

CAA comments on regulation and on BAA's performance

1. The CAA made extensive comments on the analysis of regulation and BAA's performance contained in our Emerging Thinking and provisional findings: its [submissions are published on our website](#). We have taken the CAA's comments very seriously, given the importance of its role as economic regulator and in implementing some of the remedies we have put forward, and have considered them very carefully. Some of its main comments have been set out in the body of the report, but given the extensive nature of the comments and the CAA's position in the industry, we also thought it appropriate to set out some of its other main comments in this appendix, together with our response. In this appendix, following this paragraph, the CAA's comments are set out in the numbered paragraphs, and our responses are given in the bulleted paragraphs which follow. Unless otherwise stated, therefore, the text in the numbered paragraphs represents our understanding of the CAA's views, while the text in the bulleted paragraphs represents the CC's views. (The cross-reference at the beginning of each CAA comment is to the relevant paragraph in the main text of this report.)
2. On paragraph 6.13(a), the CAA noted that it did have an obligation, which it took seriously and had fully discharged, to have regard to the CC's recommendations in formulating its own conclusions. The CAA set out in detail its reasons for its decision on this issue in the final decision document on the price controls at Heathrow and Gatwick.
 - We do not suggest, at any point in any of our reports, that the CAA has acted contrary to its legal obligations under the Airports Act. We have taken note of the CAA's detailed explanation for its actions in its Q5 decision document for Heathrow and Gatwick, published in March 2008.
3. On paragraph 6.13(b), the CAA said that we may have misinterpreted the CAA's position, which was set out in paragraph 7.14 of its November 2007 proposals document for Heathrow and Gatwick. In summary, the CAA did not agree that our suggestion to appoint jointly—with BAA and the airlines at each airport—a firm of accountants to consider the appropriate basis for allocating costs, and to conduct an annual audit of cost allocation, would be justified against the CAA's statutory duties. In particular, the CAA considered that users' reasonable interests would be better served through ongoing consultation with BAA on the cost basis of non-regulated charges and through the transparent and audited statements which BAA would provide to users. The CAA did, though, adopt two suggestions made by airlines to strengthen protection for users against any abuse by BAA in setting non-regulated charges. The CAA disagreed with any view that it was reluctant to regulate BAA's conduct in respect of the planning of capital investment, and did not consider that evidence has been presented that would support such a view.
 - Our reference to an independent audit in paragraph 6.13(b) is merely to illustrate how the CAA can depart from our recommendations, with no inference as to the merit of doing so.
4. Also on paragraph 6.13(b), the CAA said that, under the Airports Act 1986, it must have regard to the CC's recommendations as to what the maximum charges should be and how adverse public interest findings should be remedied and must explain the reasons for any departures from those recommendations. It did so both in its proposals published in November 2007 and in its final decision of March 2008. The CAA

was bound by the statutory objectives of section 39 of the Act, and indicated in its proposals of November 2007 that it would be prepared to depart from our recommendations where to do so would, in its view, be better calculated to meet its statutory duties. There were a number of factors on which the CAA concluded that it could achieve the objective we had identified, and with which it agreed, in a less intrusive manner, and which fell well within scope of its own regulatory discretion.

