



# Best Practice in Economic Regulation: Lessons from the UK

ICAO Global Aviation Cooperation Symposium  
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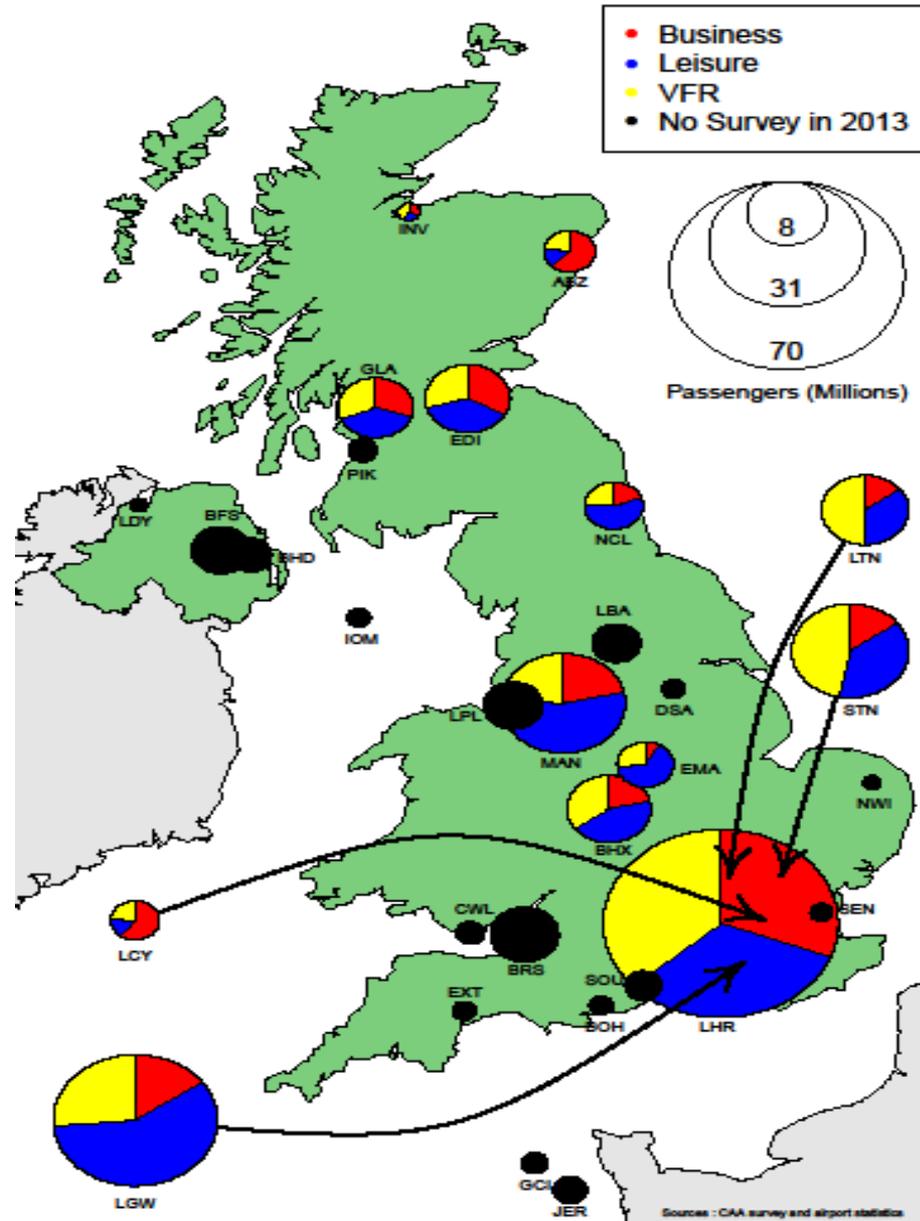
# Scope of Economic Regulation



