Regulation of an increasingly competitive airport sector

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1. Executive summary

I BACKGROUND AND THE DISCONNECT IN POLICY

1.1. I have been asked to advise on issues associated with regulation of the increasingly competitive airport sector, particularly at Gatwick and taking account of the Commitments and Contracts that Gatwick Airport Ltd (GAL) has offered.

1.2. UK airline and airport sectors are now more competitive, and the new Civil Aviation Act 2012 puts an onus on the CAA to demonstrate that an airport has market power before it can be price regulated. Yet surprisingly, the CAA is still proposing to license all the ex-BAA south-east airports and impose RAB-based price controls, or arrangements that replicate significant aspects of them.

1.3. This "nothing has really changed" stance suggests a substantial and worrying disconnect: the significant change in circumstances calls for a significant change in regulatory policy, but the detailed working of the regulatory machine has responded only in form rather than in substance.

1.4. How to explain this? Perhaps the CAA's present thinking is inconsistent with its previous thinking, which suggests regulatory uncertainty. Another possibility, as argued in this paper, is that the CAA has not given sufficient consideration to the meaning of competition and the significance of its new duty to promote competition where appropriate. As a result, the CAA has overestimated the benefits of regulation and its impact on price in the short-term, but failed to realise the adverse effects that its proposals will have on the development of competition, and hence on the benefits to users over the longer term.

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II THE NATURE OF COMPETITION

1.5. Despite the CAA's new duty to promote competition, its consultation documents have barely considered how to do this. Its *Gatwick initial proposals* contains merely a few sentences in some tables about this duty, but devotes over 120 pages to calculating a "fair price" for which the CAA has no explicit statutory basis.

1.6. The CAA has an unduly limited concept of competition, essentially meaning that price equals cost. Hence the CAA is led to think that promoting competition means keeping price equal to cost, which it

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considers is best achieved by means of a RAB-based price control or equivalent.

1.7. Competition is more realistically understood – not least by the Competition Commission (CC) in its market investigations including into the airport sector - as "a dynamic process of rivalry between firms seeking to win customers' business over time". Airports and airlines seek to discover and provide the prices, qualities of service, terms and conditions, duration of contract or rack-rate tariff, and other arrangements that best suit each individual user given the other competing offers available.

1.8. To promote competition means to encourage this rivalrous discovery process, not to second-guess the answers. Indeed, inappropriate regulatory restrictions may stifle that process and thereby restrict competition. In particular, maximum price caps and minimum quality of service conditions, that may seem in the short-term interest of airlines and passengers, may discourage potentially competing airports from exploring and offering alternative opportunities that could be in the longer term interests of these same airlines and passengers.

1.9. The mode of regulation needs to reflect the complexity of the airport sector, where a competitive process is needed to discover the best terms for each airline. The CAA says that "competition should as far as possible mimic the conditions a firm would face in an effectively competitive market." But the CAA does not have a duty to mimic the conditions a firm would face in a competitive market. It has a duty to promote competition. In a complex market, trying to mimic competitive prices and other conditions could deter, rather than promote, competition.

III THE MARKET POWER TEST

1.10. The new market power test is in three parts. Test A is whether an airport has market power. The CAA's assessment of competition places relatively little weight on the increased competitive incentives induced by the changes in ownership at the south-east airports. These can be expected to have increasing effect over time. Furthermore, they are not independent of regulatory action: holding down prices will dampen these competitive forces whereas allowing the airports greater commercial freedom will enhance them.

1.11. Test B is whether competition law provides sufficient protection against the risk of abuse of market power. The CAA argues that competition law does not provide as much or as rapid protection as regulation does. However, GAL's proposed Commitments reduce the extent of any such risk, the extent of potential market power abuse may not be as great as the CAA's initial calculations of RAB-based price controls suggest, and the lower price levels that the CAA proposes would discourage competition between airports, against the longer-term interests of customers.

1.12. Test C is whether the benefits of regulation by licence are likely to outweigh the adverse effects. The CAA argues that regulation will provide lower prices and greater benefits than the Commitments offered by GAL, and that GAL's Commitments lack substance and enforceability. However, the CAA overlooks the disadvantages of enforcing lower prices

and apparently greater benefits by licence, in terms of their disincentive effect on competition. The CAA is concerned about consultation and transparency, but its requirements there seem greater than would characterise a competitive market. It is concerned about enforceability, but there are other ways of increasing enforceability of the Commitments than regulation by licence. For example, Ofcom has accepted commitments offered by BT. Licensing will also increase pressure on the CAA to intervene in the market, which will tend to undermine the competitive process rather than promote it.

1.13. The CAA has thus overstated its case for finding that GAL passes all three elements of the Market Power Test. The case for regulating Gatwick by licence has not been clearly established.

IV REGULATION OF AN INCREASINGLY COMPETITIVE AIRPORT DEEMED TO HAVE MARKET POWER

1.14. Assume, for the sake of argument, that an airport passes the Market Power Test. What kind of regulation would be appropriate?

1.15. In its early discussions the CAA acknowledges that RAB-based approaches can distort incentives and adversely affect competition, but refers to other regulators using RAB-based price controls. However, the products in these other sectors are simpler than the mix of services provided by airports, and these regulators do not use RAB-based controls in their competitive sectors.