- We do not dispute, and have not disputed, the CAA's characterization of its statutory obligations under the Airports Act.
5. On paragraph 6.18(a), the CAA said that, in practice, there were several safeguards against each airport simply ignoring users' interests in deciding what to invest in: quinquennial scrutinies by the CC and CAA of out-turn capital expenditure performance, express regulatory linkages between BAA's consultation and capital expenditure delivery performance and the inclusion of investment spending in the RAB, and a public interest remedy if BAA's performance in this area was lacking.
- As we note in paragraphs 6.59(b) and 7.62 of the main report, there is little evidence of such a safeguard applying in practice. For such a process to operate in practice would require an effective involvement of airlines in consultation processes, and of the CAA in monitoring, and if necessary facilitating, such processes. We have seen limited evidence of such monitoring or facilitation by the CAA in practice, especially during the recent Stansted Q5 review.
6. On paragraph 6.20(a), the CAA noted that one factor behind lower returns at Heathrow had been higher than projected capital expenditure, resulting from BAA bringing forward investment at T5 to meet BA's needs. At both Heathrow and Gatwick, BAA had been exposed to lower than forecast traffic growth and higher operating expenditure, some of it as a result of external factors (eg tighter security requirements, higher energy costs). At Stansted, BAA had benefited from higher than projected traffic, but at the cost of underrecovery of airport charges versus the price cap. These factors illustrated aspects of business risk which remained with each airport even under the admittedly imperfect incentives of a five-year RPI-X price cap.
- These points are consistent with information in our reports on the Heathrow/Gatwick and Stansted Q5 reviews.
7. On paragraph 6.20(d), the CAA noted that the 7 per cent maximum rebate level it had set was in the middle of the 5 to 10 per cent range that we had recommended. Its decision to complement the rebate regime for poor service with a bonus scheme (implemented through the design of the price control rather than the service quality rebates scheme) did not detract from the penalties for below-target performance, but rather increased the revenue at risk to each airport from 7 to 9.25 per cent. The bonus scheme was introduced to provide an additional incentive on BAA to continuous improvement.
- We note the CAA's points, but remain of the view we expressed in paragraph 6.47 of our Heathrow/Gatwick Q5 report,¹ namely that we see no justification for the introduction of bonuses as well as rebates since BAA would gain in other ways if performance standards were met.

¹BAA Ltd: a report on the economic regulation of the London airports companies (Heathrow Airport Ltd and Gatwick Airport Ltd), CC, presented to the CAA on 28 September 2007. See also: www.competition-commission.org.uk/inquiries/ref2007/heathrow/index.htm.

8. On paragraph 6.22, the CAA noted that we did not acknowledge—let alone analyse—the array of countervailing measures (such as capital expenditure scrutiny, RAB clawback potential and precedent, explicit expectations on capital expenditure delivery and consultation, with RAB exposure for poor performance) applied by the CC and the CAA over several quinquennia.
 - From our analysis of BAA’s performance in Section 6, we remain concerned about the effectiveness of such countervailing measures: as we note in paragraphs 6.59(b) and 7.62, there had, until recently, been only one instance of BAA’s expenditure not being allowed in the RAB at subsequent quinquennial reviews; and the more recent item of past expenditure which we recommended in our recent Stansted Q5 review, and the CAA has decided, to exclude from the RAB for Stansted.
9. On paragraph 6.22, the CAA did not agree with this interpretation of its regulatory duties and their implementation in practice.
 - We accept the CAA’s point on the interpretation of its duties; but on their implementation remain of the view set out in our provisional findings.
10. On paragraph 6.26, the CAA said that there was very extensive freedom under the Airports Act for it to set a wide range of price controls at each airport, having had regard to the CC’s recommendations. Among the parameters which had been actively debated between the CAA and CC in previous reviews were: the scope of airport charges themselves; the regulation of BAA’s airports as a system or separately; the scope of the airport business to be regulated (dual or single till); the time horizon taken into account in setting price controls (longer-term financial modelling, regulatory policy statements, price path commitment concepts); the design of the price control mechanism (revenue cap versus tariff basket); financial incentives towards better service quality and timely delivery of investment; and RAB incentives towards improved consultation and capital expenditure performance. In addition, the CC had through its public interest findings been able to extend the scope of regulation at each airport where need be, beyond the mandatory price cap conditions. So, while the CAA’s and CC’s legal powers and the airport market structure may be taken as given at each price review, most other parameters of price regulation were open to revision by the airport’s regulators. The CAA’s flexibility was more limited than that of other sectoral regulators, but it was nonetheless significant.
 - We agree with the CAA’s description of the level of flexibility which it enjoys in setting price controls at each designated airport, and note the constructive dialogue between the CAA and ourselves in quinquennial reviews. But we are concerned about the limitations on the CAA’s flexibility. Unlike other sectoral regulators, the CAA has extremely limited scope to apply economic regulation to companies in its sector which are not designated for regulation by the Secretary of State for Transport. It also has no scope to set price controls of either shorter, or longer, duration than the five years set out in the Airports Act (though it may review the controls if the airport operator agrees and it may extend the five-year period by one year). Again, the CAA has no scope to regulate non-price aspects of the airports’ performance, such as quality of service, without a public interest finding from the CC, but the CC cannot make such a finding unless it relates to the behaviour of the airport operator in the five years preceding the review (or six years if the quinquennium has been extended). This means that it has been impossible to anticipate problems by imposing ex-ante solutions. These are some examples, by no means exhaustive, of limitations on the CAA’s flexibility.