- Airports
  - Among the 60 airports in the UK, two are subject to economic regulation
  - Some airports enjoy locational advantage
  - Five-year regulatory cycles in the past.
  - Different forms of regulation and review cycles going forward
- National Air Traffic Services (NATS)
  - A national monopoly
  - A five-year regulatory cycle
  - International dimension: economic regulation need to follow decisions made in the European Union
- Airlines
  - Limited economic regulation but new concurrent competition powers
- This presentation focuses on economic regulation of airports

# UK Airports – Relative Sizes

- CAA Passenger Surveys
  - To inform its regulatory work, the CAA conducts surveys in UK airports
  - About 100,000 interviews are done every year
  
- Observations
  - Activities concentrated in the Southeast of England
  - Proportion of business passengers is highest in London, Aberdeen and Edinburgh



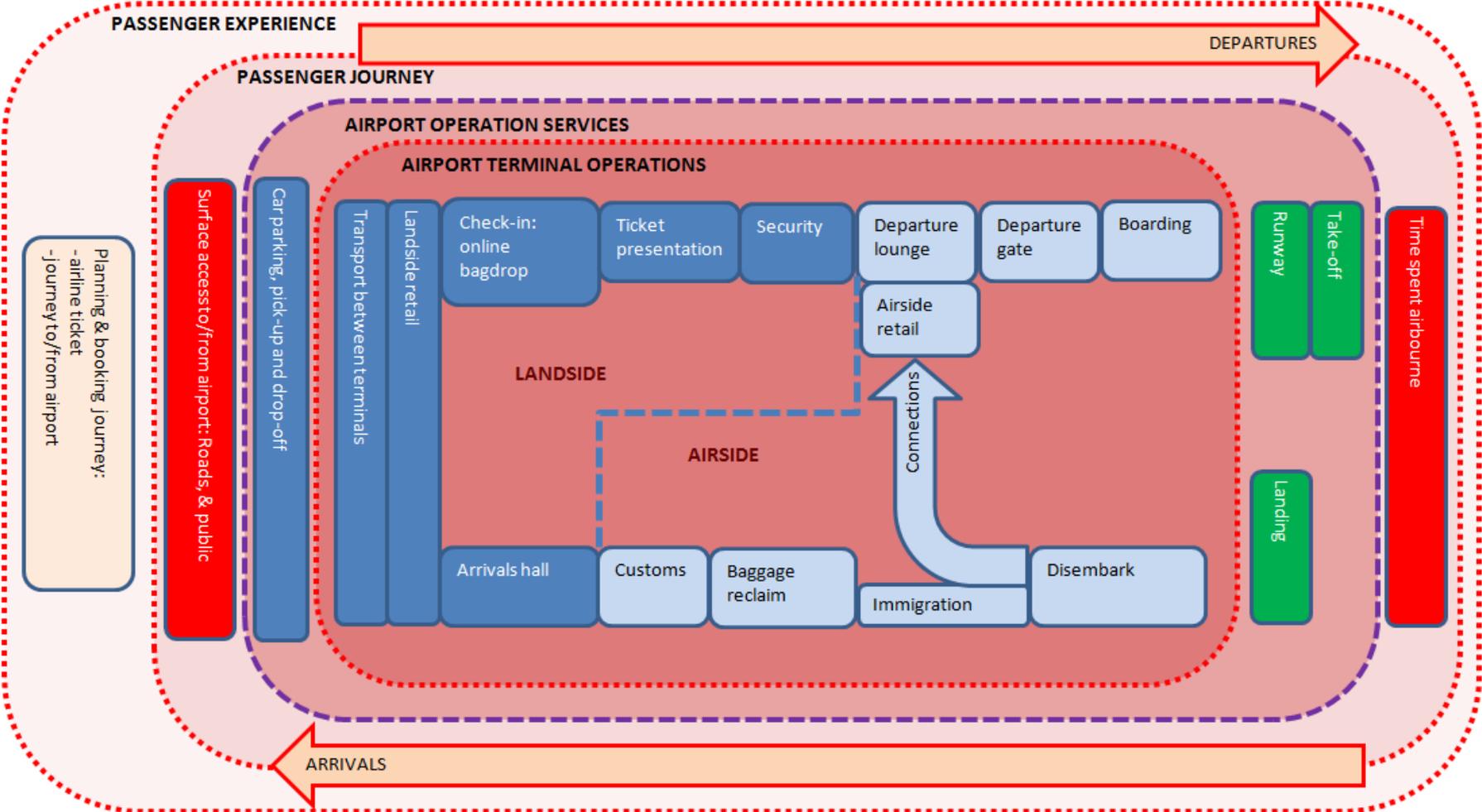
# Why Regulate?



