore unpublished discounts, but not published discounts, for the purposes of calculating the price cap.¹ Manchester stated that it could offset published discounts against charges under the regulatory rules because the published discounts were available to all users. As for unpublished discounts, Manchester said that these were treated as a cost and were therefore not netted off and were commercially sensitive.

11.17. Manchester told us that profitability was an important driver of its strategy, and said that it did not agree with the CAA view that it was not a profit maximizer. Manchester intended to grow its business by working with the airlines and appreciated what standards they expected within a competitive environment. Manchester was making joint plans with airlines, such as BA, on, for example, marketing.

11.18. We asked Manchester whether, when developing its strategy, it specifically took account of its objective to contribute to the development of the North-West. Manchester said that it believed the profitable growth of the airport would bring automatic benefits to the North-West since the owners of the airport were the local authorities of Greater Manchester.

11.19. We asked Manchester about its acquisitions of other airports and synergies that could be achieved. Manchester said that the synergies would be mostly on the cost side. Administrative functions could be provided more cost effectively through a Group structure, for example in purchasing and certain head office functions such as government lobbying.

11.20. We put it to Manchester that some concerns had been expressed that revenues from Manchester Airport might be used to cross-subsidize activities at the other three airports (Humberside, Bournemouth and East Midlands) owned by MAG. Manchester said that there was no element of cross-subsidy between Manchester and the other airports. A separate 'ring-fenced' financing structure had been used for the acquisitions.

11.21. We asked what the position would be if the other three airports were running unprofitably. Manchester responded that MAG plans envisaged the other three airports managing within their own resources. However, that issue would be for MAG rather than MA to tackle. Manchester added that BAA, which owned Southampton and the Scottish airports, was essentially in the same position.

11.22. We asked about Manchester's attitude to the application by Finningley Airport to develop as a commercial airport, which had been the subject of a public inquiry. Manchester said that objections had been made by East Midlands and Humberside Airports, which were within MAG, because those airports were concerned about the impact of the possible development of Finningley.

11.23. We asked Manchester how it saw its involvement in other regional airports evolving over the next few years. Manchester said that it would take an interest in other airports if they became available and if they added value to the business.

Performance since the last review

11.24. Manchester summarized performance since the last review. Comparisons were made with predictions at the time of the last review. The main points were:

- (a) The last review, in 1997, forecast growth in passengers of 22.6 per cent; in fact the increase was 19.93 per cent. Passengers in 2001/02 numbered 19.07 million, as compared with a forecast of 19.4 million.

¹The CAA conditions on the economic regulation of Manchester Airport, 1998–2003, CAP 679, Appendix 4, define 'average revenue yield per passenger' as the revenue from airport charges levied in the relevant year, before any deduction of unpublished discounts or payments under SLAs, divided by the total number of passengers using Manchester Airport in that year. This definition was amended on 16 March 2000 to '... the revenue from airport charges levied in respect of relevant air services in the relevant year ...' and 'relevant air services' were defined as 'air services carrying passengers that join or leave an aircraft at MA, including air services operated for the purpose of business or general aviation' (CAA Official Record Series 6 Part 2, No 123).

- (b) Although Manchester Airport had achieved passenger volumes close to those forecast, its rate of growth had been only 4.6 per cent a year, one of the lowest in the UK. Over the quinquennium, Liverpool Airport had grown by 28.4 per cent a year and regional airports had grown by 6.4 per cent.
- (c) Manchester Airport had lost market share in all its major market segments. In the charter sector, its share had decreased by 1.2 percentage points to 20.5 per cent. This had been driven by tour operators developing regional markets and competitor airports offering aggressive prices and discounts.
- (d) In scheduled domestic traffic, excluding traffic to or from London, market share had fallen by 0.8 percentage points. In the international scheduled market, market share loss equated to 1.6 percentage points.
- (e) Manchester Airport was facing increasing competition to attract new airline services, particularly as a result of the development of the low-cost market.

Financial performance over the quinquennium

11.25. MA summarized its financial performance over the last quinquennium.¹ Further details are set out in paragraphs 4.17 and 4.18. The key income variances to which MA drew our attention were:

- (a) Operational income from its aeronautical activities had increased by £21.9 million; the majority of this increase, £17.5 million, was related to passenger volumes. The remainder represented income received on non-passenger-carrying aircraft.
- (b) Car-parking income had increased by £14.9 million due to a combination of price rises in excess of inflation in certain charge bands, coupled with the introduction of block car parking which had resulted in a greater utilization of existing car-parking assets. Car parking is discussed in detail in paragraphs 7.95 to 7.115.
- (c) Concessions income showed a reduction of £18.6 million. This reduction was a result of two factors. First, the losses experienced as a result of the abolition of intra-EC duty-free sales in 1999 were greater than allowed for at the time of the last review. Second, Manchester said that the airport had experienced the same pressure on prices as those experienced in high street retailing; consumers had been more reluctant to spend. Those factors had resulted in the average spend per passenger falling by £0.35 from £3.04 in the 1997 MMC forecast to £2.69.
- (d) Employee costs showed an increase of £23.3 million or 10.5 per cent above that forecast.² Some of this was attributable to essential staff increases associated with R2, and replacement of contractors with employees, but the majority was attributable to implementation of a Government Directive to double the level of hand-baggage searches, which had resulted in the need to employ additional security staff.
- (e) Supplies and services had increased by £49.7 million. A number of areas accounted for the increase, the largest of which was £30 million attributable to leasing costs. Manchester told us that it had pursued a policy of leasing equipment in T3 in preference to capital expenditure; see paragraph 6.47. Hire of services had increased by £13.1 million, partly as a result of the outsourcing of IT functions. Insurance costs were only 1.21 per cent below the MMC 1997 forecast, but would significantly rise for the fourth quinquennium as a result of the consequences within the insurance market of the events of 11 September 2001.

11.26. We asked Manchester for more detail about its statement that the airport had experienced greater than expected competition from high street retailing and in particular which type of retailing had

¹Manchester said that it had assessed performance over the quinquennium taking the period 1998/99 to 2001/02. The comparison had been made by taking the figures used in the financial model submitted during the 1997 review and comparing these against actual results. Figures had been restated to 2001/02 prices. Indices had been taken from the RPI provided by the Office for National Statistics using the September figure for each year.

²This was the statement made by Manchester in its initial submission on the basis set out in the footnote to paragraph 11.25. Later analyses of employee costs are to be found in Chapter 6.

suffered. Manchester responded that the 1997 review had indicated that retailing performance should improve by RPI+2 and that projection had been assumed in the modelling. In fact Manchester had not been able to get anywhere near that sort of income increase because high street prices had not increased over the quinquennium. All sectors in retailing had been affected in this way.