11. On paragraph 6.36, the CAA argued that this very summary description overlooked the very substantial issues which still needed to be resolved at the point at which the CC reported to the CAA. The CAA argued that the CC itself had recommended that the CAA take forward further analysis and make appropriate allowance in the final price control decision in a number of areas (eg preliminary expenditure on developing Heathrow third runway options, concluding assessment of the appropriate security and other service standards, with associated costs). The CAA had taken on the regulatory analysis and decision-making, having regard to our own report and recommendations. It argued that the processes which had followed in doing so were robust and lawful, and led to a lawful price control decision being made in March 2008. The CAA also suggested that we should consider in more detail the circumstances of that autumn, particularly the Government's developing requirements in relation to security throughout the second half of 2007.
 - We acknowledge the CAA's points. We are in no way questioning the lawfulness of any of the CAA's regulatory decisions: but the effect of the increases in costs, coming so late in the process, was that the level of charge was only apparent in the final decision. This meant that alternative trade-offs of capital expenditure or operating expenditure (eg to meet BAA's enhanced objective for security queuing) could not be considered by respondents to the CAA's consultations.
12. On paragraph 6.36, the CAA told us that it recognized that there were challenges for airlines (as there were for the CAA and the CC) in obtaining and analysing data from BAA at times during the price reviews. However, it considered that the airlines were not collectively as passive and impotent as we were suggesting. There were tools and information available (including from the CAA) during the price review to enable airlines to understand the price implications of operating and capital costs. Airlines were able to (and did) commission their own expert scrutiny studies (eg a capital expenditure efficiency study for Heathrow airlines). Airlines also demonstrated an ability to pool their analytical resources in order to scrutinize aspects of BAA's operations (eg BA's operational research on BAA's security costs, conducted on behalf of airline groups at Heathrow and Gatwick respectively).
 - We accept the value of the role played by the airlines in the regulatory process: but nonetheless believe that even the collective efforts of airlines are insufficient to negotiate on equal terms with BAA, a position reinforced by BAA's common ownership of all three main London airports. Revenues from regulated airport charges are a much higher proportion of BAA's revenues than they are of airlines' costs, meaning that BAA is likely to be willing to devote significantly more resource to the regulatory process. BAA's monopoly on the provision of many types of information increases its advantage, requiring engagement by an active regulator, to redress the balance.
13. On paragraph 6.38(a), the CAA agreed with this generalization, and has said as much previously to us. Nevertheless, there are some issues on which the interests of passengers and airlines diverge, including, in at least some contexts, the important issue of substantial capacity expansion at an airport regulated by RAB-based price controls. In such circumstances as the CAA has argued might currently pertain at Stansted, there would be advantage in the regulator having a clear and unequivocal duty to the interests of the end-users (passengers) rather than intermediate suppliers (airlines).
 - Our thinking on this point is set out in Section 10—Remedies.
14. On paragraph 6.38(c), the CAA argued that we endorsed, and to some extent reinforced, its original proposals with respect to capital expenditure triggers. As drafted,

this could suggest that the CAA was alone in advocating such regulatory measures. It agreed that there was inevitably a need for the CAA to be involved as issues arise during quinquennia—as a statement of fact. Nevertheless, the emphasis that the CAA had applied to the setting of the price caps to date had been to establish a clear framework of regulatory incentives (price cap plus service standards plus capital expenditure triggers), complete the detailed definition of such incentives as soon as practicable within the quinquennium, and then allow each airport to respond to the incentives set, with the CAA's subsequent role focused on monitoring and adjudication where necessary, for example where triggers were missed.