Why does the CAA regulate Heathrow and Gatwick?

- CAA regulates when an airport has Substantial Market Power (SMP) over its users (airlines, cargo and passengers)
- Main reason for regulation is to prevent:
  - excessive pricing (above a competitive level);
  - under and inefficient investment;
  - poor efficiency;
  - poor service quality;
  - imposing unfair trading conditions
- In January 2014, CAA issued SMP decisions for Heathrow, Gatwick and Stansted
  - (<http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=12275>)
- On 13 February 2014, the CAA published airport licences:
  - Heathrow (<http://www.caa.co.uk/cap1151>)
  - Gatwick (<http://www.caa.co.uk/cap1152>)

# What Aspects of the Passenger Experience do we Regulate?



# Heathrow – Market Power and Regulation



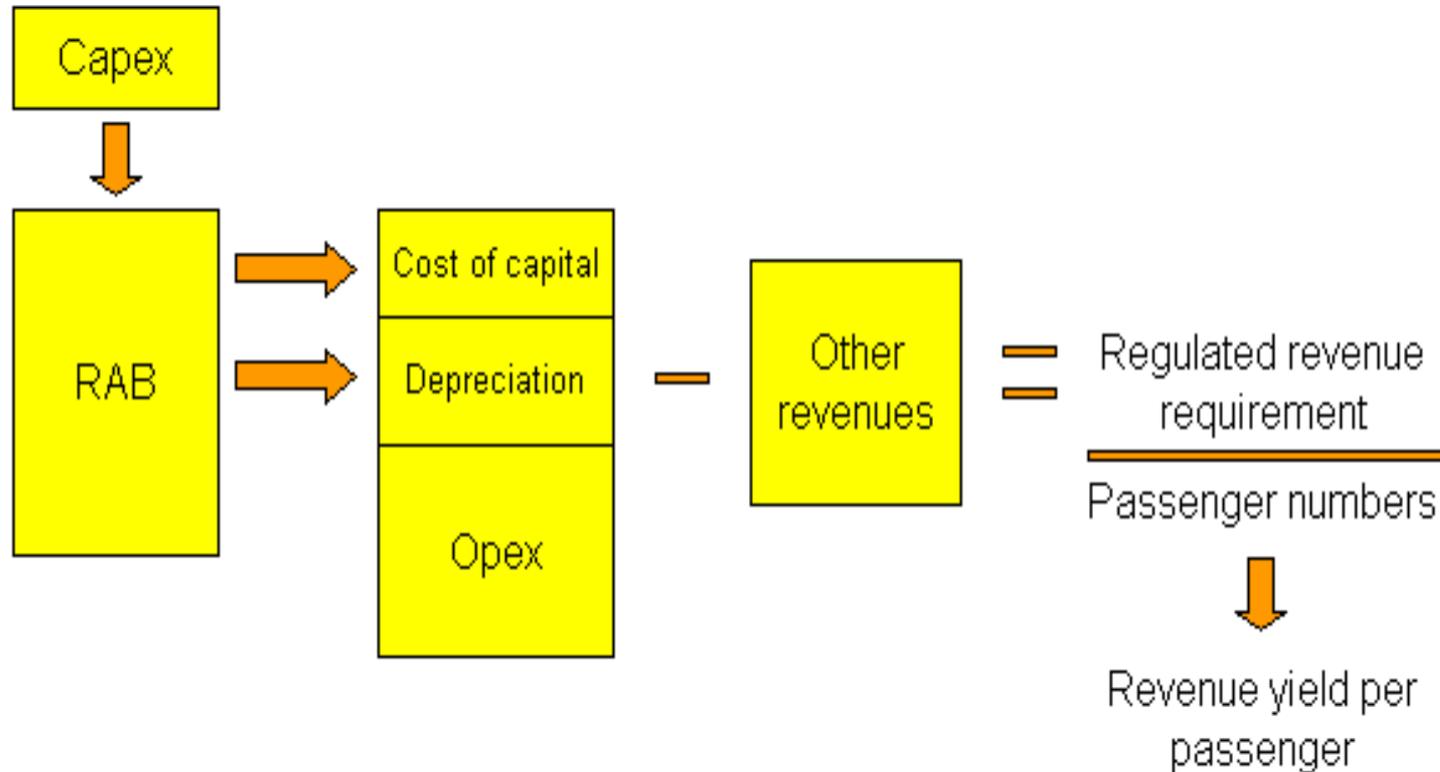
- CAA determined that the three components of the market power test were met by Heathrow, due to:
  - Lack of capacity and hub effects means that Heathrow has Substantial Market Power (SMP)
  - Competition law is unlikely to prevent high prices
  - Performance under the current regime suggests that the benefits of regulation outweigh the costs
  
