Regulatory options

1. In this appendix we first discuss the augmented building block approach to price regulation, which is our chosen approach for setting the Q5 price cap at Stansted. We then go on to discuss the alternative options that we considered during our review and the reasons why we ultimately rejected these options in favour of our preferred approach.

Option 1: Augmented building blocks

2. The 'standard' building block calculation sets the price cap in order to allow the airport to earn an appropriate rate of return on its capital base, taking into account the operational costs and other revenues expected to be achieved over the period. Where there is significant risk that the airport operator has, or will acquire within the quinquennium, a position of substantial market power, the building block approach provides one way of mitigating the risk of the airport operator abusing this position.

3. The CAA stated in its reference to us that a price cap based on the 'standard' building block calculation would have to be augmented by a regulator-led process for approving capital expenditure so as to reflect the specific circumstances of Stansted in Q5—in particular, the considerable disagreement between the airport and its airline users over the plans for the expansion of Stansted and the level of investment in the capital base which is necessary.

4. Under a RAB-based approach the airport has the incentive to undertake as much capital expenditure as possible in order to inflate the RAB on which it earns a return. Historically, the check on this incentive has been the regulator's review at the end of the quinquennium, which should ensure that any inefficient or unnecessary expenditure is excluded from the RAB and that the cost is borne entirely by the airport. However, it is not clear how rigorously this check has been applied.

5. At the start of Q4, the CAA sought to utilize some of the expertise and interest of the airlines at each of the regulated airports by establishing a continuous programme of constructive engagement. The CAA indicated that agreements made between airports and airlines, based on their respective commercial and operational perspectives, such as on capex investment projects, would provide a valuable input into its price control review process.

6. However, the process of constructive engagement at Stansted was not effective and the CAA decided that it could not be relied upon to deliver usable outputs for its price control process. Instead, the CAA indicated that it would commence work on a more regulator-led approach to the price control. The CAA believes that there are fundamental reasons why the incentives of the airlines at Stansted and the airport operator were not aligned, which explained why the process of constructive engagement was not going to be successful.

7. Given the scale of the capex programme at Stansted in Q4 and Q5 due to SG1, and in Q5 and Q6 due to SG2, the CAA expressed concern that the standard building-block approach would require extensive intervention on the part of the regulatory authorities and that this approach might not be consistent with its statutory duties. The CAA believed that the regulator would have to be significantly involved in specifying the appropriate capex programme and its costs.

8. We looked at how much detailed specification of the capex programme would be required by the regulator under this approach. We found that, because the scale of BAA's proposed capex programme for Stansted in Q5 was now much smaller than the CAA had anticipated, the number of projects that the regulator needed to evaluate, and therefore the burden of augmentation, was much lower than the CAA had originally envisaged.

9. Our evaluation of traffic forecasts and our consultants' review of BAA's proposed capex programme found that a significant amount of the capex required for SG2 should be postponed until Q6. Further, given the uncertainty surrounding SG2 and the planning inquiry process, we believed that there should be an interim review of the price cap, which should take place once the planning application has been resolved.

10. With regard to SG1, we were not convinced that, in practice, the airport and airlines could not reach agreement on many items of capex, despite the theoretical presence of misaligned incentives. Through the course of our review, we saw significant progress in the discussions between Stansted and its airline customers, which we hope will continue. Also, we noted that there are many practical ways of addressing the uncertainty surrounding the capex programme at Stansted, including the use of positive and negative triggers. Following the discussions between the airport and the SACC, the need for such triggers was removed, as the parties reached substantial agreement on almost all aspects of the scope and phasing of SG1 capex in Q5.

11. We recognized that the traditional RAB-based approach might not always be the most appropriate form of airport regulation, but we did not perceive there to be the degree of problems with it as suggested by the CAA in its reference to us. Rather, we believed that the uncertainty surrounding BAA's capex programme in Q5 could be addressed in other ways, and a RAB-based approach could continue to provide a suitable means for mitigating the risk of the airport operator abusing its market power, while providing it with sufficient incentives to meet efficiently the needs of its users, both in its day-to-day operations and in its longer-term development plans.