- We note in paragraphs 6.42 and 7.56 et seq, however, that the CAA did not fully accept our recommendation on triggers, which are therefore only partially effective in ensuring airports are no better off if certain projects are not carried out. In addition, a smaller proportion of BAA's capital expenditure than we recommended is covered by triggers, and trigger dates have been set three months later than the completion dates of projects set out in the airport CIPs.
15. On paragraph 6.38(d), the CAA said that it had set out in its regulatory proposal and decision documents, subsequent to our report, that the introduction of service quality bonuses was an initiative of the CAA to alter the price control incentive structure in order to provide additional incentives on each airport to continuous improvement in passenger-facing services (this is also an example of where airline and passenger interests may not coincide). It was not, as the CAA had previously explained, a remedy implemented to address our public interest finding that service standards had fallen below acceptable levels; the CAA followed our recommendation on this finding by strengthening the rebate scheme. The CAA said that our summary of the situation in paragraph 6.38(d) (7.34(d) of the provisional findings) was not accurate, and was contradicted by the more accurate description in paragraph 6.13(a) (7.15(a) of the provisional findings). In particular, we had understated the importance of our role in this process. Once the CC had made a public interest finding, the CAA was required to impose conditions to remedy or prevent the adverse effects specified by the CC.
- We accept the CAA's characterization of its Airports Act duties in respect of public interest findings made by the CC.
16. On paragraph 6.44(b), the CAA did not accept that we had provided evidence to support our finding that BAA could materially compromise the CAA's ability to conduct its own assessment of BAA's costs, or to conduct effective and timely consultation with airline users by submitting new information late in the process of a price control review. We might recognize that, as part of running an effective price control review process, it was for the regulator to strike an appropriate balance between allowing new, potentially relevant, information into the price review process, while setting aside adequate time and processes for consulting with users and analysing such additional information. The fact that BAA made late submissions did not, by itself, constitute a systematic weakness in the regulatory process.
- We regard the increases in BAA's expenditure requirements (see Table 7.2) following our Q5 report and following the CAA's proposed decision on airport charges at Heathrow and Gatwick as themselves evidence of BAA's control over the timing of information; and changes in the Gatwick capital expenditure assumptions, particularly on Pier 7, as a further specific example. We consider that there is a danger that increases in costs which appear late in the process arrive too late to be properly consulted on, and the magnitude of the increases gives us considerable concern.

17. On paragraph 6.45, the CAA rejected our finding, which it argued failed to take account of the realities of complex airport planning overlaid by an understandably contentious regulatory price review (and parallel market investigation), each with their own timescales and information flows.
- We accept that there are complicating factors, but consider that our finding remains valid.
18. On paragraph 6.45(b), the CAA rejected our assertions that (a) Constructive Engagement ‘failed’ at Heathrow or Gatwick, and that (b) the CAA failed to act when it became apparent that Constructive Engagement might not deliver a consensus between BAA and the airlines. The CAA’s view was that the measure of success of Constructive Engagement was whether it provided a better basis for setting price controls more informed by the commercial requirements of airline users than a traditional regulator-led price review would have done. The CAA judged that Constructive Engagement at Heathrow and Gatwick passed this test, and could not reasonably be classified a failure. The fact that BAA and airlines disagreed on a range of issues under discussion did not, in and of itself, constitute a failure of Constructive Engagement. Furthermore, the CAA did not fail to act when it identified that there may be significant outstanding differences emerging from Constructive Engagement. It took a more active role, for example through scrutinizing the emerging provisional results from Constructive Engagement, setting out its own emerging conclusions on this evidence, and guiding the parties to focus remaining consultation on key outstanding issues, thereby actively shaping the agenda for consultation in order to elicit evidence for the CAA’s ultimate price control decision. At Stansted, the CAA monitored the early stages of Constructive Engagement and concluded, in light of no progress by December 2005, that it could not rely on outputs from this process to inform the airport price review. It therefore put in place other processes to collect evidence and analysis to inform the price review.
- We have acknowledged that the introduction of Constructive Engagement was to the credit of the CAA: but our view remains that it could—and should—have worked better. In particular, the CAA should have been more proactive at ensuring that information was provided, at resolving disagreements when they emerged, and at ensuring that the process remained on track. The process at Stansted did not run smoothly and by December 2005 the CAA had terminated the process of Constructive Engagement, indicating to us that it would not be able to rely on the outputs of the process for its price control decisions. However, we took the step of rekindling the process and saw considerable progress. This indicates that CAA efforts in this direction might have had similar success at an earlier point.
19. On paragraph 6.45(c), the CAA rejected our finding. The CAA would have had statutory powers to enforce a condition (or conditions) based on Annex 4 only if we had first made a relevant public interest finding, which was not forthcoming in either our 2002 or 2007 price control reports. Nor did we in 2007 recommend a RAB reduction on account of BAA’s performance against Annex 4, which we would have been able to do.
- Many of the concerns raised with us relate to developments after the date of the Q5 reference to us (any public interest findings being confined to the period up to the date of the reference), to developments after we reported, or were raised subsequent to our Heathrow/Gatwick Q5 report. As noted in our response in paragraph 10 above, this means that we cannot make a public interest finding, as, under the Airports Act, such findings can only relate to conduct pre-dating the reference to the CC.