Regulatory questions

Single or dual till

11.27. Manchester's submission about the single or dual till is reproduced at Appendix 11.1. Manchester made the following points:

- (a) Manchester summarized the case in favour of the dual till by saying that the dual till would end the enforced cross-subsidization of airport charges by commercial income; provide a direct incentive to invest in aeronautical facilities; encourage economically efficient provision and pricing of airport assets; minimize regulatory involvement; meet better the CAA's statutory obligations; and, because it would allow pricing below the cap, would enable Manchester to demonstrate that regulation was no longer needed.
- (b) Manchester objected strongly to the implication within the single till regime that all commercial profits above the cost of capital were appropriated to the airlines; that entailed distortions in terms of investment and the timing of developments and gave opportunities for 'gaming' by the airlines.
- (c) Manchester strongly held the view that designated airports subject to increasing competition should be given every incentive to invest on their own account. The most likely consequence of moving to a dual till would be that the airlines would benefit, Manchester said, 'from a slightly smaller share of a much bigger cake'. The airlines were objecting to the ending of the single till because they wanted to be able to benefit from 'a much bigger slice of the same sized cake (at least the cake would not grow to the same extent that a move to a dual till would entail)'.
- (d) Manchester said that it did not agree with our statement of current thinking, issued in July 2002, indicating that we were minded not to recommend the dual till. Manchester stated that in its view the reasons put forward in that statement were totally inadequate and did not amount to anything like a proper consideration of the CAA's original proposals.
- (e) With regard to the change in the ICAO guidelines (see paragraphs 3.26 to 3.29 and Appendix 3.2), Manchester stated, first, that these guidelines were not formal stipulations binding on national governments, nor a prescription on how regulatory systems should be operated. Second, the guidelines recognized that flexibility was the key. Some middle ground, perhaps allowing some but not all commercial income to be taken into account, was an option (this was in use at a number of European airports). Manchester stated that the CC consideration of the till debate needed to address this option properly. The CAA's RRCB option was really a variant of the dual till and was perhaps the first step along the road to a middle ground.
- (f) Manchester said that the single till provided no incentive to invest to increase passenger numbers. In the past, it had never been able to overperform in terms of commercial investment. A dual till would give clear incentives to get the balance right between commercial and aeronautical investments, and would be the most efficient means of encouraging investments that would increase air traffic.
- (g) Under a dual-till regime, the regulator would draw back from regulation in a large number of areas, for example retail development.
- (h) Changes in airport charges were not necessarily reflected in passenger fares. The approaches of individual airlines to setting fares differed greatly depending on the dynamics of their markets. Also, the proportion of cost represented by airport charges varied depending on the type of flight. That said, it was possible that off-peak discounts might ultimately have an effect on passenger volumes.

11.28. In other submissions, and at hearings, Manchester made further points:

- (a) It contended that it operated in an intensely competitive environment, and that the continuation of the single till and imposition of tight pricing control would be unnecessary and would distort decision-making.
- (b) However, Manchester contended that, if the dual till were to be adopted, surface access should be included in the aeronautical till, contrary to the CAA's proposals. The reason for Manchester's stance was that, in creating a scenario whereby planning permission for R2 would be granted, Manchester had made a number of agreements with Cheshire County Council and other local authorities under section 106 of the Town and Country Planning Act. These agreements included a commitment to public transport investment. Manchester drew an analogy with the CAA's proposals for Heathrow, where the CAA had taken the line that, if access projects were a direct condition of planning permission, as was the case with the Heathrow Express and Piccadilly Line tube extensions, then those projects might be included in the aeronautical till. Manchester drew the conclusion that projects such as the GTI should also be included in the aeronautical till, because to exclude them would effectively penalize Manchester for taking such initiatives.
- (c) Manchester acknowledged that the price cap that would be produced under the dual-till regime would invariably be higher than the price cap that would be produced under a single-till basis, pointing out that the CAA had proposed a transitional arrangement which smoothed the price path. However, the smoothed price cap would be only of theoretical importance as in reality prices would be determined by the marketplace and by competition and would be substantially lower. Price caps ought to allow the airport to demonstrate through pricing the degree of competition to which it was subject; a tightly binding price cap would not allow Manchester Airport the opportunity to do this and would appear to be continuing regulation for its own sake.

11.29. We asked Manchester how it reacted to the views of the airlines, which all disagreed with the CAA contention that the reasonable interests of users did not extend to an automatic claim on locational rents. Manchester acknowledged that it had found some of the CAA's argumentation hard to apply in the Manchester context. The rationale for moving to the dual till at Manchester appeared to be one of principle rather than an argument about whether that would be right at a particular time. Manchester's view was that if the RRCB were introduced at the BAA airports, it would be perverse not to introduce it at Manchester. That perversity would lie in the incentive given to Manchester to become congested in order that it might qualify for the RRCB.

11.30. Manchester said that the practical issue raised by the RRCB was very important to it, and that it was a down-to-earth reason rather than an economic issue. The RRCB brought an enormously helpful discipline with it in terms of clarity of decision-making about capital investment and isolating the capital investment that was entirely related to the development of aeronautical facilities, with the result that the airport would be clear what it was developing in terms of aeronautical facilities and for what it was charging. That clarity was not found under the single-till approach.

11.31. Manchester said that the single-till regime was inherently unbalanced because it did not allow for any return on aeronautical investment and relied entirely on commercial revenues for profitability. Within any quinquennium, under the single till, there was likely to be a distortion because the system encouraged short-term investment decisions focused on commercial revenues where a return on investment would be likely to be realized relatively quickly.

11.32. We asked Manchester why the airlines should not get some benefit from the commercial revenue, which they effectively brought into the airport, through passengers. It said that that argument was analogous to saying that a train operating company should get revenue from railway stations or taxi drivers should get some revenue from the cinemas or hotels to which they were taking people. In Manchester's view, the framework of the provision of the infrastructure, namely the aeronautical facilities, needed to be clearly set out in cost terms so that the user appreciated the cost without distortions. The introduction of the RRCB would remove many uncertainties, and would assist consultation on capital expenditure. Under the current system, landing charges could fall even if the costs of providing the aeronautical facilities had risen. That situation was unsustainable in the longer term.

11.33. We asked Manchester if it could give examples of any investments that it had not been able to make under the single-till regime. It said that it could not give such examples but it considered that air-

ports would need encouragement to make appropriate investment in the future. It said that the question should not be whether or not it had invested adequately, but whether the regulatory regime had provided incentives for, or perverse incentives against, efficient investment. In Manchester's view, such issues were relevant irrespective of the position in the investment cycle; otherwise regulation became opportunistic and second rate.