Two alternative forms of augmentation

12. We considered two modifications to a traditional RAB-based approach, which we thought might help to address the specific circumstances of Stansted in Q5. These options were: 'assets in operation' and 'airline pre-approval', which we describe below.

Option 1a: Assets in operation

13. Under this option, assets would be allowed to enter the RAB only when they are in operation (AIO) and not when in the course of construction (AICC), as under the traditional augmented RAB option outlined above. We noted that the capitalization of the return on capital in the period of construction means that the financial return to the airport under AIO should be the same as under AICC.

14. In our Q4 report, we concluded that allowing assets in the course of construction was necessary to secure funding for major projects and/or to reduce the costs of funding. We also found that it had desirable properties of reducing the volatility in prices and generating a price path profile more like the profile which might be expected in a competitive market.

15. However, the practice of allowing a return on capex for assets in the course of construction has been particularly controversial for Q5 at Stansted because of the significant increase in the RAB implied by SG2, and the potential for current users to have to pay for assets which may not be used by them but which would instead be used only by new entrants.

16. We found that allowing assets to enter the RAB only when they are in operation could be more equitable as it would avoid current users subsidizing future users. We also found that it might encourage the airport operator to undertake contractual arrangements with customers to mitigate its additional investment risk, so replicating the behaviour of expanding airport operators in competitive markets. On the other hand, we recognized that it would change the profile of prices by causing a significant step change in charges when the new assets enter operation and would also cause an increase in financing costs.

17. We found less reason to oppose the regulatory argument for charging for assets in the course of construction where the projects concerned are small and do not have a long delay between the capital expenditure outlay and the assets becoming operational, as the financers of such developments are more likely to be its users. As a result, we found less reason to pursue an AIO approach for SG1 than for SG2.

18. BAA was concerned that the size of SG2 relative to the existing RAB meant that moving to an AIO approach would lead to deterioration in the financial position of the airport operator and would increase risk from an investor's perspective, potentially giving rise to financeability issues. Increased risk would arise as a result of pushing returns on Q5 expenditure into Q6, due to the inability of the regulator to commit itself to a particular course of conduct during future reviews. In addition, the airport would bear additional capex delivery risk and demand risk, resulting from an increase in price at the time assets become operational. BAA felt that this option could threaten capacity expansion at Stansted and, in addition, that uplifts in the cost of capital necessary to compensate for additional risk could result in higher charges for airlines and their passengers.

19. The CAA raised concerns similar to those of BAA. In addition, it questioned our suggestion that this option might be more equitable, noting that current airline users had benefited from cross-subsidization under 15 years of system regulation. The CAA also questioned whether AIO would lead to more efficient investment on the grounds that the airlines' incentives do not necessarily serve as an effective proxy for users' interests generally. Finally, it noted that there could be an adverse effect on competition, because AIO would result in a tighter price cap at a time when the short-run competitive price might be expected to rise.

20. The SACC supported AIO on the grounds that it better reflected the commercial situations of airports and airlines and prevented cross-subsidization between airlines. It noted that the problem of the long time delay between the commencement of construction and assets entering operation could be dealt with using long-term debt financing and forward contracts, as was often the case in commercial infrastructure projects.

21. Our work on passenger forecasts has suggested that construction expenditure on SG2 may not be required until Q6 and, therefore, only preliminary expenditure should be necessary in Q5. We were concerned that AIO might have an adverse effect on the cost of capital. At the same time, we were mindful that, following reviews by both the CC and the DfT, the system of regulation and the operation of airports in the South-East might be about to change. For all these reasons, we believe that the

forthcoming Q5 period is not an appropriate time to change the regulatory regime at Stansted from AICC to AIO.

Option 1b: Airline pre-approval

22. Under an airline pre-approval approach, assets above a de minimis limit would be allowed to enter the RAB only when pre-approved by the airport's current airline users.