- RAB approach deemed the most appropriate form of regulation:
  - Suitable for markets with high level of market power
  - Balances the needs of passengers and investors
  - Agreement between airport and airlines

# Heathrow – Q6 Regulatory Settlement

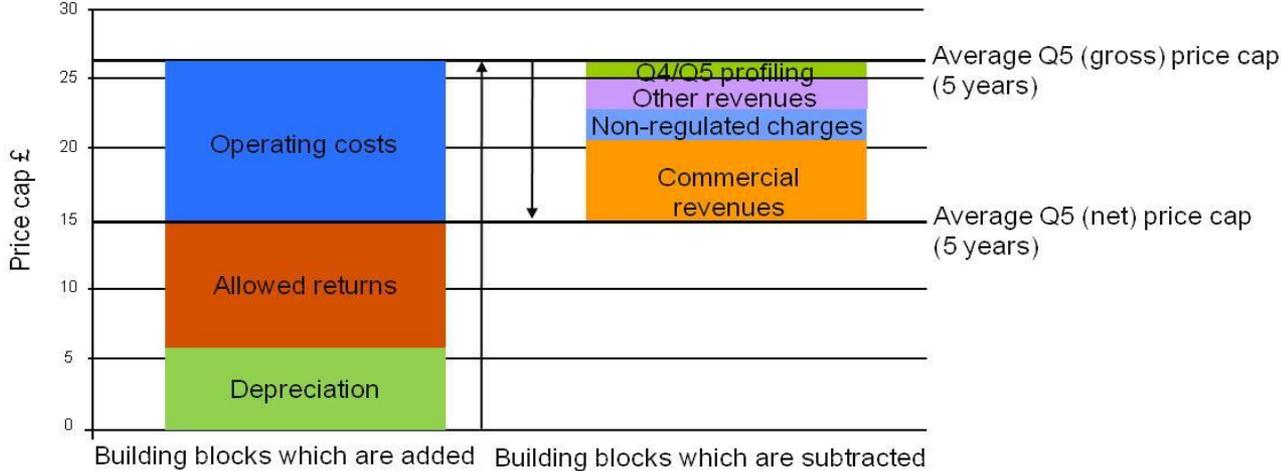


- Heathrow's charges will not rise by more than RPI-1.5%, based on:
  - 74 million passengers per year by 2018
  - £3bn capex plan
  - 2% annual opex efficiency target
  - WACC = 5.35%
  - Yield per passenger will fall from £20.60 to £19.10 by 2018
  