11.34. We asked Manchester if, in its view, there would be problems in splitting the aeronautical and commercial assets, on which we understood it had been working with the CAA. Manchester said that it did not think there would be problems. The splitting of the assets had largely been agreed and in future that split would simply need to be kept up to date.

11.35. We asked Manchester why it considered that it could not price according to the competition it faced if the price cap was tightly binding. Manchester responded that it was its intention to price in accordance with what it thought the market required. If a tight price cap were imposed, Manchester would never be in a position to demonstrate that its behaviour had been driven by factors other than the cap.

11.36. Manchester said that it had received from IATA last year an Eagle award for the provision of information, and for making costs transparent. This was the approach which it wished to encourage further through the dual till. Currently, it was making a negative rate of return on aeronautical activities. The CAA proposals did not imply large increases in prices but would allow for a return on investment in aviation infrastructure of just over 2 per cent after five years. Manchester reiterated that it needed to push its prices down and it did not need a tighter price cap in order to make that happen. Ideally, it would like to be de-designated.

11.37. Manchester said that the CAA in proposing light-handed regulation had drawn attention to the existence of the CA98, and had suggested that competitive concerns about the commercial activities at Manchester could be addressed under that Act. Manchester agreed with the CAA (see also paragraph 11.89). In Manchester's view, the correct approach was to concentrate on the regulation of the aeronautical activities and allow competition law to deal with any other monopoly concerns. We asked Manchester to amplify its case to us that the dual till would encourage it to run its aeronautical activities in a profit-maximizing way. Manchester responded that, under the single till, it considered that investment decisions had the potential to be distorted. Currently, airlines tended to complain that commercial investment was prioritized over aeronautical investment in terms of space. Manchester said that it was talking about principles; in practical terms, because it was a well-invested airport, it was difficult to give examples of cases where the single till had inhibited investment.

11.38. We discussed with Manchester the profitability of its commercial activities, and whether it would be possible to predict the likely effect of a dual till on these. Manchester said that most profits were made from retailing, catering and car parking. The pattern was not the same at airports which were used by low-cost carriers; at East Midlands and Liverpool, car parking was the activity which generated the most profit. Passengers using low-cost carriers appeared not to spend much at the airport. Manchester was constantly reviewing the allocation of space at the airport and benchmarking with activity in city centres and out-of-town shopping centres. It said that it was relatively difficult for it to make a success of specialist retailing compared with, for example, Gatwick. Generally, Manchester required retailers' prices to be comparable with high street prices. Returns on commercial activities had exceeded the average cost of capital overall, but this was only to be expected under the single till.

11.39. We put it to Manchester that arguably the dual till might have the effect of leading to an increase in the market power of the airport's commercial activities. Manchester responded that if that were the case, the same conclusion should be drawn about all airports. It said that it did not dissent from the CAA view that if there were concerns in this regard, the CA98 could provide a remedy (see also paragraph 11.89). It added that it did not consider that passengers or others were losing out; there had been no complaints, and passengers appeared to exercise choice whether to protection from possible monopoly abuse of commercial activities.

11.40. We asked Manchester particularly about choice for car parking. More detail is in paragraphs 7.95 to 7.115. Manchester said that it had about 30 per cent of the market for long-stay car parking. As to short-stay car parking, passengers could choose to come by taxi or train.

11.41. We asked Manchester for further details of its view on the effect of a dual till on airline charges and passenger fares. It said that the current CAA proposals using a dual-till approach would amount in effect to a freezing of the airport's price cap; in practice, it hoped to reduce its charges. It was difficult to say what the relationship was between airport charges and passenger fares. The low-cost carriers contended that the level of airport charges had a strong effect on fares but the effect was doubtful in other areas. If Manchester succeeded in developing the market so that volumes of traffic increased, that in itself would make a difference to passenger fares.

11.42. We asked Manchester whether, if a dual till were to come about, there would be a fundamental change in its relationship with the airlines. Manchester said that in its view, once the allocation of assets had been established, it should not be difficult to maintain discussions with the airlines about the continuing allocation of assets, although there might be difficulties at first. Manchester hoped that if the airlines saw benefits arising to them out of higher returns on commercial investment together with reductions in charges, then they were likely to be willing to understand Manchester's investment priorities and framework for regulation. Manchester hoped to reduce charges by 5 per cent a year on average in real terms and was working hard to develop a partnership approach with the airlines. Furthermore, the CAA would in effect act as the regulatory arbitrator if there were disputes about the boundaries of the two tills.

11.43. We asked Manchester further about the treatment of surface access costs under a hypothetical dual till. It said that although the GTI was not built as a result of a condition of specific planning permission to build R2, Manchester had to comply with legally-binding agreements with neighbouring local authorities under sections 106 and 278 of the Town and Country Planning Act; these required that surface access and roads to the airport would be improved (see paragraphs 8.45 to 8.47). Manchester considered that surface access costs should be treated as if they were a condition of planning permission and included in the aeronautical till; it rejected the CAA view that public transport was not a matter for the aviation industry to fund. Manchester was investing some £54 million in the GTI and considered the GTI as integral to the operations of the airport. Manchester said that the CAA's attitude appeared to discourage airports from taking a proactive approach towards securing planning permission for major projects, and was at odds with current Government thinking on this subject.

11.44. In summing up its position on the dual till, Manchester reiterated that it was supporting the dual till as a point of principle, not a point of difference of what would happen in application. It was working very hard to reduce its costs. The dual till would allow Manchester to demonstrate to the airlines that serious restructuring of the business was necessary; otherwise, the airlines might be suspicious that Manchester was acting under regulatory pressure. Although Manchester had given no evidence that the dual till would make any substantive difference in the way in which it would price relative to what might happen under a single till, Manchester considered that it had given every evidence of its intention to be much more appropriate in its pricing and its desire, in five years' time, to be able to make a very clear case not to be regulated at all.

Service quality

11.45. MA initially stated that, on service quality, it agreed with the CAA's proposals. These are set out in paragraphs 10.23 to 10.28 and service quality is discussed in paragraphs 5.122 to 5.138. In answer to questions from us at an early stage in the inquiry, Manchester made the following points:

- (a) Manchester had told the CAA that the system of 'best endeavours' SLAs had been patchy in its effectiveness. See paragraph 11.84. It said that it had had a number of SLAs drawn up but they were in effect gathering dust.
- (b) We asked Manchester if it would be supportive of airlines which wished to contract for facilities additional to the services in an SLA; Manchester said that it had no objection to this, and some arrangements of this type already existed—for example, bmi had arranged to have its own dedicated lounge, for which it paid a separate and additional charge.
- (c) We asked Manchester for its views on the possibility of a Q term in the price cap, although that had not been suggested by the CAA. Manchester said that it was not necessary to include a Q term in the price cap. It had indicated its willingness to enter into legally binding agreements on service quality with its customers. The issue of quality was best resolved by getting the contents

of the agreements right. Many agencies were involved with processes at an airport, and failures needed to be tackled collectively. Manchester published a great deal of performance information and reported every month to the AOC on performance in a number of key areas.