23. We found that this approach could encourage the airport operator to develop a more cooperative relationship with its users and would reduce its ability to undertake capex programmes thought inefficient or unnecessary by the airlines. It would also require less regulatory intervention than the augmented RAB approach, and could introduce incentives to deliver capex programmes more efficiently, whilst retaining the incentives under the RAB to control opex and increase traffic. Regulatory risk could therefore be reduced, resulting in a fall in the cost of capital.

24. We also found a number of potential drawbacks associated with this approach. We recognized that it might place a disproportionate burden on airlines with limited presence at Stansted, leading to the largest users being able to control the process. These incumbent airlines might oppose efficient, economic and commercially justified expansion plans in order to restrict the amount of capacity available to new entrants. In a similar way, the development of cargo and long-haul traffic at Stansted could be hindered since neither type of traffic currently has sufficient presence at Stansted to influence the capex programme.

25. One way to avoid restricting the activities of the airport under this approach would be to allow revenue earned on non-approved assets to be treated separately from assets in the RAB. The airport operator could then be remunerated for assets used by new entrant airlines. However, this option would then share many features of the legacy price cap, discussed below, and a dual-till approach.

26. We also noted that this approach could encourage the airport operator to dis-aggregate large capex projects into smaller projects with expenditure falling below the de minimis limit and to exaggerate the cost of projects important to the airlines in order to increase charges. Furthermore, the transition to this approach could be difficult as BAA has already committed a significant amount of expenditure on the assumption that it will be included in the RAB.

27. BAA expressed concern that differences in the time frame of the risk horizon between airlines and the airport, along with differences in the incentives between current and future airline users, meant that agreement would not be reached under this approach, threatening the delivery of SG2. BAA stated that it would also constrain the operator's discretion and reduce its commercial flexibility to respond to changing conditions. It could also be anti-competitive as incumbent airlines faced incentives to restrict capacity in order to keep slot values high. BAA also pointed to a United States Federal Aviation Authority study which found complaints from many airport operators that the pre-approval mechanism restricted competition in the airline market by strengthening the position of incumbent airlines.

28. The CAA raised a number of concerns in relation to a pre-approval approach, in particular that the behaviour of airlines could not be assumed to represent the interests of users generally, and that the voting arrangements would in effect hand control of capex to Ryanair and easyJet. The CAA suggested that the adverse effects on airline competition could result in higher air fares if incumbent airlines blocked capacity expansion and could have unintended effects, including putting downward

pressure on the level of capex, leading to a deterioration in quality. The CAA was of the opinion that it would lead to more regulatory intervention rather than less, and questioned the legal basis for any system of voting rules. It noted that there were likely to be unintended consequences associated with any voting system, for example encouraging airlines to set up subsidiaries in order to increase their voting share.

29. We believed that there were many advantages in the airlines being involved in developing and scrutinizing the airport operators' significant capital expenditure plans. However, given that SG2 may be delayed until Q6, due to current uncertainty over passenger demand, we did not believe that there is a good reason to change the regulatory regime to require pre-approval at Stansted in Q5. Rather, we sought to encourage a greater level of airport–airline engagement in other ways.

30. Instead of Options 1a and 1b, BAA proposed an alternative option that would help to overcome current airport and airline disagreement over capex plans: Capital Investment Condition Precedents (CICPs). Under this proposal, a set of qualifying conditions, based on objective and transparent tests intended to demonstrate economic principles, would have to be met before major elements of the Stansted capital programme would be undertaken. BAA proposed that the projects that would be subject to these additional tests would be those projects over £10 million and would account for around 65 per cent of Stansted's capex programme for Q5.

31. We considered BAA's proposals for CICPs but, due to the progress made between the airport and the airlines on an agreed capex programme for Q5, the need for this alternative regulatory mechanism was removed. We discuss CICPs further in Section 8 of the main report.