20. On paragraph 6.47, the CAA said that it exercised its own discretion as an independent regulator in how it weighed up its four statutory duties, along with the other factors to which it must have regard in its decision-making, having regard to the CC's own recommendations, along with any international obligations of the UK Government. This was the legitimate sphere for its own judgement and discretion, in light of the evidence and circumstances in each case.
- We agree that it is legitimate, and indeed necessary, for the CAA to exercise its own judgement in this way. However, decisions which it makes may still be criticized, even when consistent with its statutory duties, if they lead to inappropriate outcomes.
21. On paragraph 6.54, the CAA agreed with our conclusion, in so far as it related to the legislative framework for economic regulation, the CAA's duties and the powers available to deliver these. As noted in paragraph 7.48, the CAA did not accept that its approach had been unduly light touch, or at odds with the requirements of the Airports Act.
- As noted in paragraph 6.47, while we consider that the CAA's approach may have been unduly light touch, we do not consider that it was at odds with the Airports Act.
22. On paragraph 6.58, the CAA argued that we might look again at the CC's history of decisions in successive price control reviews when framing its analysis of the impact of regulation to date. The CC had played a joint role with the CAA in assessing BAA's performance at quinquennial price reviews and in developing a recommended framework of regulatory incentives on each of the designated airports. It was surprising that the CC had not previously in the course of earlier price reviews, including the most recent review of Heathrow and Gatwick on which we reported in September 2007, alighted on the faults which we now identified. Indeed, the contrast between the findings in this inquiry and those in the CC's previous price control inquiries gave rise to questions as to the extent to which the CC has previously fully discharged its statutory duties under the Airports Act.
- As we have noted in paragraph 1.27 et seq, we believe that the scope of the Airports Act and Enterprise Act inquiries are quite different. The wider scope of Enterprise Act inquiries means that characteristics of the market (such as the ownership structure or nature of economic regulation itself) which we take as given during quinquennial inquiries conducted under the Airports Act may be considered during Enterprise Act inquiries. We also note below that we have taken a different view to the CAA on a number of issues arising during quinquennial reviews.
23. On paragraph 6.60(c), the CAA noted that our conclusion appeared to be based on the wrong test, namely whether the system of economic regulation has performed as it might have done in a perfect world. The CAA in particular rejected our finding that the CAA's 'limiting its activities unduly in relation to the first three [statutory] objectives and emphasizing the fourth (which is to impose the minimum restrictions consistent with achieving its other objectives) has adversely affected competition through the impact on airlines and passengers of inadequate investment and service standards'. The CAA said that we did not seem to have given due consideration to its substantive evidence on this issue, and, contrary to all better regulation guidance, appeared to be making unsubstantiated assumptions about the beneficial effects of more intrusive regulation.