1.16. The CAA reviews several options for regulation, finding that each has limitations. It mentions Constructive Engagement (CE). Appendix A to this paper explains that CE has worked well in helping to implement RAB-based price controls but is not an appropriate basis for an increasingly competitive market. An example from the Canadian gas sector shows how increasing competition led regulated companies and their customers to move from collective negotiation to bilateral contracts.

1.17. The CAA's *Gatwick initial proposals* repeats its review of alternative regulatory options, but now calculates its "fair price", and uses this to assess the alternative forms of regulation. From a competition perspective, this puts the cart before the horse. It assumes that the regulator can know the competitive outcome without the need for a competitive discovery process. Not surprisingly, given that its fair price is defined as the average revenue resulting from the application of its previous RAB-based price control approach, the CAA finds that alternative forms of regulation are inferior to a RAB-based price control.

1.18. The CAA indicates its preference for GAL's Commitments in lieu of a RAB-based price control, but only on condition a) that the substance of the Commitments is modified to reflect the substance of the RAB-based price control, and b) that the Commitments are enshrined in the licence in order to ensure enforceability. My reservations are threefold. First, it is not clear that the CAA's additional demands are consistent with what a competitive market would provide and they may unduly constrain the development of competition, to the detriment of users of Gatwick airport. Second, there are alternative ways of enforcing the Commitments without a licence, for example via bilateral contracts with users or undertakings to

the CAA. Third, the licensing of Gatwick would encourage the CAA and other parties to intervene more frequently, which again would not be conducive to the development of competition.

1.19. The CAA has proposed monitoring at Stansted, and suggested voluntary undertakings. Given the drawbacks of licensing, I have considered the possibility of regulation at Gatwick by means of monitoring plus Commitments from GAL, where these Commitments are not included as part of the licence.

1.20. Appendix B to this paper reviews the CAA's consultants' reports on monitoring and Australian experience with such a policy. Monitoring has been a generally successful approach in the Australian airport sector, and there is no call to bring back price control. There is an annual monitoring review, carried out by a regulator that does not have power to bring about reregulation or impose additional licence conditions.

1.21. Monitoring would reduce the burden of regulation. Uncertainty about acceptable prices would be overcome by GAL's price undertaking Commitment. Monitoring would promote competition via negotiation between airports and airlines. Enforcement would be possible via bilateral contracting or undertakings, and does not need licensing.

1.22. Monitoring plus Commitments would be more flexible than licensing, a step closer to an unregulated competitive market, and therefore more consistent with promoting competition. While not preventing the CAA from taking an active role and proposing a licence if it considered that GAL was exercising market power, the monitoring approach would promote competition by reinforcing the expectation that issues and differences should be resolved by means of commercial negotiations and contracts rather than by regulatory intervention and a revised licence condition.

1.23. The CAA recognises that price monitoring would have costs, but considers that the annual report would allow transparency to facilitate negotiations with GAL. The CAA could therefore determine the frequency and detail of monitoring to balance the costs and benefits. A monitoring report every two or three years, rather than annually, might well suffice.

1.24. A regulatory body cannot hope to determine the most appropriate prices and services for each airline at each airport. The most effective way to promote competition is to give maximum opportunity for the airports and airlines to work out these details for themselves. Commitments and monitoring can provide reassurance during this process.

1.25. It may at first seem difficult for a regulator to argue that licensing and price regulation are no longer appropriate. But maintaining licensing and price regulation will mean that debate on their merits will continue to be based on hypothetical conjectures rather than on empirical evidence, and will prevent the learning from experience that is necessary for improving the regulatory framework. With the most significant changes in airport sector and regulatory conditions for nearly three decades, a window of opportunity is open that will gradually close. If licensing and price regulation are not removed now, will they ever be?

PART I BACKGROUND AND THE DISCONNECT IN POLICY

2. Terms of reference

2.1. Gatwick Airport Ltd (GAL) has asked me, as an economist, former GB electricity regulator, and consultant on regulation internationally, to advise on the following. Significant changes have taken place in the UK airline and airport sector, particularly the divestment of airports by BAA and the introduction of the Civil Aviation Act December 2012. These changes are intended to increase competition and to modify the nature of regulation accordingly. I am asked to consider what issues regulation needs to address in this context. What form of regulation, if any, would be appropriate in future, making reference where relevant to experience in other markets that have been characterised by a transition to competition? I have focused in particular on regulation of Gatwick, bearing in mind the proposals that GAL has made in the form of "Contracts and Commitments", and considered the possibility of Commitments plus monitoring as a regulatory approach.

3. Background and context

3.1. There have been significant changes in the UK airline and airport sectors over the last decade.[1] To some extent the changes in airport sector structure have been prompted by the evolution in thinking of those institutions responsible for airport regulation. For example, the Civil Aviation Authority (CAA) and the Competition Commission (CC) recognised that the UK airport sector was becoming more competitive, that some restructuring of the sector could assist this, and that changes in regulatory approach were also appropriate. In 2007 the CAA argued that greater competition in the airport sector meant that Stansted could be de-designated (deregulated), that there would be advantage in BAA selling off some of its airports, and that the traditional regulatory approach to price control, which had become confrontational, could usefully be complemented by the introduction of Constructive Engagement (CE) between airports and airlines.