Option 2: Legacy price cap

32. Under a legacy price cap approach, the price cap would be applied to the existing (ie legacy) airport assets based on the 'standard' RAB approach, but incremental investment in capacity and/or improved service quality would fall outside this price cap and would be free to earn what the CAA referred to as a 'more commercial' return.[1]

33. The CAA considered that the legacy price cap approach might suffer from practical difficulties, such as the difficulty of defining the boundary between existing and incremental assets, which might cause distortions in the airline market, but the CAA also considered that the approach may align the airport operator's investment incentives more closely with those of an operator in a commercial environment, benefiting consumers.

34. In our Issues Statement, published in May, we stated that we were initially of the view that a legacy price cap would not be appropriate and invited comments. No third party proposed that we should consider this option further.

35. We found that there were significant complexities with this option, resulting from the need to separate legacy and new assets. We also thought that a legacy price cap might have an adverse effect on airline competition due to the possibility that incumbent airlines and new entrants could face significantly different airport charges. Therefore, we did not think that a legacy price cap was appropriate for regulating airport charges at Stansted in Q5.

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[1]CAA reference to the CC, April 2008, paragraph 9.3.

Option 3: Terminal development tendering

36. The concept behind a terminal development tendering (TDT) approach was originally outlined by easyJet to the CAA and the CC in meetings in December 2007 and February 2008. Under this approach, competitive processes would be introduced into the provision of terminal facilities, by putting the development of additional terminal capacity (and related facilities) out to competitive tender, and making the construction of the second runway contingent on the results of that tender. easyJet's proposals reflected its desire to ensure that any new terminal at Stansted was built to the specification required by the LCCs.

37. The terms of the tender would be drawn up by the regulator who would set the timing, nature and extent of proposed runway and access infrastructure, as well as the price at which this infrastructure would be provided to a terminal operator. BAA would provide the runway infrastructure but would be unlikely to be permitted to provide terminal facilities. The results of the tender would be used to determine whether runway investment would be permitted under the price control, with a successful tender triggering construction of a second runway. The use of runways would most likely be priced using some form of access regime and the price cap for the original assets would be set to equal the price cap for the new runway and terminal (ie at incremental cost). One advantage of this approach would be that it would introduce a degree of market testing into the provision of new terminal facilities; however, it would also involve significant regulatory involvement by the CAA.

38. We did not believe that TDT would help us to discharge our legal duties under the Act, which are to recommend a price cap at Stansted for Q5. Given that the need for construction of SG2 is expected to be delayed until Q6, and given that moving to TDT would represent a significant change to the framework of airport regulation, we believed that it is an option for the CC to consider in its market inquiry and for the DfT to consider in its regulatory review.

39. However, we did note that there may be other legal problems with terminal development tendering under the existing regulations. Part IV of the Act states that: (i) in airports with a turnover in excess of £1 million, the airport operator must have permission in order to levy airport charges; and (ii) in designated airports (such as Stansted Airport) the airport operator must levy airport charges subject to a price cap. In this context, 'airport operator' and 'airport charge' are defined terms. The reference requires the CC to report on the maximum amounts that should be capable of being levied by the airport operator by way of airport charges in the relevant period and we were not sure that TDT could meet this requirement for the following reasons:

    (a) A terminal building is not an airport, but is part of an airport. We thought that it might be straining the scope of the definition of 'airport operator' to make it extend to include 'the operator of part of an airport'.

    (b) 'Airport charges' are, in effect: (i) the landing charge; (ii) the aircraft parking charge; and (iii) the departing passenger charge. The charges made by a third-party operator for use of a second passenger terminal would not easily come within this definition.

    (c) TDT is a mechanism for introducing competitive pricing for use of terminal building facilities. It may discipline the cost, size and timing of related developments at the airport, but it does not set a maximum price for airport charges, nor does it enable such a limit to be calculated.

40. Furthermore, we recognized that the CAA has no existing power to override BAA's property rights in order to facilitate TDT, and so this option would need BAA's consent in order to proceed. Unless BAA were given significant financial incentives, which would itself be liable to introduce distortion, we could see no reason why BAA would give such consent.