- We consider that we have given due consideration to the CAA's substantive evidence on this issue. We do not accept that anything we have said is contradicted by better regulation guidance.
24. On paragraph 7.23, the CAA also argued that we had introduced the concept of adequate consultation, and associated it with a well-functioning market, without much explanation of the 'benchmark' for behaviour or evidence as to how many other airports meet such a standard.
- We regard the examples of consultation at other airports as material, and do not accept the CAA's view that the nature of the airport, its airline users, and the scale and complexity of capital plans in and of themselves condition the nature of consultation and what might reasonably be expected from an airport operator.
25. On paragraph 7.29, the CAA said that its and BAA's interpretation of the Annex 4 agreement was also the CC's interpretation in its [2002 price control report on BAA's London airports](#). The report referred (in paragraph 2.422) to the Annex 4 agreement as: 'The agreement of the CAA and BAA to improve the process on consultation of the CIP in future years ...' (referring in this instance to Heathrow's development plan, but by implication also relevant to Gatwick and Stansted). It argued that we were now giving the misleading impression that the CAA and BAA each distorted a previously agreed interpretation of what the Annex 4 agreement should entail. This interpretation was given even greater currency in paragraph 2.69 of our provisional findings, which stated unequivocally that the CAA had 'reduced the scope of the information to be provided to the CIP and the masterplan'. The CC's 2002 report, however, showed that this was simply not true.
- We acknowledge in paragraphs 7.29 and 7.33 that Annex 4 was an agreement between BAA and the CAA, not the result of any recommendation by us: and 'central business plan document' was the term used in Annex 4.
26. On paragraph 7.32, the CAA said that Annex 4 was not a formal binding condition on the airports, because the CC did not make a public interest finding for Q4 (nor for Q5), without which the CAA had no legal locus to impose such binding conditions. Annex 4's status was that of an informal agreement between the CAA and BAA on a set of expected behaviours and procedures with respect to consultation on airport development, performance against which would inform the CAA's judgement on the opening Q5 RAB. In other words, BAA was incentivized to comply in order to minimize the risk of Q4 investments being excluded from the RAB. There was no other mechanism, either intended by the CAA or legally feasible (given the absence of a CC public interest finding), for the CAA to 'enforce requirements'. The CAA implemented its own regulatory policy consistently with its statement in the Q4 decision, and considered the degree and effectiveness of consultation (along with evidence on efficiency of project management) when assessing the Q5 opening RABs. As a result, the CAA excluded one relatively small project which, in the CAA's view, BAA had not consulted airlines on at all. We could have advised the CAA to make further, penalizing, reductions from the RAB on account of any perceived non-compliance with Annex 4 but we did not do so. On the broader point of whether BAA is customer-focused, it should be observed that the substance of Annex G (which replaced Annex 4) was developed and very largely agreed between BAA and the airlines, without the need for the CAA to press for specific improvements. The CAA did settle a small number of outstanding differences between BAA and airlines right at the end of consultation between the parties on the text of Annex G. BAA said that Annex G represented a commitment by BAA to extend the Annex 4 agreement in line with the evolving requirements of airlines. BAA therefore factored into Annex G a number of additional commitments at the request of airlines which extended BAA's obligations

on consultation far in excess of Annex 4. There was no basis for us to infer that BAA took these steps on any basis other than to meet the requirements of its customers. No contrary view had previously been expressed by any of the participants in the review of Annex 4 or the consultation supporting Annex G.

- We accept the CAA's point that Annex 4 was a voluntary agreement between the CAA and BAA, but, as noted in paragraph 7.68, see a need for the CAA to be involved in monitoring and/or facilitating the effective operation of consultation mechanisms between quinquennial reviews, given, inter alia, its requirements for the subsequent review.
27. On paragraph 7.39(b), the CAA said that the additional projects were those specifically requested by airlines to be included in the Q5 programme (many of which were accelerated from Q6) in order to deliver in Q5 the standards of airfield and terminal infrastructure the airlines wanted. The CAA said that this example might thus be cited positively as one of BAA responding to users' demands, as might, indeed, the fact that BAA spent materially more on capital expenditure than in the Q4 determination (without remuneration for the return on that capital in Q4) to enable BA to move into T5 more swiftly than originally planned. In our Q5 report, we recommended that some provision be made to enable the options for development of a third runway to be funded in a timely fashion during Q5.
- We acknowledge that many, if not all, of the additional projects seem to have been requested by airlines. We remain concerned, however, that those projects were put into the Q5 determination with too little discussion of their costs and benefits, because of a lack of time between the CAA's proposals in November 2007 and its decision in March 2008. The lateness of these increases in the process gives rise to a concern that BAA has 'gamed' that process, at least to some extent.
28. On paragraph 7.39(b), the CAA noted that in our Q5 report we recommended that some provision be made to enable the options for development of a third runway to be funded in a timely fashion during Q5. A return on that expenditure was subsequently allowed by the CAA subject to appropriate protection for users. Such protection would take the form of *ex-post* tests applied to the Q5 expenditure on the Project for the Sustainable Development of Heathrow (ie a new runway and terminal facilities, subject to environmental limits not being breached) both at the mid-quinquennial review and as part of the Q6 review, covering (a) best practice management; and (b) effective consultation in line with the processes for enhanced information disclosure and consultation (set out in Annex G to the decision document). The CAA would also expect to apply a further *ex-post* test, namely to review whether the expenditure was necessary at the time it was incurred. The CAA said that it would expect decisions about whether expenditure was necessary (or not) to be taken by reference to the CAA's statutory duties under the Airports Act. To facilitate the application of these tests, the CAA would expect BAA to maintain adequate accounting records, regularly updated and disclosed to users, setting out the out-turn expenditure on Heathrow expansion incurred in Q5 against the budget. But it concluded that BAA might, in any case, wish to enter into other specific charging arrangements with airlines that dealt with the possibility that Heathrow expansion took place in a different way, or to a different timetable, from that envisaged, or did not take place at all. It would, for example, be open to BAA to charge beneath the cap to reflect savings arising from the absence of government support for Heathrow expansion. In this respect, BAA had recently indicated that it would not price to the cap to the extent that it did not incur expenditure, as planned, on Heathrow expansion in Q5.