- Settlement includes several features:
  - Constructive Engagement over capex programme
  - Core and development capex to allow flexibility
  - Capex triggers to incentivise timely delivery of projects
  - Passthrough for security and rates revaluation costs
  - Service Quality Rebate and Bonuses

# Heathrow – RAB Based Approach to Regulate Price



# Heathrow – Building Block Sensitivities



Impact on price cap					
	10% reduction in			10% increase in	
	capex	opex	cost of capital	commercial revenues	number of passengers
Heathrow	-2.1%	-7.6%	-6.0%	-4.3%	-10.0%

# Heathrow – Regulating Capital Expenditure



- Standard RAB-based approach incentivises the airport to:
  - bid 'large and early' and deliver 'less and late';
  - To 'gold-plate' (if airport considers it can outperform WACC)
  
- Airport and the airlines agree what is built
  - CAA doesn't dictate what is built
  - Has influence through RAB treatment, service quality and operational resilience licence conditions
  
- If no agreement, the CAA will take a view on what is allowed into the RAB and its value
  
- Need to avoid retrospective changes to RAB rules

# Gatwick – Market Power and Regulation



- CAA determined that the three components of the market power test were met by Gatwick:
  - Gatwick has SMP, due to its density of leisure routes, wealth of catchment and the inherent attractiveness and limited capacity of the London market
  - Airlines are unlikely to be able to credibly threaten Gatwick
  - Competition law does not provide sufficient protection against the risk that Gatwick may abuse its SMP
  - The benefits of licence regulation are likely to outweigh the adverse effects
  
- Commitments should provide benefits over RAB based regulation:
  - Encourages bi-lateral, tailored contracts
  - Provides increased certainty
  - Reduces direct costs of regulation