3.2. After the Office of Fair Trading (OFT) referred BAA to the Competition Commission (CC), the CC reported strong criticism of the CAA by the airlines. The CC itself also expressed a number of critical views. It criticised airport market structure, taking the view that the airport sector could and should be more competitive and recommended a breakup of BAA. It criticised the regulatory framework (eg the CAA's statutory duties), and suggested changes (eg providing for appeal to the CC after the CAA's price control decision, rather than an automatic reference beforehand). It criticised the CAA's conduct of CE rather than the concept of CE itself. Indeed, the CC itself subsequently used CE in proposing Stansted's price control.

[1] See for example David Starkie, *Aviation Markets: Studies in Competition and Regulatory Reform*, Ashgate, 2008

3.3. BAA was required to dispose of several airports. It has sold Gatwick, Edinburgh and Stansted. Significant restructuring of the airport market has thus happened. There is also evidence that this restructuring has begun to change airport conduct, not least at Gatwick.

3.4. The Government felt sufficiently strongly about airport regulation to take steps to change the law. The Civil Aviation Act of December 2012 makes several changes, particularly to the regulatory framework and to regulatory duties. The CAA is now required to regulate "in a way which is transparent, accountable, proportionate and consistent", targeting regulatory activities "only at cases in which action is needed". The Act also provides that the primary duty on the CAA is to further the interests of users, and immediately qualifies this by stating that "The CAA must do so, where appropriate, by carrying out the functions in a manner which it considers will promote competition in the provision of airport operation services."

3.5. In these respects the Act brings the CAA into line with other regulatory offices. But in another respect there is a significant difference. Before the present type of regulation may be applied, there is a new onus on the CAA to demonstrate that a three-part Market Power Test has been met.

- Test A is that the relevant operator has, or is likely to acquire, substantial market power
- Test B is that competition law does not provide sufficient protection against abuse of that market power
- Test C is that the benefits of regulation by means of a licence are likely to outweigh the adverse effects.

Only if the CAA can prove market power, and establish that all three tests are met, can the CAA license and price-regulate an airport. .

3.6. To summarise, the structure and conduct of the UK airline and airport sectors have already changed significantly. Policy was intended to make the sector more competitive and there is already evidence of this. In addition, the Civil Aviation Act makes a number of changes, including a new onus on the CAA to regulate so as to promote competition and in effect to demonstrate why it should intervene in what could and should be an increasingly competitive market. The CAA will therefore need to consider what changes in its approach will be appropriate to discharge its new responsibilities.

4. Top-down and bottom up regulatory analyses

4.1. A regulatory technique that has proved useful in the context of price controls, but has applicability more generally, is the concept of parallel top-down and bottom-up analyses. How these are applied varies from one case to another, but the general idea is to compare the messages that come from two different perspectives or approaches in order to provide a cross-check on the validity of the policy being developed.

4.2. For example, taking a top-down approach to an energy or water network price control, one might consider the general level of costs, quality, prices, profits and share prices achieved over the previous control period, how these compared with previous expectations, the prospects, obligations and expectations for the future, the general sense of

satisfaction or dissatisfaction with the companies, the situation in this sector compared to other sectors, and other relatively general and sometimes less tangible indicators of whether the next price control should reflect an increase or decrease in prices and of what magnitude.

4.3. In contrast, a bottom-up approach would look in detail at each element of operating cost and capital expenditure, trying to assess whether each company had been as efficient as it might be, noting where it exceeded or fell short of its performance in previous years or of the performance of its comparator companies, taking account of differing factors beyond its control that might help to explain its performance, drawing on consultants' investigations and reports, carrying out regression analyses, considering the implications for each element of the future price control.

4.4. If these two approaches provide broadly consistent suggestions for the price control, they provide the regulator with some assurance that it is on the right track. The more formalistic and mechanistic bottom-up analysis supports the more intuitive top-down sense of the right direction. But if there is a disconnect between the two approaches this suggests that something is amiss. One of the approaches is missing something that the other considers important. The regulator then needs to consider this issue carefully, to see whether one or the other approaches should be modified in order to reconcile the two approaches.

5. Top-down versus bottom up in the more competitive airport sector

5.1. What regulatory response would one expect to the new situation in the UK airport sector? In simple terms, a top-down analysis might run along the following lines. This sector has gradually become more competitive. Reflecting this, the CAA recommended in 2007 that Stansted be deregulated (de-designated). Following the CC's report in 2009, two of BAA's three south-east airports have been divested into separate ownerships so as to create more competition. The Civil Aviation Act 2012 has set up three significant hurdles before an airport can be regulated. One would therefore expect that the CAA would continue to recommend that Stansted not be regulated; that there would be a strong case for not regulating Gatwick either, especially in view of the Commitments that GAL is offering; and that even Heathrow had a credible case for not being regulated given that a competitive market would ration out scarce capacity by market-clearing prices that might be difficult to reconcile with regulation.