- We note the CAA's points on the treatment of expenditure on PSDH, though also note that the profile of expenditure will have changed significantly given the Government's decision to reject mixed mode for Heathrow in January 2009.
29. On paragraph 7.42, the CAA noted that our Q4 inquiry had referred to 'the agreement of the CAA and BAA to improve the process on consultation of the CIP in future years', and this was also the CAA's interpretation set out in its February 2003 Consultation Document (see also paragraph 25 above).
- We note the CAA's point.
30. On paragraph 7.42, the CAA noted that it was not clear that such disclosure by an airport of its full commercial business plan to its airline users was in fact the norm in well-functioning competitive markets. Airlines could expect, though, from every major airport a clear masterplan for the physical development of the airport over the medium term.
- We note the CAA's point, but consider that this may not be relevant to consultation in a regulated environment, where the discipline of competition is largely absent. In Appendix M of our Stansted Q5 report (reproduced at Appendix 10.8), we accepted that certain information might not be disclosed.
31. On paragraph 7.46(a), which stated that '[Currie & Brown] reported "a mismatch" between the regulatory assessment criteria aimed at encouraging investment in airport facilities and the criteria aimed at driving a 'lean' capital efficient investment plan', the CAA considered that our assessment misinterpreted its statutory duties, by suggesting that it inevitably favoured timely investment rather than efficient investment, with resulting cost to users. This was not the case. It was true that each of the CAA's individual statutory duties could, if taken on its own, lead to different regulatory conclusions. But it was tasked under the Airports Act to combine these considerations in reaching its regulatory decisions, and must therefore find the appropriate balance between the competing factors which (in the CAA's view) best met its statutory duties taken together.
- See our comment on paragraph 9 above.
32. On paragraph 7.53(c), the CAA said that significantly more detailed scenario analysis was required. Consultation was also required on the quality of service implications of each project.
- We accept that all this could be argued to be necessary under Annex G (which, for instance, says 'Consultation with airlines will also be required to take account of their views on current and future operational processes, requirements and airline moves. This may involve discussions about future airline plans for check-in, fleet, baggage etc'), but we consider that Annex F is much more explicit about what is required.
33. On paragraph 7.58, the CAA's approach was to encourage normal commercial dealings between airport and airlines (and to try not to hinder these processes by getting involved when unnecessary). In the event of disagreement, each party would be aware that the CAA would step in, to consult on its own proposed trigger definition, informed by the consultations between airport and airlines up to that point.
- Our concerns about the agreement of capital expenditure triggers at Heathrow and Gatwick are detailed in paragraphs 7.66 and 7.67. It is unlikely to be reflective of normal commercial dealings that, one year into Q5, and while airlines are

paying for most of the triggered projects, there are still no triggers in place to return money to customers in the event that those projects are not started. The value of a facilitator role was shown by our own experience in the Stansted inquiry (see paragraph 6.23).