# Gatwick – Form of Regulation

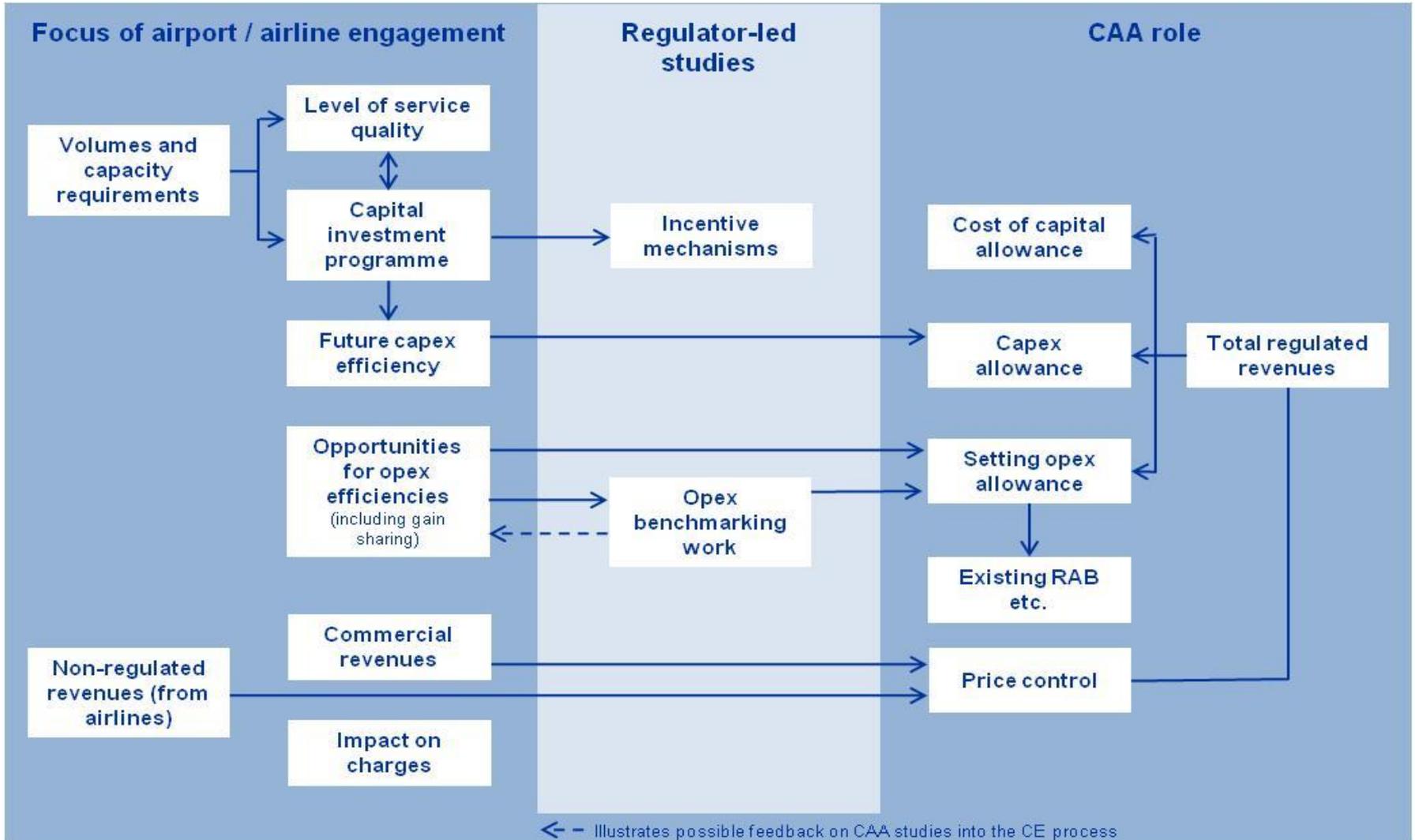


- 7 year commitments offered by Gatwick to airlines backed by a licence and a monitoring regime
  - Enforced by the CAA – with statutory duty to further passengers' interests
  - As opposed to Gatwick's commitments being enforced by airlines
- Monitoring regime to ensure Gatwick's price based on published charges and bilateral contracts does not rise above RPI-1.6% pa
- Integrated framework tailored to individual airlines and their passengers
  - Service quality
  - Capital investments
  - Operational practice
  - Volume commitments
  - Price
- Suite of minimum service quality standards
- Obligation on Gatwick to improve operational resilience

# Constructive Engagement used to reach our decision

- Formal process of airport and airlines discussing what they want
  - Co-chairs airport and airline
- Introduced for Q5
  - Addressed capex only
  - 'Price' revealed by CAA later in the process
  - Q5 Standed: major disagreement over development (2nd runway) which frustrated CE
- For Q6
  - Capex, opex, other revenues, service quality and forecasting in scope
  - Cost of capital out of scope (zero-sum game)
  - Mid- CE review by CAA
  - Airlines and airports set out jointly what they have and haven't agreed in the final report