5.2. Such a policy conclusion would be consistent with the CC's 2009 airports market investigation[2], which refers to "the prospect that price control, at Gatwick and Stansted at least, is withdrawn as competition develops" (para 9.13) It says "Proportionality and the avoidance of over-regulation are principles of better regulation that are particularly appropriate for a marketplace where competition is expected to become increasingly workable over time. Faced with just such a marketplace, it will be the task of the regulator of airports to modify regulation appropriately to promote competition and as competition develops." (para 10.340) And "we

[2] *BAA airports market investigation*, 19 March 2009

strongly support the reduction and in due course, the removal of regulation, as competition develops". (para 10.344)

5.3. What in fact is the CAA's present regulatory response to these new circumstances? Surprisingly, the CAA's initial views on market power at the three south-east airports, and its recent consultation on Stansted,[3] and now its initial proposals for the three airports[4], all of which proposals may be said to be based on detailed bottom-up analyses, envisage that all three airports will meet the Market Power Test. That is, they will all continue to be licensed. Moreover, the CAA has now calculated RAB-based price controls for all three airports along the lines of the ones imposed in the last quinquennium. The CAA's initial proposals for Heathrow are precisely such a cap. The CAA's initial proposals for Gatwick are another RAB-based price cap; the CAA is open to the possibility that the airport might be subject instead to undertakings on prices and quality of service, but only on condition that these alternative arrangements have a similar effect as the calculated RAB-based price controls. The CAA's initial proposals for Stansted are for a price-monitoring and transparency regime, but backed up by a "show-cause" trigger equal to a price cap based on calculations of RAB-based price caps.

5.4. Thus, there seems to be a disconnect between a top-down analysis, which would suggest a significant reduction and removal of airport regulation, and the CAA's bottom-up analysis which proposes the continuation of regulation at all three airports using the previous RAB-based priced control calculations.

6. Taking account of the changes in structure and conduct?

6.1. The CAA argues that Test A is met at Stansted because the airport has market power in the short-haul market that may currently be substantial and is likely to become substantial over the next quinquennium. It argues that Test B is met because competition law would not necessarily produce a sufficiently comprehensive, swift or certain solution. It argues that Test C is met because regulation would prevent undesirably high prices without enforcing undesirably low prices, would stimulate greater increases in efficiency and improvements in service quality, would not in practice distort investment incentives, and would impose lower direct and indirect costs than in the past.

6.2. The CAA argues that Test A is met at Heathrow and Gatwick, too, because of their market power. It argues that Test B is met at both airports because of "the difficulties that result in pursuing potential exploitative vertical abuses" via competition law. It argues that Test C is met at Heathrow because the direct costs of regulation are small compared to the potential increase in efficiency and savings for passengers, and at Gatwick

[3] *Heathrow, Gatwick and Stansted – market power assessments, Summary of the CAA's initial views*, January 2012, *Consultation on Stansted Market Power Assessment, Summary*, December 2012 and *Stansted Market Power Assessment, Developing our 'minded to' position*, January 2013.

[4] *CAP 1026 Heathrow MPA Summary, CAP 1027 Economic Regulation at Heathrow from April 2014: initial proposals, CAP 1028 Gatwick MPA Summary, CAP 1029 Economic Regulation at Gatwick from April 2014: initial proposals, CAP 1030 Economic regulation at Stansted from April 2014: initial proposals*, all April 2013.

because GAL's proposed commitments are deficient with respect to substance and enforceability.

6.3. In its discussions of Test A, the CAA makes virtually no mention of the significant change in structure and conduct of the airport sector in the south-east. There are a very few exceptions: the CAA briefly acknowledges that things have changed at Gatwick:

> "The CAA acknowledges GAL's commitment to raising service quality since its change of ownership" and "The CAA considers that GAL's efficiency has improved under the new ownership" (*Gatwick MPA* paras 44, 45).

There is also prospect of change at Stansted:

> "It is also possible that, following the divestment of Stansted and the adoption of different management practices by the new owner of the airport, more airlines (and more passengers) might start to view Heathrow and Stansted as substitutes, particularly if STAL actively markets itself" and "The CAA is also mindful of the distortions of STAL's behaviour that may have been due to its joint ownership with Heathrow airport, and have seen evidence that this may have dulled its incentives to market itself aggressively" (*Stansted MPA* paras 7.4 and 7.18)

6.4. These are valid and important observations, but the first two remarks represent only a couple of sentences out of about 20 pages in the Summaries of analysis of Test A at Heathrow and Gatwick, and the second two remarks represent only another couple of sentences out of 167 pages of the analysis of Test A at Stansted. With these negligible exceptions, there is nothing in the CAA's analyses that suggests that the divestment and separate ownership of the three south-east airports has made any difference at all to any of its assessments of market power.

6.5. On Tests B and C, the CAA's argument is essentially that regulation by licence is likely to be more effective than resorting to competition law, so tests B and C would always be met. In fact, the logic of this argument seems to be that regulation by licence should be extended not only to all big airports but to all sectors of the British economy. This shows a touching faith in regulation, which is typically felt more strongly by regulators than by others.

7. How different is the airport sector now? Has anything changed?

7.1. The CAA fails to grapple with a key question. The many unregulated non-utility sectors in GB that are taken to be broadly competitive are surely nonetheless riddled with market imperfections and market power of many different kinds. Arguably there too a regulator could step in to protect customers more quickly and effectively than by resorting to competition policy measures. Yet Parliament deems that regulation would be unnecessary and inappropriate in those sectors. What then is different about the increasingly competitive airport sector? If competition law provides sufficient protection in sectors such as air travel, ports and land, all of which have elements of market power, and if the benefits of regulating those sectors are outweighed by the adverse effects, why is that not the case for airports too?

7.2. In effect, the CAA is saying that nothing has really changed in the UK airport sector. Different types of price control are appropriate for the three south-east airports, to reflect their different characters, but this would have been appropriate anyway. The restructuring of the sector and the more competitive conduct that this has induced have had no significant

impact on market power, and the new regulatory duties and the three part test in the new Act make no difference because regulation is better than competition law. So regulation by price control in one form or another should be continued as before. The appropriate form of regulation is for consideration, but as we shall see is to be judged according to whether it would produce broadly the same outcome as the previous RAB-based approach.