34. On paragraph 7.66, the CAA did not accept our characterization of the capital expenditure trigger process in the Q5 price control decision. The definitions adopted in the March 2008 Q5 price control decision were summary references, linked explicitly to the outline project plans which formed the January 2008 investment plans on which each airport's price control was based, with a clearly-defined process for subsequently refining and specifying the detail of the trigger milestone definitions during April–August 2008, following which the CAA would consult on and then determine itself the trigger definitions against which performance would be measured.
- Following airport–airline consultations, the CAA published proposals for the specification of capital expenditure triggers in October 2008 for Heathrow, and December 2008 for Gatwick. It published its decision for Heathrow in February 2009, and is still (in March 2009) considering the responses to its consultation for Gatwick. It is difficult for us to comment further on the process, beyond noting our concerns (see paragraph 33 above) until the process is concluded.
35. On paragraph 7.66, the CAA did not agree with this generalized assessment. It argued that airlines would each take an individual commercial judgement about the level of resources to devote to consultation processes at each designated UK airport. There were, however, established airline consultative committees at each airport through which airlines could make their views known without devoting substantial amounts of their own resources, or duplicating their efforts. In addition, airlines (through IATA) had been able to procure specialist technical advice during the Q5 review (on capital expenditure efficiency at Heathrow) in order to provide their own evidence base for use in debate with BAA.
- We note that there are mechanisms for airlines to make their views known to BAA, either alone or in combination with other airlines. We consider, however, that each of those mechanisms has weaknesses which may mean that smaller airlines are not represented, or are represented insufficiently. The SACC, for instance, has told us that it only takes a position on an issue when it can do so unanimously. Some airlines have repeatedly emphasized to us throughout the market investigation that the level of resources required for participation in Constructive Engagement is a serious impediment to the effectiveness of that process, and therefore to the delivery of appropriate investment at the designated airports.
36. On Appendix 7.2, paragraph 3, the CAA referred us to its description of the history of the HET development. The emerging delays in the planned opening of HET are mentioned in paragraphs 8.25 to 8.28 of its March 2008 decision document, including its conclusion to endorse the inclusion of BAA's latest plan for HET within the Q5 capital investment programme. The CAA told us that it was familiar with the apparent concerns of some airlines about some aspects of HET cited by the CC, as well as concerns of Star Alliance which had been expressed during 2006 to early 2008, in the earlier stages of HET development. It appeared to the CAA, based on discussions with Star Alliance representatives, that these concerns had largely been addressed satisfactorily by BAA in its latest iterations of the HET plan, or were continuing to be debated as part of the process of refining the design.
- The feedback we have received from Star Alliance, summarized in paragraph 7.44 and paragraph 7 of Appendix 7.1, is at variance with the CAA's and BAA's

relatively positive assessment, though Star Alliance considered that some progress had been made over the past year.

37. On Appendix 7.2, paragraph 8, the CAA did not agree that only BA had the wherewithal to engage fully with BAA at Heathrow. The comparison between T5 and HET in its view said little about the ability of Star Alliance members to engage effectively with BAA. It was apparent that Star Alliance had been very closely engaged in negotiations with BAA around the design and specification of HET for some period of time, since the project was first announced in 2006, and Star Alliance continued to be so involved. It was also apparent that the results of this active engagement had been changes to BAA's design and construction plans for HET to align better with Star Alliance's emerging requirements, for example construction of the HET midfield pier in its entirety in Q5, in advance of any outer pier, the provision of closed gaterooms in part of the midfield pier, and the provision of a tunnel link between HET and the midfield pier on opening of the new terminal. This would suggest that airlines, other than BA, were able to shape BAA's construction plans at Heathrow to their advantage by investing appropriate levels of resources in consultation with BAA. Another interpretation of the facts was that the two terminals were very different projects. The differences between the projects included that: T5 had a very protracted design and planning phase, during which many of the design issues currently facing HET were resolved away from the regulatory spotlight; it was a 'greenfield' site, landside, and some way from current airfield operations; and it had a single airline occupant. HET by contrast had been subject to more accelerated planning and development, partly driven by the 'window of opportunity' afforded by the opening of T5 to move airlines away from the T2 site of HET and thus construct a new terminal; it was situated right at the heart of the airside operations, with inevitable constraints on construction and operation of existing and new facilities; it required a complex sequence of prior airline moves to free up the construction site; and it was planned for multiple airline and alliance occupancy, with associated challenges in aligning all stakeholders around a single plan. It was not surprising that BAA's consultation with Star Alliance and others on HET had been more challenging than BAA's collaboration with BA on T5—general conclusions about BAA's behaviour could not necessarily be inferred from the specifics of the HET project. The CAA did, however, regard it as important that HET should provide competitive equivalence with BA for the Star Alliance airlines, and shared the concerns about the delays in achieving this and how adequately it would be achieved.
- We agree that Star Alliance (which is a grouping of more than 20 airlines, rather than a single airline) has engaged with BAA on the development of HET: but remain concerned about the asymmetry of resources available to Star Alliance compared to BAA and the adequacy of aspects of current consultation procedures.