- (d) We asked Manchester what it meant by saying that SLAs would be legally binding. Manchester replied that it could be legally bound to investigate each service delivery failure; to report to the AOC what the causes of the failure were; and agree with the AOC a corrective action plan which it would be bound to carry out within a reasonable period. If Manchester failed to meet its obligations, then the issue would need to be settled in court. At an early hearing, Manchester added that it had reservations about a system incorporating financial penalties, though it thought this was a weapon of last resort, because it introduced the possibility of gaming into the regulation of quality between the airport and the airlines.
- (e) We asked Manchester about the consequences for its terms and conditions, because its fees and charges booklet contained some fairly wide-ranging exclusions of liability for non-performance. It said that it would need to review this in consultation with the airlines, and in the light of legally binding SLAs. See further paragraphs 11.84 to 11.88 on progress on quality standards during the inquiry.

The S factor

11.46. Manchester disagreed with the CAA's proposal to drop the S factor. It submitted that the proposal to drop the S factor was inappropriate and difficult to understand at a time when aviation security was exceptionally high on the agenda of governments, the travelling public, airport operators and airlines. The critical issue for the aviation industry, and for the CAA, in the light of the events of 11 September, was how to achieve regulatory stability.

11.47. If the S factor were to be removed as the CAA proposed, the risk associated with aviation security requirements, which were imposed by the Government, would be effectively transferred from airlines to airports. As a result the CAA might be in the perverse position of using regulation to encourage airport operators to focus more upon keeping down the costs of unforeseen security requirements rather than satisfying the requirements in full, because airport operators would be required to bear those costs alone.

11.48. In addition, Manchester submitted that the CAA, by seeking to transfer the risk from airlines to airports of enhanced aviation security costs, were ignoring the fundamental issue that aviation security activities at airports were in large measure carried out to prevent aircraft being attacked used in attacks from the air. Manchester said that it believed, in common with the European Commission, that the costs of enhanced aviation security measures, including those introduced in the wake of the 11 September attacks, should actually be met by the state. Manchester said that while there appeared to be little likelihood that the UK Government would accept that view, at the very least the arrangements currently in place should continue, as a way of sharing the burden within the aviation industry.

11.49. We asked Manchester about a proposal, by some airlines, to allow only 75 per cent of additional security requirements to be passed through to the airlines. Manchester said that it did not understand the logic of that suggestion. Additional security costs largely consisted of costs for equipment and Manchester did not see how it could be more efficient if it were permitted to recover only 75 per cent of the cost of the equipment. There were few choices in selecting the correct equipment and the competitive tender would be overseen by the airlines; it was not credible to suggest that Manchester would be further incentivized if it could only recover 75 per cent rather than 95 per cent. Most of the security measures required were not under Manchester's control.

Price discounts

11.50. We discussed with Manchester the published discounts off aeronautical charges. Manchester also gives unpublished marketing support to certain airlines through its sales development fund; this is discussed in paragraphs 11.54 to 11.65. Details of the published discounts are given in paragraphs 7.39 to 7.47; views are summarized here. With regard to the off-peak discounts which had been introduced in April 2002, Manchester said that this was uncharted territory across the industry, and it would be as well

to take a cautious approach on the value of the scheme; it would take some time for the results to emerge with clarity, as the CAA was predicting. Manchester said that it thought there was a strong possibility in the course of time that airlines would come in with new traffic in the off-peak periods in order to establish themselves.

11.51. We raised with Manchester the question of whether differential pricing to airlines might be discriminatory in its effects, and asked Manchester for its comments on the proposition that discounts should be transparent; should treat airlines in the same way on the same route or at the same time of day; and that discounts which could not be objectively justified might be against the public interest. Manchester responded that it needed to be able to offer discounts to grow its business and compete with other airports. The need to meet competition was just as important in justifying discounts as were differences in variable costs. If price discrimination were ever suspected of being used in a fashion which might be unfairly competitive, the issue could be considered under section 41 of the Airports Act and under the CA98.

11.52. In further discussion towards the end of the inquiry, Manchester told us that its future policy would be driven by assisting airlines that had possibly wanted to withdraw from Manchester Airport and also by encouraging new routes and the inclusive tour and charter market. In the short term, different airlines had different needs. In the long term, Manchester's objective was that all customers could avail themselves of the same framework, whether the discounts were published or unpublished. Manchester said that key accounts needed to be managed and it had to work in partnership with airlines. Airlines had different needs at different stages; an airline trying to set up on a new route was in a different position from an airline that was trying to grow existing business. BA, for example, was substituting smaller planes for larger planes but was likely to increase flight frequencies. Manchester said that its ability to tailor prices was clearly conditioned by the need for equity in terms of common use of common facilities and obviously by the boundaries of competition law.

11.53. Manchester added that it was intending to move into consultation with the airlines on the subject of individual pricing over the next few months, with a view to publishing the results. It would approach this exercise in the context of seeing how the airlines would respond to an extension of the off-peak pricing initiative. It also wanted to explore the possibility of differential pricing according to whether airbridges were used or whether passengers were taken by coaches to parked aircraft. Manchester added that off-peak pricing was largely cost-related.

Sales development support

11.54. We discussed with Manchester the rationale for its sales development support. This subject is covered in paragraphs 7.48 to 7.54; the main points made by Manchester at a hearing are summarized briefly as follows:

- (a) Sales development support was an industry-wide practice. All airports, with the possible exceptions of Heathrow and Gatwick, did this to a greater or lesser degree. Some of Manchester's non-designated competitors did it on a very large scale indeed and for substantial periods of time; for example, Birmingham Airport had recently announced free flying for five years for new routes. Manchester's designated status did not confer on it any favours with its customers, nor should it confer any disbenefits. Manchester needed to be able to compete without its hands tied behind its back, and to do that it needed a realistic sales development budget.
- (b) Manchester said that if the CC decided to take a different approach to that which had been previously agreed in Q3, or change the quantum of the sales development fund, then clearly that would have an adverse impact on traffic forecasts. It would also increase the business risk since Manchester would be working within a framework in which it would have great difficulty in evaluating the impact of not being able to support development. Indeed, Manchester would be the only airport that would be unable to operate in a flexible way in that regard.
- (c) Manchester said that both the CAA and the OFT recognized that it was economically efficient for enterprises where there were large fixed costs and low marginal costs to charge different prices. Those practices were usual and legitimate in commercial practices and were not in any way an abuse. Over the coming quinquennium, Manchester anticipated that more and more airlines would seek some kind of support with the introduction of new services. Historically, the original requests for support of this kind had come from inclusive tour operators who wanted, for

example, to launch a service to Florida. It was now commonplace for low-cost carriers in particular to invite airports to bid for their business. The sales development fund of £6 million was basically intended to offer support in this type of situation. There was also an additional fund, projected to grow to £9.9 million by 2006/07, which was intended as a proxy for market conditions, and which could be used when there was likely to be a need for a general reduction in fees and charges beyond the RPI-5 assumed in Manchester's business plan.