41. Given these legal constraints, we had general concerns over the feasibility of the TDT option within the existing regulatory regime. More immediately, we did not believe that TDT was a viable approach for setting the price caps at Stansted in Q5.

Options 4 and 5: Market-led and precautionary price caps

42. The CAA put forward two options based on an assessment of long-run average incremental cost (LRAIC): the market-led price cap option, in which the price cap is set just above the LRAIC to include a mark-up for uncertainties in forecasting or equal to the LRAIC estimate with under-recoveries rolled forward into subsequent periods; and the precautionary price cap option, which sets the price cap just below the level which would be considered excessive by competition authorities. Both of these options are 'safeguard' caps, and as such require competitive constraints sufficient to keep prices below the cap.

43. As explained in Appendix B, we found that Stansted does not currently face sufficient competitive constraints to merit a safeguard approach and, furthermore, would be unlikely to do so over the course of Q5.

44. Although we did not consider a safeguard cap to be appropriate, we did consider whether the price cap at Stansted in Q5 should be based on the actual value of LRAIC, without a mark-up. In doing so, we noted that this approach would require a more precise calculation of LRAIC than required under either of the CAA's safeguard options.

45. The LRAIC is equal to the total costs of a specific variation in output (the increment) averaged over the units of output which the increment produces, resulting in a constant charge over the life of the asset. It is related to the long-run incremental cost (LRIC), which is the cost of adding a non-marginal change in output or capacity, but whereas the LRIC estimate increases when capacity nears full utilization and falls when there is spare capacity, the LRAIC estimate smoothes these fluctuations over the life of the asset.

46. Under a LRAIC-based price cap, there is no link between the actual or planned investment of the incumbent operator and the price cap. Instead, the LRAIC price is based on the efficient specification of a given increment. As a result, in theory, the regulator is removed from specific investment decisions, reducing the risk of regulatory gaming and allowing the operator a greater degree of flexibility over the specification and timing of investment.

47. We found that this approach could offer a number of benefits. Removing the link between the price cap and actual investment undertaken and/or proposed by the airport operator could help to align investment incentives. The airport's incentives to invest would not be based on trying to increase the price cap, while the airlines' views on a project would not be affected by its impact on charges. Furthermore, a LRAIC-based price cap could result in prices closer to the long-run competitive level, providing appropriate signals to the market for efficient entry, investment and innovation.

48. However, we were mindful that the past use of a RAB approach had created a regulatory contract with regard to all past investment and an implicit commitment to future investment. Therefore, any change to the regulatory regime should not be undertaken without very good reason. We believed that any changes to the regulatory regime would be expected to lower the perceived level of regulatory commitment in the future, and not just at Stansted but at all UK regulated airports. We were concerned that adopting a LRAIC approach at Stansted, whilst Heathrow and Gatwick continued to operate under a different price control methodology, could introduce distortions by increasing uncertainty over the future regulatory regime at these airports. We believed that this uncertainty could make it harder for Heathrow and Gatwick to contemplate significant capex development.

49. We also found a number of practical difficulties in applying a LRAIC price cap. These problems were specific to the question of setting a price cap at Stansted in Q5, and were not problems with a LRAIC approach more generally:

- We found it difficult to identify what should be the appropriate increment on which to calculate the LRAIC. For example, whether the increment should be just SG2 or whether we should consider it to be the whole airport, including existing assets, SG1 and SG2.

- We also found that, even if the appropriate increment could be identified, it would be very difficult to find appropriate comparators from which to establish an efficient investment benchmark for the increment, due to the unique circumstances of each airport and the indivisibility of airport capacity expansions.