7.3. It is difficult to reconcile this "nothing has really changed" attitude with the concerns about industry structure that led to the restructuring of BAA, notably the forced sale of Gatwick and Stansted, and the concerns about the CAA's regulatory approach that informed the Civil Aviation Act 2012.

7.4. I have already cited (para 5.2 above) what the CC said about divestment by BAA. Here are a few more extracts:

> "The divestiture of both Gatwick and Stansted to different purchasers is required to remedy effectively the AEC [adverse effect on competition] arising from BAA's ownership of London airports." (para 32(a))
>
> "Under separate ownership, alternative approaches to regulation, or deregulation, could be preferable as effective competition developed between them." (para 24)
>
> "while the precise outcome under separate ownership is uncertain, the evidence enables us to reach a clear expectation that competition will develop. Consequently, we do not agree that the scope for competition is speculative and contingent on other unlikely events." (para 5.19)

7.5. How can such significant changes, which clearly motivated the CC, have had no effect on the CAA's approach to regulating these airports? What was the point of making these changes?

7.6. There is a contrast here with electricity regulation in the 1990s. The regulator Offer told the "duopoly" of National Power and PowerGen that their market power warranted a reference to the Monopolies and Mergers Commission (MMC) unless they divested a significant amount of generation plant in order to create more competition. They agreed to do so, an interim price control was lifted when divestment was complete, and an MMC reference was thereby avoided. Later, the same two generators agreed to divest further generation plant. This was a quid pro quo for being allowed to vertically integrate into distribution networks, mergers that would otherwise have been challenged by Offer. In both cases significant divestments made significant differences to regulatory policy.

7.7. In contrast, a significant divestment of airports seems to have had no effect at all on regulatory policy. Compulsory divestment is a significant incursion into shareholder rights of ownership, an action that should be considered only in extremis. What was the point of requiring it if it made no difference to the regulatory approach?

7.8. This seems to me a substantial and worrying disconnect between top-down and bottom-up regulatory analyses. The significant change in circumstances calls for a significant change in policy, but the detailed working of the regulatory machine has responded only in form rather than in substance.

8. Explaining the disconnect

8.1. How to explain this disconnect? One explanation might be that the CAA's present thinking is inconsistent with its previous thinking. What we might

call the 2007 CAA argued that there was sufficient competition at Stansted for that airport to be de-designated. The 2007 CAA might therefore have been expected to conclude that the subsequent significant restructuring of the sector means that regulation of Stansted, and probably Gatwick, was no longer warranted. The 2007 CAA would have concluded that there is no longer market power at Stansted and Gatwick, and if there were then competition law would have been an effective and better way to deal with it.

8.2. The 2013 CAA argues that conditions have changed, that all these airports can now be expected to have market power, and that regulation is the best way to deal with this. The 2007 CAA, it might be said, would not have found these arguments plausible. Hence, one would not expect a disconnect between the top-down and bottom-up thinking of the 2007 CAA.

8.3. This argument seems plausible, though others are more familiar with the thinking and arguments deployed then and now. But whether or not there has been a change in regulatory thinking, it suggests that regulatory uncertainty and change are realities, which need to be taken into account in designing regulatory policy. The greater the extent of regulation, and the more detail into which it goes, the greater is the risk to the regulated parties and hence the higher is their cost of capital, and the greater is their reluctance to invest and to enter into other longer term arrangements. This is a consideration to be taken into account in deciding whether or not, and if so how, to regulate an airport.

8.4. Whether or not there has been a change of stance by the CAA, it raises the question: which stance was more appropriate, that of 2007 or of now? The remainder of this paper suggests that the CAA has not given sufficient consideration to the meaning of competition and the significance of its new duty to promote competition. As a result, the CAA has overestimated the benefits of regulation and its impact on price in the short-term, but failed to realise the adverse effects that its proposals will have on the development of competition, and hence on the benefits to users over the longer term.

PART II THE NATURE OF COMPETITION

9. The CAA's interpretation of its new duty to promote competition

9.1. The CAA has a new obligation "where appropriate, to promote competition in the provision of airport operation services". This raises the obvious question: what kinds of policies would promote, as opposed to hinder or fail to promote, such competition? The CAA's key consultation documents have barely considered this question, which ought to be central to its thinking in the new circumstances of the airport sector.

9.2. Thus, the *Guidance on the assessment of airport market power* (April 2011) sets out a relatively conventional approach, using concepts familiar from previous decades of CAA regulation. These guidelines are intended, inter alia, to inform investigations into whether an airport has market power and "how to design regulatory approaches that are broadly proportionate to the level and nature of an airport's substantial market power" (para 1.4) But they do not discuss how to promote competition.

9.3. The Summary and Introduction to *Setting the Scene for Q6* (July 2011) make no mention of the new duty. Section 2 says that "it is important for the CAA to assess the effectiveness of competition at the designated airports" but makes no reference to actually "promoting competition". It moves on, instead, to the strategic objectives that the CAA has set itself, rather than to the statutory objectives that the Civil Aviation Bill (as it then was) would set. Section 4 mentions the CAA's guidance on how competition should be assessed, but again provides no discussion of how to implement the new duty to promote competition.