- (d) Manchester was in the process of moving more and more towards having all its discounts published or a much larger number of them, but it faced the difficulty that the airline market was very fragmented and it needed an incentive budget which would enable it to act with flexibility and alacrity to emerging opportunities; it had lost market share in the charter sector in recent years, despite having targeted discounts on charter operators.
- (e) Manchester said that the revenues per passenger at airports such as Luton and Liverpool differed very widely from what the airports would receive if they were to charge their published tariffs. Only an airport's management knew how best to focus incentives to specific competitive threats; it should not be prevented from exercising this discretion.
- (f) Manchester added that, as far as it was aware, there was no evidence that, in supporting airlines in the way discussed, it had caused any harm to any airport or any other airlines by these activities, and it had no doubt that passengers had benefited enormously from the additional range of services that existed at Manchester Airport now simply because Manchester had made use of the sales development fund in the past. Sales incentives had not been disallowed in principle by the MMC in 1997; it would be inconsistent to do so now.
- (g) Broadly, Manchester planned to use £6 million a year over the quinquennium to encourage new business and some £9.8 million to respond to competitive threats in the market. We asked it what would be the effect on its passenger forecasts if we were to take into account for the purpose of setting the price cap only £6 million allowable expenditure per year. MA replied that, if that were to happen, its previous passenger forecasts would no longer be valid. In the light of the fact that all airports now routinely offered airlines incentives of the type being discussed, Manchester submitted that the quantum of money allowed by the MMC in the past was not appropriate going forward. Manchester gave us examples of airlines which had indicated that they intended to withdraw services from the airport but changed their minds when offered sales development support. Compared with conditions in 1997 when the MMC decided to disallow marketing support, Manchester said that the market was now much more volatile and much less easy to forecast. The market had been affected by the rise of the low-cost carriers; by the events of 11 September; and by the pressure of the USA wanting to become involved in the Middle East again. In the circumstances, Manchester needed to be able to offer more help than would otherwise be the case to attract airlines. In 1997, MA had forecast that, without the sales development fund, its traffic would be 2.8 per cent lower than it would have been; this time, the impact would be in the order of 250,000 to 280,000 passengers per year. Additionally, if there were no sales development fund, Manchester would not be able to offer help to the tour operators, who were the real drivers of passenger volumes.
- (h) Furthermore, given the difficult situation of BA, which was Manchester's biggest customer, the emphasis now had to be on protecting the existing carriers and the existing base at the airport. Despite growth in other areas, Manchester was still very dependent on BA for a core area of its business. Manchester needed to have a defensive strategy in a way which had not been necessary five years ago, as well as growing its business. It would be very damaging for Manchester Airport to lose traffic because of the fragile nature of large parts of its market.

11.55. We asked Manchester how it made judgements on the best way to offer marketing support selectively. Manchester said that it needed to judge each case on its merits. Ultimately all airlines would benefit as the business would grow stronger as a result. Discounts were all time-barred and never continued indefinitely. Furthermore, the internal business case for supporting particular airlines might depend on individual circumstances; for example, MA instanced one case where it attached weight to the incremental commercial revenues that it would earn from the passengers. In every case the additional revenue from additional passengers, or passengers not lost, exceeded the costs, although MA accepted that in a few cases this calculation depended entirely on commercial revenue. Those incremental revenues drove profitability and hence drove MA's ability to reduce charges across the board.

11.56. We asked Manchester why it did not reduce charges generally rather than offering incentives to particular airlines. Manchester replied that this would not be optimal in terms of growth. There were different degrees of elasticity between carriers. For a low-cost operator that operated on extremely low margins, the charges levied by airports were critical to their ability to grow. That was not true of full-service established airlines. We asked Manchester to what extent discounts were won by airlines which threatened to move to other airports. Manchester responded that, if it had not supported certain airlines, they would not have operated from the airport.

11.57. We put it to Manchester that, as a matter of principle, it could choose to support airlines in this way, but expenditure which had the effect of requiring some airlines to subsidize others should not, in principle, be included in the regulatory till. Manchester said that, in the short term, if marketing support were not given, then charges would be higher for all because the volume of traffic would be less than it might have been. Essentially, Manchester needed to give marketing support in order to be able to compete.

11.58. We put it to Manchester that, after the 1997 MMC report which had disallowed marketing support, Manchester had not in the event spent the money on marketing support, and we asked Manchester if that situation was likely to arise again on this occasion. Manchester replied that its judgement in the current competitive situation was that it needed to offer incentives, as discussed, in order to serve the development interests of its business, bearing in mind that its competitors were behaving in the same way. Every airport except Heathrow and Gatwick discriminated between airlines in its charges. Manchester added that possibly it had been a mistake not to spend more by way of sales development in the last quinquennium, given its loss of market share. As to the future, Manchester would be willing to refund through price reductions any money put into the till for sales development purposes which was not spent in the event.

11.59. Manchester submitted that in considering the question of marketing support, it was not right to look at the matter as if it were a question of subsidization by one airline of another. In reality, this was price discrimination of a kind that appeared to be legitimized and agreed to by the OFT, in paragraph 4.15 of the guidelines in respect of the Chapter II prohibition of abuse of a dominant position under the CA98.¹ In the OFT guidance, it was clearly stated that price discrimination was economically efficient pricing. What was critically important was that the regulator could step in if such pricing had the consequence of adverse economic effects on an airport or on airlines. As to allegations that some airlines were subsidizing others, these had to be considered against the facts, first, that some routes might not have been served without marketing support to an airlines; and second, that airlines not benefiting from one type of discount might benefit from another type of discount. Manchester gave us information about which airlines benefited from which discounts, and this is discussed in Appendix 7.5.

11.60. Manchester submitted that there was no evidence that the discounting deals resulted in any detrimental effect on airlines or passengers. It also said that, in 1997, the MMC had considered that some £6 million expenditure on sales development was well founded; if the CC was proposing now to adopt the principle that no sales development should be allowed, that would seem inconsistent from a regulatory point of view.