- A robust estimation of LRAIC would require regulators to conduct a detailed specification of the relevant increment and the efficient level of investment required to build and operate it. The regulator would have to take a view on the initial cost of investment, the capacity and quality requirements of all the necessary assets, the life of the assets and the future investment needed on these assets. In addition, the regulator would need to form a view on how many passengers the investment would serve, the profile of passenger numbers, and the level of opex and commercial revenues throughout the life of the increment. We believed that this analysis would require similar cost and demand forecasts to the RAB-based approach, but would require them over the entire life of the asset rather than over a five-year period. As long-term forecasts are subject to greater risk of forecasting error, we concluded that it would be more difficult to forecast the correct LRAIC accurately.

50. We looked at other sectors where LRAIC (or LRIC) was used in price regulation, including telecommunications, gas and electricity. We noted that LRAIC is used in these sectors as a way of costing particular services provided by network industries, which seemed to us to be a very different purpose from applying LRAIC as an approach to regulating the overall profitability of Stansted.

51. We also noted that applying a LRAIC approach to Stansted would raise a number of problems. Due to the long life of assets in the airports sector, forecasts would be required over a very long period, and long-term aviation forecasts are subject to considerable margins of error. Further, there was likely to be a significant problem in identifying an efficient comparator, as airports are differentiated products, both by their location, which determines their different catchment areas, and by their facilities.

52. We believed that the practical difficulties of determining the LRAIC for Stansted in Q5 meant that the process would take a significant time. We noted that Ofcom's process for designing, consulting upon and implementing a network cost model for mobile call

termination charges lasted about two years. Given the lack of agreement historically between the airport and airlines at Stansted, we concluded that we could expect a robust consultation process at Stansted to be just as lengthy. We noted that the regulatory experience in the gas and electricity markets supported this conclusion, even though in these markets the level of agreement on the necessary specification and quality of investment was high relative to the airports sector. Given the failure of constructive engagement at Stansted in Q4, we believed that the necessary negotiations between the airport operator and the incumbent airlines would be unlikely to result in agreement on the specification and costing of the increment very quickly. Certainly, we did not believe that it would be practical to conduct the necessary modelling and consultation exercises to calculate a robust estimate of LRAIC within the time frame of our Q5 review.

53. We were also concerned that adopting a LRAIC approach required a commitment to a particular price path over the course of the asset life and therefore over considerably more than five years. This requirement raised an issue of regulatory credibility, as neither the CAA nor the CC can enter into legally binding commitments regarding the method of setting price caps at future reviews or their future price cap calculations, in which key assumptions and parameters may change.

54. BAA and the SACC agreed that a LRAIC-based approach would not be appropriate for setting the Q5 price cap at Stansted, citing many of the reasons set out above.

55. BAA believed that a LRAIC approach might be no less onerous than a RAB approach, as each regulatory review would provide an opportunity to update the LRAIC calculation. We noted that, although the regulatory reviews do provide an opportunity to update the cost of producing the pre-specified increment, the specification/design elements of the increment should not be updated and therefore future regulatory reviews might be less onerous, raise less uncertainty and be less open to regulatory gaming. However, we agreed with BAA that if the periodic reviews were taken as an opportunity to revise the specification of the increment, this possibility would increase the analysis required at each review and undermine the perceived benefits of a LRAIC approach.

56. The CAA considered that the competitive interaction between Stansted and Luton was significant and that Stansted also faced other competitive constraints (see Appendix B). The CAA proposed that, though a safeguard price cap at Stansted would be different to the approach adopted for Heathrow and Gatwick, it would remove some of the distortions to the airport and airline incentives at Stansted, as well as providing more appropriate investment signals to airports competing with Stansted. However, whilst we recognized the existence of competitive interactions between Stansted and Luton, we were told that Luton's business case for expansion assumed that charges at Stansted remained at or above current levels, and, furthermore, we found that there were immediate constraints on Luton's ability to undertake significant capacity expansion in Q5. We considered whether a RAB-based approach at Stansted would affect the investment incentives of any other airport but we did not find that it would. Therefore, we did not believe that setting the price cap at Stansted under a RAB-based approach would have any significant distorting effect.