9.4. Similarly with *Q6 Policy Update* (May 2012). Section 1 is an introductory Summary to discuss several new aspects of the Bill, but it does not mention the new duty to promote competition. Section 2, on the impact of the Government's reform on airport economic regulation, highlights the most significant changes but does not mention the new duty (other than in a formal listing of provisions). Section 3, on ensuring that Q6 is passenger-focused, is driven by the new Clause 1 to further the interests of users, but again makes no mention of the immediately qualifying Clause 2, requiring the CAA to do so where appropriate in a way that will promote competition. Nor is the duty to promote competition mentioned in Sections 4, 6 and 7 on the rationale for continued airport regulation, improving regulatory incentives, and airport risk and financing.

9.5. Section 5 of *Q6 Policy Update* makes two brief, indirect and rather insubstantial references to a transition. Pegging tariffs to comparator airports "might provide a way to move towards a lighter touch regime for airport transitioning to a more competitive market position". (p 57) Price monitoring "may have merits as a transition strategy to deregulation". (p 59)

9.6. Annex 1 of *Q6 Policy Update* provides an initial appraisal of eight alternative forms of regulation against eight criteria, one of which is promotion of competition. I discuss this appraisal in section 17 below. But the arguments of Annex 1 are not translated into the text of the CAA's document. Nor, it seems, is Annex 1 even cross-referenced in the main text.

9.7. Finally, the various initial proposals of April 2013 do no more than mention the duty to promote competition in an opening note of the new duties. The duty to promote competition is not subsequently built on or acknowledged in the way that other duties are. For example, at Heathrow and Gatwick the lead subheading is "The CAA's initial proposals reflect its firm commitment to put users at the heart of airport economic regulation". There is no parallel commitment, firm or otherwise, to promote competition where appropriate, nor any further consideration of that equally important duty.

9.8. At Gatwick, particularly, this failure to consider the duty to promote competition has distorted the CAA's perspective. Part A of *Gatwick initial proposals* explains that the CAA finds that the conditions of the Market Power Test are likely to be met at Gatwick, affirms its commitment to put users at the heart of airport economic regulation, and explains how it has sought to understand users' interests. Part B then launches into "an analysis of what the CAA considers to be a fair price, based on a RAB-based methodology". (*Gatwick Initial Proposals* p 62) This takes over 120 pages. In contrast, reference to the new duty to promote competition is limited to a couple of sentences in a table for each of nine alternative forms of regulation, perhaps taking up a couple of pages in total. The new Act does not even mention a fair price – this is the CAA's own concept - yet the CAA has focused on it to the virtual exclusion of a duty that the Act ranks on a par with the duty to protect the interests of customers.

9.9. Since Clause 2 of the Act requiring the CAA to promote competition is qualified by the phrase "where appropriate", it might of course be argued that it is not appropriate for the CAA to promote competition in deciding whether to regulate/license an airport and in deciding what kind of regulation to propose. As far as I am aware the CAA has never put forward that argument. Indeed, the CAA states that competition is generally better than regulation. (*Setting the Scene for Q6* p 5) It has recently reinforced that view. "The CAA considers that present and future users' interests are generally best served where they have genuine choice among airports that are competing and innovating vigorously for custom." (*Gatwick initial proposals* para 8) So the CAA accepts that it is appropriate to promote competition in this context.

9.10. Of course, the CAA has to consider the promotion of competition along with its other statutory duties, taking the situation as a whole. Nevertheless, there seems no doubt that, in deciding whether and how to regulate each airport, the new Act requires the CAA to consider much more explicitly how to promote competition, and also to take into account the adverse effect of some of its proposals on the development of competition.

10. The nature of competition

10.1. Any discussion of how to promote competition should begin by establishing what competition is. For most of the last half-century, at least, economic discussions of markets and of public utility pricing and regulation have assumed that competition could be characterised

essentially as a situation where price is equal to cost (appropriately defined). Cost curves and demand curves and the nature of the product(s) were taken as given. Market power was characterised by price in excess of cost. This could lead to inefficiently low investment in, or usage of, particular facilities.

10.2. Increasingly, it is recognised that this kind of analysis is a theoretical construct that captures only part of the concept of competition. It is a static analysis, looking at a market at a point in time, typically in an equilibrium situation. It does not examine how the market gets to that situation, or how it changes over time. It does not capture the concept of competition as a dynamic process: a process of discovery and of rivalry.

10.3. This concept of competition as a dynamic process is well documented in the economic literature.[5] It is also integral to the CC's approach to market investigations, not least in the airport sector. For example, the CC's investigation of BAA pointed out that "competition is a dynamic process of rivalry between firms seeking to win customers' business over time".[6] The CC also cited its guidelines endorsing and explaining this very approach.[7] As I shall show, this is a process that is particularly relevant in the newly competitive airports sector in the South East of England.