# Constructive Engagement Process



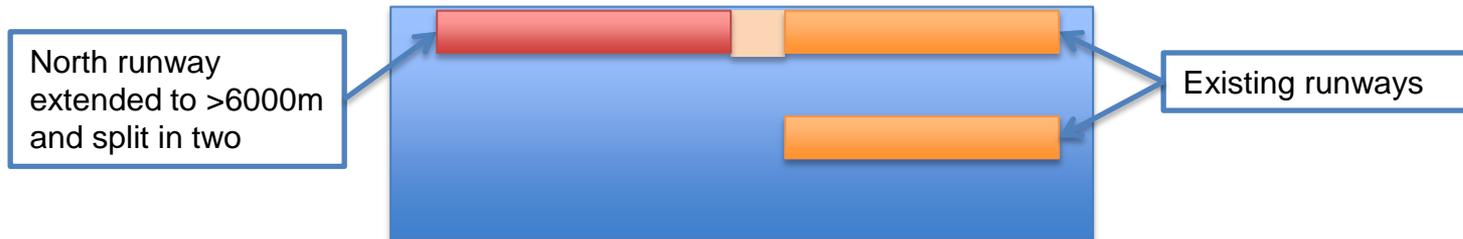
# New Runway Capacity - Background

- Airports Commission set up by Government in 2012
- Examine options to ensure UK retains position as Europe's most important aviation hub
- Interim report (December 2013):
  - nature, scale and timing of the steps needed to maintain the UK's global hub status
  - immediate actions to improve the use of existing runway capacity in the next 5 years
- Final report – 2015 (after election)
  - options for meeting international connectivity needs, including economic, social and environmental impact
  - recommendations for the best way to meet needs
  - recommendations for ensuring need is met ASAP
- CAA is the key advisor to the Airports Commission



# New Runway Capacity - Options

- Interim report concluded that demand will require
  - One additional net runway by 2030
  - One further net runway by 2050 (outside of Commission's remit)
- Short list for long-term option:
  - An additional 3,000m runway at Gatwick, south of the existing one
  - An additional 3,500m runway at Heathrow, north west of the existing two
  - Developing the northern runway half of the so-called Heathrow Hub proposal



- Thames Estuary
  - Now ruled out after studies on economic impact, airspace implications, habitat and surface access

# Runway capacity – Economic Regulation Issues

- Regulatory certainty & cost of capital
- When to conduct a new market power assessment
- Financing options
  - Same RAB / Separate or split RAB / Special purpose vehicle
- Regulatory time period
  - Set the WACC for 5, 10, 20 years (or other)
- Allocating risk to those parties best able to manage it
  - Financing / Construction / Cost / Demand / Regulatory / Political
- Recovery of costs
  - Pre-financing - Assets in course of construction (AICC)
  - Assets in operation
  - Scrutiny of costs
- Impact of slot regulations

# Summary – The Benefits



- Lower airport charges
  - Significant investment at regulated airports
  - Rising commercial revenues and lower operating costs
  - Improved operating efficiency
  - Better quality of service
  - Higher overall passenger satisfaction
  - Reduced flight delays
  - Competitive airline market
- 
- With appropriate economic regulation frameworks, these benefits could be replicated in other international airports

## CAAi Services in Economic Regulation

Benefitting from over 25 years of experience in economic regulation as a subsidiary of the UK CAA, CAAi offers a number of services providing advice on aviation policy from an economic standpoint. Applying our expertise on economic policy and strategy in aviation, we aim to secure the best sustainable outcome for users of air transport services in the following areas:



- Economic regulation of airports and Air Navigation Service Providers
- Government aviation policy
- Service quality regulation and audits
- Design of capital and cost efficiency incentives
- Consultation processes and constructive engagement
- Airport / ATM regulatory financing
- Economic and regulatory training
- Airport passenger surveys and market reports
- Aviation forecasting and statistical analysis
- Competition and market power assessment
- Environmental impact assessment
- Consumer policy and enforcement
- Aviation dispute resolution

# Appendix A: CAA duties and market power assessment

## Market power assessment

**Test A:** The relevant operator has, or is likely to acquire, substantial market power in a market, either alone or taken with such other persons as the CAA considers appropriate

**Test B:** Competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that substantial market power

**Test C:** For users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects

## Duties

Further the interests of passengers (and cargo owners) regarding the range, availability, continuity, cost and service quality of airport operation services

Pursue this objective by promoting competition, where appropriate

When undertaking these duties have regard to:

- the need for a licence holder to finance its activities;
- that all reasonable demands for airport services are met;
- promote economy and efficiency of the licence holder;
- regulatory activity to be transparent, accountable, proportionate, consistent and targeted only at cases where action is needed;
- any guidance issued to the CAA or international obligations.