11.61. Manchester said that because its business had high fixed costs, it had to target its support to airlines; otherwise it would not be adding the best value to the business. We asked Manchester about particular instances where an airline was offered marketing support in order to compete with an established airline on the same route; and whether there was any commitment to ensuring that the balance between two individual airlines was not affected by such a deal. Manchester responded that it was keen to minimize any anti-competitive practice and it was for that reason that it had discontinued after a short time, following airline representations, the Millennium Discount Scheme (see paragraphs 7.45 and 7.46). Manchester added that airlines operating on the same route might require different treatment—for example, an inclusive tour and charter operator would need to be treated differently from a no-frills scheduled airline. Manchester added that incentives or support to airlines could take many different forms—for example, T3 at Manchester Airport had been built largely for BA's benefit.

¹Paragraph 4.15 of the OFT guidelines on the Chapter II prohibition reads: 'Price discrimination raises complex economic issues and is not automatically an abuse. There are many areas of business where it is a usual and legitimate commercial practice. For example it might be objectively justified in industries where there are large fixed costs and low marginal costs. ... It may therefore be more efficient to set higher prices to customers with a higher willingness to pay.'

11.62. We put it to Manchester that a company which had market power had to be more cautious about price discrimination than a company which was not in that position. Manchester said that the OFT guidelines were intended to indicate to firms in a dominant position what did and did not constitute abuse.

11.63. We put it to Manchester that discriminatory pricing could have an effect on competition between airports, in that competition between Manchester Airport and others in the region might be stifled if Manchester persisted in offering very favourable deals to certain airlines. Manchester responded that it priced on the basis that it covered incremental costs as a minimum and that any deal had to be in the interests of the airport, but not predatory in any sense. Manchester said that it had failed to attract certain airlines to Manchester Airport precisely because other airports in the region had offered better deals (for example, it had not managed to attract [*✂*], which had gone to [*✂*] Airport, and [*✂*] had chosen to locate additional charter operations for the North-West at [*✂*] Airport).

11.64. Generally, Manchester said that it would not price its product below marginal cost and that it was aware of potential opportunity costs of pricing too low. It supported airlines only for short introductory periods, unlike other airports which offered 10- or 20-year deals. Support generally lasted for three to five years, after which airlines would be expected to bear their full costs. In further discussion, Manchester defended marginal cost as the contribution made by a particular route less the direct costs associated with that route; ‘contribution’ included the contribution made by passengers to the airport’s commercial revenues. In assessing the right level of support for any particular route, Manchester estimated the rate of return expected from that route over five years.

11.65. Manchester put a paper to us on the case for requiring the sales development fund in the future and this is shown at Appendix 11.2.

Level and balance of charges: regulated and non-regulated charges

11.66. We asked MA about the airlines’ contention that Manchester had in effect priced up to the cap over the last quinquennium, because it had increased non-regulated charges by the amount by which it chose not to increase regulated charges. Manchester reiterated that it had been under no obligation to make countervailing reductions in regulated charges to reflect changes in non-regulated charges. Manchester’s action had reflected its determination to keep charges down. The increase in non-regulated charges had been in all cases reflective of the cost of providing services. Manchester added that the revenues from non-regulated charges were a relatively small element in its total income streams.

11.67. We asked Manchester about its policy on car-parking charges. Manchester responded that in the case of public car-parking charges, it thought that it was not appropriate to price according to cost. Staff car parking was partly based on cost-recovery principles, for the surface car parks, but spaces for staff in multi-storey car parks were more aligned with charges that would be paid by the public using those spaces.

11.68. Manchester also said that, in the case of airbridges, it had reduced charges to the airlines even though there had been no cost justification for doing so.

11.69. We asked Manchester about its policy on unregulated charges over the next quinquennium. Manchester said that, under regulatory requirements, it was aiming to produce cost transparency statements on all its charges—see paragraphs 4.38 to 4.48. The return on the unregulated charges should in effect be the cost of capital. Manchester said that it was not expecting significant changes in the unregulated charges over the quinquennium, nor was it aiming to introduce any new unregulated charges. Manchester gave us an assurance that it was not intending to increase unregulated charges by any more than the RPI over the next quinquennium, but that if it did so or if it did bring in any new charges, it would make appropriate adjustments to regulated charges.

The structure of the charging formula

11.70. Manchester made the point to us that it did not need pressure from the price cap to reduce costs for commercial or competitive reasons. It believed that it was a profit maximizer and was operating as such. It was also held to account by its shareholders.

11.71. We put to Manchester the principle that it was reasonable to construct the RPI-X formula in such a way that it provided a fairly strong and transparent incentive to reduce costs. Manchester said that it aimed to reduce costs in any event. It drew our attention to its business plan which stated:

For the purposes of this business plan, it is assumed that regulation will not be used to inform outcomes or provide constraints on the business plan. In fact, it is a core objective that Manchester Airport should operate as if it were unregulated. The projections assume that Manchester Airport reduces aeronautical charges to market levels (rather than pricing to the regulated cap) and that operating costs will also be reduced to competitive levels.

It would never be able to prove that it would have done this in the circumstances of a tightly binding price cap. MA said that over the quinquennium it was planning to reduce staff costs by 30 per cent and controllable costs overall by 25 per cent. We discussed its plans with Manchester, and our decisions as to assumptions on operating costs for the purposes of calculating the price cap are set out in paragraph 9.52. In connection with R2 compensation claims, Manchester argued that compensation payable under the Land Compensation Act 1973 should be regarded as part of the costs of R2.

11.72. Manchester gave us details of its benchmarking against Gatwick and other airports. This is discussed in paragraphs 6.24 and 6.54.

11.73. We asked Manchester about forecasts of passenger demand. At the time that Manchester submitted evidence to us, the CAA's central scenario for the review period estimated total Q4 passenger numbers at 120.2 million, whereas Manchester's estimate was 107.2 million. The forecasts which had been produced prior to 11 September 2001 had been much closer. During the review Manchester modified its forecasts, as did the CAA; the final projections of both Manchester and the CAA are discussed in paragraphs 9.21 to 9.31. The gap in the end was widest in 2005/06 where Manchester forecast 21.2 million passengers and CAA forecast 22.9 million.

11.74. We asked Manchester if a volume term should be considered for inclusion in the charging formula. The effect of a volume term would be that if passenger numbers rose above an expected level, charges could fall, and if passenger numbers fell below what was expected, charges could rise. Manchester said that it was against the inclusion of a volume term, on the grounds that the airport might be deterred from making efforts to increase passenger throughput; and it was reluctant to raise charges simply because passenger numbers had fallen. We asked about the impact of the low-cost carriers on forecasts generally; Manchester said that they were growing the market although Manchester Airport itself hoped to grow through the inclusive tour and charter market.