10.4. Competition is a discovery process because the products and their costs and demands are not "given": they have to be discovered or invented. Suppliers are continually trying to discover what customers want, and what kinds of products and services are most appealing to them. They are also trying to discover on what terms customers prefer to be supplied: fixed or variable prices, one-off purchases or short-term or long-term contracts, risk-free or risk-sharing terms. Customers, for their part, differ one from another, so will generally prefer different products. And they, too, are continually trying to discover, not only what products are on offer, but what products *might* be available if they were to indicate interest, and what kinds of products would suit them best. (This is a particularly relevant and challenging process at Gatwick because of the

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[5] Key contributions to this concept of competition include J A Schumpeter, *Capitalism, Socialism and Democracy*, Harper & Row, New York 1942 3rd ed 1950 especially chapter VII The process of creative destruction; F A Hayek, "The use of knowledge in society", *American Economic Review*, September 1945, reprinted in Hayek, *Individualism and Economic Order*, London: Routledge and Kegan Paul, 1948; F A Hayek, "Competition as a discovery procedure" in Hayek, *New Studies in Philosophy, Politics, Economics and the History of Ideas*, Chicago: University of Chicago Press, 1978; I M Kirzner, *Competition and Entrepreneurship*, Chicago: Chicago University Press, 1973; I M Kirzner, "The Perils of Regulation: A Market Process Approach" in Kirzner, *Discovery and the Capitalist Process*, Chicago: Chicago University Press, 1985; I M Kirzner, "Entrepreneurial discovery and the competitive market process: an Austrian approach", *Journal of Economic Literature*, March 1997. A recent and accessible succinct exposition is in I M Kirzner, *How Markets Work: Disequilibrium, Entrepreneurship and Discovery*, Institute of Economic Affairs, Hobart Paper No 133, June 1997, available at www.iea.org.uk

[6] *BAA airports market investigation*, 19 March 2009, para 5.21

[7] *Market Investigation References: Competition Commission Guidelines*, CC3, June 2003, para 1.17. The CC's Revised version makes essentially the same points. *Guidelines for market investigations: Their role, procedures, assessment and remedies*, April 2013, CC3 (Revised), at para 10. See also the quotation below from a former CC chairman.

variety of different airlines operating there, relative to Stansted and Heathrow, as the CAA itself acknowledges.[8])

10.5. Competition is a rivalrous process because suppliers have to offer better terms and/or better products than their rivals, otherwise they will not capture the available business. Rivals are continually offering better terms or improving their products to tempt customers away from their rivals. So the prices and products that will secure business at one point in time may well be inadequate later as rivals find better ways of competing.

10.6. These processes are set in an uncertain world. Present costs and preferences have to be discovered, and future costs, demands and preferences are uncertain. Producers and customers will all make mistakes of various kinds: producers failing to realise what customers want or what future demand will be, customers failing to spot the best products available, and so on. Some choices and commitments are made that later turn out to have been unwise. Those who make fewer mistakes tend to survive longer, and to grow. Competition is thus also a process for discovering the most shrewd and farsighted suppliers as well as the most efficient in terms of production costs.

10.7. Prices can go up as well as down: part of the competitive process is to discover which resources are scarce, and to set prices to ration those scarce resources rather than to price them at inefficiently low levels. And even where prices are higher as a result of market power rather than as a result of scarcity, this does not prevent the competitive process from operating: even a monopolist needs to discover what its customers want, and to ensure that its own price-quality package is continually adjusted to remain preferable to what rivals can devise. Thus, the existence of market power does not mean that there is no scope to promote competition.

10.8. Competition does not require that all prices are equal, or that price equals cost. Competition is about much more than price, and a price control that weakens the rivalrous discovery process is undesirable, as a former chairman of the CC once pointed out.[9]

10.9. Suppliers need to ensure that their package of prices and products and quality of service is sufficiently better than the packages offered by their competitors that they do not lose their customers. They also need to ensure that the resulting revenues more than cover their costs, otherwise they will not survive in business. And they constantly need to innovate, to make themselves more distinctive and attractive than their rivals, and to keep improving these price and product combinations to meet the continually changing demands of the market place.

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[8] "12.26 Airlines and passengers at Gatwick are more diverse than at other airports subject to economic regulation." (*Gatwick initial proposals* p 198)

[9] "Lower prices are by no means sufficient if the process of rivalry is weakened." With such weakening, "several dimensions of rivalry will often still be diminished, including the choices available to consumers concerning the number of independent sources of new ideas, new strategies, innovative products or processes and the like." Competition is not only about price: "competition is, to an important extent, a mechanism by which new ideas emerge and the best ones survive, only to be superseded by other still better ones." Sir Derek Morris, "Dominant firm behaviour under UK competition law", paper presented to the Fordham Corporate Law Institute, Thirtieth Annual Conference on International Antitrust Law and Policy, New York City, 23-24 October 2003, at http://www.competition-commission.org.uk/our_peop/members/chair_speeches/pdf/fordham2003.pdf

10.10. Where suppliers have a few large customers they will typically negotiate individual terms and conditions. Where suppliers have large numbers of small customers, they will typically use standard terms and conditions. Where suppliers have a mix of customers they may well have a mix of negotiated and standard terms. Since this is the case at Gatwick, the challenge of trying to identify the appropriate mix of terms is particularly acute there.

10.11. Suppliers and customers value stability and predictability. They value commitments on price and quantity to make it worth investing in long-lived assets, both to supply services and to consume them. But suppliers and customers also value flexibility, in the event that market conditions change. Finding the arrangements that best balance stability and flexibility for each supplier and each customer is part of the challenge of competing in a market. Just as competition tends to discover the most preferred types of services, and the most efficient suppliers, so too it tends to discover the most preferred contractual arrangements for long-lived investments.

10.12. The recognition of competition as a discovery process has implications for assessing the extent of market power. For example, an assessment of market power taking products, costs and demands as given will tend to underestimate the competitive threat from new variants of products, or new and more attractive terms of contract, that rivals are constantly attempting to devise. It will therefore tend to overestimate the extent of market power.