57. The CAA argued that the uncertainty involved in estimating a RAB price is at least as great as that involved in estimating a LRAIC. However, we found that the LRAIC calculation has more scope for variability on the underlying assumptions and is much more sensitive than the RAB calculation to changes in estimates of the rate of return and capex. We found that the greater sensitivity of the LRAIC compared with the RAB is due to the RAB approach being built up using several building blocks (eg

opex, regulatory depreciation and other revenues) and not being dependent to the same extent on the cost of SG2. We also noted the longer-term traffic forecasts required for a LRAIC approach, which we believed added to its uncertainty.

58. We concluded that the many practical difficulties in calculating an accurate LRAIC made this option infeasible within the relevant time frame of our review. In particular, we believed that determining the appropriate increment and establishing both reliable long-term forecasts and an accurate estimate of the efficient level of capex should take much longer than the time available to us and the CAA in this process. Furthermore, we were mindful of the problem of regulatory commitment and the possibility of increasing regulatory uncertainty at other designated airports by changing the regime at Stansted. In addition, given that both the system of regulation of airports and the operation of airports in the South-East may be about to change (due to our market inquiry and the DfT review of regulation), it did not appear to us to be a sensible time to make significant changes to the way in which the price cap is calculated, particularly a change to a methodology which arguably requires a greater degree of regulatory commitment. For all these reasons, we did not consider that applying a price cap based on a precise calculation of the LRAIC was appropriate in the context of the Q5 price review at Stansted.

59. The CAA suggested that, given the strong economic arguments for LRAIC, the practical difficulties could be overcome by introducing a transition mechanism and that this would reduce the degree of accuracy required in estimating the LRAIC. However, as we did not agree with the CAA with regard to it being a preferred regulatory option, we did not consider the CAA's transition options in any detail.

60. Although we identified a number of significant problems in applying a LRAIC approach at Stansted for Q5, we do intend to consider further the appropriateness of using LRAIC as a form of airport regulation in our market investigation.

Option 6: The default price cap

61. The CAA also outlined another option, previously suggested by Ryanair, known as the default price cap approach. Under this option, the price cap would be set with reference to the depreciated or written-down value of those assets required by current users (which might exclude, for instance, the tracked transit system or airbridges), as set out in the statutory accounts. Agreed service quality levels would be set at a basic level, with penalties on the airport operator for under-performance. Any new facilities would only be developed if they could be provided based on the level of the default price cap (or lower), or if a specific airline or airlines were willing to pay for them. Once the default price cap and the set of facilities and services which it covered was agreed, any airline which wished to have a different standard of service could negotiate a different price with the airport. The adoption of this approach would be likely to result in a significant reduction in airport charges at Stansted for all airlines, except those that aspired to a premium service.

62. We noted that many elements of the default price cap were features of some of the other regulatory options, or were features being considered by us elsewhere in our review (eg in determining the appropriate value of the Q5 opening RAB). We also found that the default price cap raised a number of concerns. In particular, we were concerned that it had the potential to distort an airport operator's incentives to invest and airlines' incentives to support new investment, and that it created a risk that assets may be left idle by airlines' ability to opt out of paying for existing assets. Therefore, we did not believe that a default price cap was an appropriate approach for regulating airport charges at Stansted in Q5. We stated this initial view in our

Issues Statement, published in May, and invited comments, but no party responded to propose that we should consider this option further.

Conclusion

63. Having considered all the alternatives set out by the CAA, and two options of our own (Options 1a and 1b), we believed that the RAB-based approach remains the best regulatory option available for Stansted in Q5 and that its flaws, such as the incentive for over-specified investment, can be addressed in other ways, including through the use of other regulatory mechanisms and through pursuing effective constructive engagement. We concluded that a RAB-based approach provides the greatest regulatory certainty in which all parties at Stansted can operate in Q5.

64. We recommend that the CAA continues to apply a RAB-based approach to the regulation of airport charges at Stansted in Q5.