11.75. We asked Manchester if it was still opposed to the tariff basket approach in setting maximum charges as distinct from the approach of revenue yield per passenger. Manchester said that that was still its view.

11.76. We asked Manchester further about its business plan and planned capital expenditure. It provided us with these and they are discussed in paragraphs 8.33 to 8.65. The most significant recent point of contention in Manchester's capital programme, which the airlines brought to our attention, was the proposal to include check-in facilities in the GTI. Manchester told us that it had now withdrawn the proposal, though the necessary space would be retained in the planning, so that the idea could be revived if circumstances were to change.

11.77. We discussed with Manchester what should be in the single till if that were our recommendation; the results are reported in paragraph 9.40. We record here the discussion on two elements of expenditure associated with the GTI. The first was the proposed connection with Manchester's Metrolink tram network. Manchester proposed to contribute to the costs involved in bringing the Metrolink network to the airport as well as equipping the GTI with the necessary infrastructure, because it saw benefits for both the airport and users in the connection being completed. The second was the GTI office block, which Manchester believed should be excluded from the till, on the grounds that this treatment would be consistent with the treatment of BAA's property subsidiary, Lynton.

Cost of capital

11.78. Manchester's submission on the cost of capital is summarized in paragraphs 4.53 to 4.78. We asked Manchester why it held different views from the CAA, using the CAPM. Manchester said that

these differences arose from the current volatility in the market overall. Recent variations in the stock market, partly related to the high-technology sector, had created a perception that the market risk was higher than it had previously been. Manchester wished to underline the risk, whereas the CAA had been arguing that the ERP had come down. Manchester argued that the RFR in the UK at present was artificially low and that the current yield curve was inverted from that which normally existed.

11.79. We asked Manchester about its debt premium—see paragraphs 4.73 to 4.76. Manchester said that its debt premium was high because it had a major amount of secured debt from the PWLB. Loans had to be routed through the shareholders and MA was not yet a recognized borrowing entity as far as the banks were concerned. Manchester argued that its embedded debt ought to be taken into account, based on the existing PWLB loans.

11.80. Manchester indicated the difficulty of creating a cost of capital based upon the beta value of BAA. Manchester argued that the value associated with BAA was affected by changes in the market such as technological stocks and by various announcements made by BAA. Manchester provided us with information on the values of beta for other European airports which could be considered to obtain a better proxy.

11.81. Manchester argued that the level of risk associated with the company was significantly greater than that of BAA. It argued that BAA enjoyed the benefits of operating a system of airports surrounding the UK's capital city, which provided a level of protection to BAA that regional airports did not enjoy. MA also argued that its capital investment had greater levels of risk associated with it, because of its need to attract demand to ensure appropriate utilization, whereas BAA in its London airports had unfulfilled demand. In commenting upon a CC paper on passenger volatility, Manchester argued that the BAA airports suffered less volatility and lower levels of risk than Manchester.

11.82. Manchester said that lowering the overall cost of capital on existing assets, particularly large projects like R2, increased the risks of airport operators being unwilling to undertake such projects in the future, when it appeared that regulators, at periodic reviews, would opportunistically seek to take away some of the returns on which the project was originally justified. Even if a lower cost of capital were justified, some form of composite which allowed a continued return on such assets at the previous level was necessary to avoid the risks of such regulatory opportunism.

Public interest issues

11.83. In its initial submission to us, Manchester made a number of points on public interest issues which had been raised with the CAA. Some of these issues were subsequently raised with us; other issues were also raised. Manchester's position was as follows:

- (a) As to public interest complaints generally, Manchester said that the CC, when investigating these, ought to establish the precise nature of the complaint; the way in which the complainant's interests had been harmed; the date when the matter was first raised with Manchester, whether it had been raised in writing, and any other relevant evidence; and the response of Manchester to the complaint, before pursuing the matter further with Manchester.
- (b) Concerning non-regulated charges, Manchester said that income earned from these, particularly fuel throughput and catering levies, would continue to be used to reduce the regulated charges, even within a dual-till scenario. Responding to complaints that these charges were not cost-related, Manchester said that essentially they were commercial charges determined by negotiation.
- (c) We raised with Manchester a complaint that disabled travellers were being charged by airlines for the assistance provided by private contractors, rather than the cost of the service being absorbed by all passengers. Manchester responded that it had no part in negotiations between airlines, tour operators and the independent contractors providing services to disabled passengers. The solution to the problem needed to be found by commercial negotiation between the tour operator and the airlines. Manchester added that it had not directly provided assistance for disabled passengers since 1992, when the service was taken over by an independent provider; subsequently a second provider became established. Manchester added that some years ago, one airline did seek to charge disabled passengers directly for providing assistance, but the issue was subsequently resolved.

- (d) On cost transparency, Manchester said that it had an exemplary record. It said that in 2001, when IATA awarded its prestigious Eagle Award to Manchester, given in recognition of airports that give value for money, IATA stated:

Manchester Airport was cited for its extensive process of consultation with airlines and transparent revenue cost-allocation system—ensuring that charges are cost-related. It has successfully operated within the stringent independent economic regulation formula applied in the UK whilst also providing the airlines with the required capacity.

- (e) As to consultation on the capital programme, which users said was still inadequate (see paragraphs 5.119 to 5.121 and 8.66 to 8.68), Manchester agreed that effective consultation with users was essential, and said that it had sought to undertake such meaningful consultation throughout the current quinquennium. Manchester said that it had indicated its willingness to work with the CAA to improve the quality of its information relating to the capital programme, and to agree a structured approach to such consultation. In discussion with us, Manchester said that it had agreed an exchange of letters with the CAA setting out the process by which it intended to consult customers on capital investment and other matters (see Appendix 5.3). Despite the public interest finding following the 1997 MMC review to the effect that consultation procedures were inadequate, Manchester acknowledged that although considerable progress had been made, work remained in producing a suitable guide and directory for use by airlines in assessing its capital programme. We asked Manchester about criteria for excluding commercially sensitive material, which the CAA left to Manchester to decide; Manchester said that it might need to exclude, for example, matters which were under negotiation with a third party but it was content for the CAA to take a final view. We put it to Manchester that the type of publication which BAA produced for its airports was the model that should be followed; Manchester accepted this.
- (f) We told Manchester that it had been put to us that lower landing charges for cargo aircraft than for passenger aircraft were not objectively justified because the differential did not reflect any differences in costs. Manchester responded that it was standard practice in the industry to charge lower fees to cargo aircraft than to passenger aircraft. The reason for this was that cargo aircraft could very easily switch to another airport in the same or another region. Cargo aircraft tended to make use of airport facilities which would not otherwise be used and all airports wanted to attract this business. Manchester offered two different cargo rates at different times of the day reflecting the availability of capacity. Manchester accepted that the cargo rates were market related rather than cost related.
- (g) We put it to Manchester that the airport's Conditions of Use seemed to be onerous as far as the airlines were concerned, and asked if Manchester had been faced with pressure from airlines to draw up individually negotiated contracts. Manchester said that it had not so far had any discussions with airlines about individual contracting, although certain airlines had individual facilities such as dedicated lounges. It did not consider that its standard terms and conditions raised any public interest concerns; these were similar to those in force at other airports.
- (h) We put to Manchester the complaints of airlines that information on utility charges was insufficiently transparent. Manchester said that it did not understand this complaint. It provided transparency statements about utility charges which showed not only the charges but also Manchester's charge for the use of its own networks. Airport users benefited from significant discounts that Manchester was able to procure from the utility providers.
- (i) We discussed staff car parking with Manchester, on which Manchester appeared to be aiming at a 17 per cent rate of return in the financial year 2001/02. Manchester acknowledged that 17 per cent was higher than the cost of capital and said that as a consequence it had not increased charges for the current year.
- (j) We asked Manchester about air traffic control charges which are included with runway charges (see paragraph 7.32). We put it to Manchester that we had received representations to the effect that these should be unbundled from runway charges. Manchester said that previously NATS had objected to the air traffic control charges being shown separately, but it believed that NATS was now prepared for this to be done. Manchester added that it would prefer to implement this change voluntarily rather than to have imposed on it a public interest finding, and intended to do so from

1 April 2003. Manchester added that two options were being considered: first, that airport charges be reduced by the amount of NATS' costs and recovered as an unregulated charge; and second, that costs be recovered from the airlines by NATS. The sum to be collected would be made up of NATS' charge plus charges for accommodation and equipment. Manchester showed us its reply to the CAA consultative document on the subject; it was willing to unbundle the air traffic control charge, provided this was not regarded as an airport charge within the terms of the Airports Act.

- (k) We raised with Manchester the concern of a ground handler that it had to bear charges on services such as check-in desks and baggage but were bypassed in the negotiations between the airport and airlines. Manchester responded that contractual arrangements were made between the ground handler and the airlines under the terms of individual IATA contracts; and therefore complaints should be addressed to the airlines, which ought to take into account the effect on the ground handlers of negotiations with the airport. Manchester acknowledged that, under the EC Ground Handling Directive, the airport could lay down minimum standards, but said that in practice these were agreed by a user committee. On check-in desks, airlines preferred not to involve their handling agents; this was a matter for discussion between handling agents and airlines.
- (l) We raised with Manchester a complaint by a private aircraft association that private aircraft (known as General Aviation aircraft) did not have sufficient access to R2. Manchester responded that preference in allocating slots was given by Airport Co-ordination Ltd to airlines operating regular schedules; subject to that, private aircraft were encouraged to apply for slots. Manchester had recently issued a press notice announcing that it had opened a grass parking area which could accommodate up to 20 General Aviation aircraft, which had formerly used wartime hangars that had been demolished to make way for R2.
- (m) We raised with Manchester a complaint raised by a concessionaire that arrangements for concession fees and terms and conditions were not characterized by the dynamics of normal free market negotiations. Manchester responded that its concessionaires were tendered following formal tender processes, and therefore negotiation would not be appropriate.
- (n) Manchester told us that it intended to remove from airport charges two elements of the passenger security charge, namely the 'triple A' security system and the labour costs of HBS. It said that any increases in these charges would be counterbalanced by reductions in the passenger security charge and appropriate transparency statements. Manchester said that these charges related to services provided to the airlines, under contract, in order to enable the airlines to meet statutory obligations. The airlines were free to carry out those functions themselves or contract with someone else to provide them.

Progress on quality standards during the inquiry

11.84. We discussed progress on quality standards with Manchester during the course of the inquiry. Detail is in paragraphs 5.122 to 5.138; the following is a summary. Manchester said that, following the 1997 review, it had commenced discussions with the airlines about a number of 'best endeavour-type' SLAs. Some were agreed and signed; others were agreed in outline only. However, the programme was over-ambitious, and lack of airline input hampered completion of the original proposals. For a time, monitoring and reporting was undertaken, but the system largely fell into disuse between mid-2000 and mid-2001. Manchester had been keen to see progress on the service quality front, and undertook a number of discussions with airlines and the AOC, but without tangible results. The CAA was anxious to solve the problem, and included service quality standards in the consultation process that formed the first stage of the current review. As a result, Manchester proposed enhanced SLAs, to be known as generic service standards, with what were called 'binding corrective action plans' as a remedy for service quality failures, and financial penalties thereafter.

11.85. Manchester told us late in the inquiry about progress made on SLAs, which by that stage were known as GSSs. See paragraphs 5.133 to 5.142 and Appendix 5.4.

11.86. We asked Manchester for its reaction to a hypothetical public interest finding to the effect that there was not in place a system whereby the airport was required to compensate airlines if service standards were not adhered to. Manchester responded that it would be unreasonable to make a public interest

finding which ignored the fact that it was now making improvements in partnership with the airlines. Manchester added that it had spent some £0.75 million in the previous year on trying to remedy deficiencies in the baggage-handling system, by taking on extra staff.

11.87. We asked Manchester if in its view a systematic series of omissions could be a course of conduct which would be against the public interest. Manchester responded that a series of complaints over five years which had now been resolved could not necessarily be considered as a course of conduct. Manchester believed that it had now responded to the serious concerns of the airlines.

11.88. Manchester told us that, during the review, it had entered into negotiations with the airlines and agreed new-style SLAs. In the end, financial penalties, mainly in the form of rebates of charges, were agreed between the parties as the main remedy for service failures. Detail is set out in paragraphs 5.133 to 5.142. Manchester indicated that it had agreed the terms of seven out of the eight GSSs with the appointed representatives of the Manchester AOC. Manchester stated that in the circumstances it did not believe that a public interest finding was appropriate, and offered an undertaking to complete the remaining agreement by 1 March 2003, for implementation with effect from 1 May; the process should be monitored by the CAA.

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

11.89. We asked Manchester to comment on the CAA view that abuse of dominance could be tackled under the CA98 and section 41 of the Airports Act. Manchester said it agreed that it was subject to the general principles of competition law. Manchester also said it believed that the CAA had the competence, resources and commitment to due process to make section 41 work in practice.