11. Promoting competition

11.1. How competition is understood also has implications for a duty to promote competition.

11.2. From the first perspective, that competition means price should equal cost, a regulator seeking to replicate a competitive outcome would need to discover or estimate what costs actually were and ensure that prices were set equal to them. By extension, a regulatory duty to promote competition could be interpreted as a duty to try to bring prices more into line with costs. So, for example, a price cap would promote competition if it prevented a producer from charging a price above cost, but would run the risk of distorting or preventing competition if the price cap was set below cost. As we shall see later, the CAA's interpretation of its duty to promote competition is mainly of this kind.

11.3. From the second perspective, that of market process, promoting competition is not a matter of ensuring that price is closer or sufficiently close to cost. It is a matter of encouraging and enabling suppliers to discover what customers want, and of incentivising them to provide this. In general, suppliers are more likely to discover and provide what customers want the more profitable it is for them to do so. Regulatory constraints that presume to know in advance what customers want, and the best way of providing this, could hinder or prevent the competitive process from working. The less that suppliers and customers are restricted in this way, the more effectively suppliers are able to compete. Regulation that inadvertently discourages suppliers and customers from entering

negotiations to discover and provide what customers want would run contrary to a duty to promote competition. Thus, a duty to promote competition has implications both for *whether* to regulate a particular entity and if so *how* to regulate it.

11.4. The first approach to promoting competition – attempting to set prices equal to cost - is vulnerable because it assumes that the regulator knows what will be discovered at the end of the competitive process. If this assumption is granted, competition is pointless, unnecessarily costly and uncertain because the regulator already knows the answer, and can simply impose it. But in reality it is unrealistic to assume sufficiently perfect knowledge of what the market participants want and the options open to them. In consequence, the regulator will find itself making and imposing crude calculations of "the competitive price" that can soon be derailed by subsequent events and that are too aggregative to reflect the circumstances and preferences of individual suppliers and customers.

11.5. Furthermore, the imposition of a regulated price can distort and hinder the competitive process. For example, requiring a supplier to charge a specified price that is lower than it would otherwise offer will make customers less attractive at that price than they otherwise would be. The supplier will be less keen to attract and keep them, for example by offering improved quality or personalised terms and conditions. Customers with the lower price will be less interested in exploring what other suppliers have to offer. Other suppliers will be less able to compete at that lower price, and less interested in devising and offering terms that the customers might find attractive. Over the longer term, improved products and services, which might in turn lead to lower prices too, are less likely to come into existence because it is less worthwhile for both suppliers and customers to spend time and resources exploring them.

11.6. There is also a feedback effect on regulation. As customers find they can get a short-term payoff from regulation, they will devote resources to persuading the regulator to tailor regulation to their preferences. Suppliers, too, will devote resources to persuading the regulator to tailor regulation to suit their business model rather than their rivals'. Rent-seeking expenditure will increase, and the regulator will find itself playing piggy-in-the-middle.

12. Competition in the airport sector

12.1. What would the competitive process look like in the airport sector? Fortunately we have a clear idea of this because the competitive process already operates in a great part of the European airport market, not unduly fettered by economic regulation. Not least, there is active competition between more than three dozen UK airports that are not presently designated. The nature of competition in these markets has been well described by David Starkie.[10]

[10] See his collected papers in David Starkie, *Aviation Markets: Studies in Competition and Regulatory Reform,* Ashgate, 2008 and more recently his "European airports and airlines: evolving relationships and the regulatory implications", *Journal of Air Transport Management*, xxx, 2012, 1 -10.

12.2. Airlines have been continually evolving, including legacy flag-carriers, charter airlines and other low-cost airlines. Increasingly they operate on a European and world-wide scale, increasingly willing and able to switch their bases from one airport or country to another. Airports thus no longer have the market power they were once assumed to have. Airlines have greater buying power than before: airports have to consider more carefully what airlines (and their passengers) want, and they run the risk of stranded assets.

12.3. This in turn has been reflected in the nature of the terms on offer. Traditionally, airports would offer a tariff (or rack rate) available to all comers. Smaller airlines, and airlines with long-haul routes for whom airport charges are not so critical, and airlines not wishing to be committed to future traffic volumes, continue to find a standard tariff appropriate. Increasingly, however, airlines are signing contracts with airports that offer lower charges in return for guarantees of traffic, for periods of a few years ahead. Other kinds of risk-sharing arrangements have also been adopted. These arrangements vary from one airport to another, depending on the size and location of the airport, the extent of alternative airports available, the nature of the airlines there and the services provided, the historical investments made there, and so on.

12.4. Thus, the discovery and provision of the most appropriate contractual terms for each airline and each airport is a critical part of the competitive process in the airport sector. Consequently, facilitating such discovery and provision is an important means of promoting competition. Discouraging these processes, including by specifying the outcome in advance, would in effect be contrary to the new duty to promote competition. In addition, specifying and limiting the prices and quality of service that an airport can offer focuses on the short-term outcomes of the competitive process, and fails to consider the impact this can have on the incentives to compete, and hence on the longer term implications for customers.

13. The CAA's assessment of regulation to promote competition

13.1. In the light of the above discussion, we may take a first look at how the CAA interprets its duty to promote competition. Annex 1 to the CAA's *Q6 Policy Update* provides an initial appraisal of eight alternative forms of regulation against eight criteria. One of those criteria is Promote Competition.

13.2. The CAA concludes that volume regulation would not promote competition, the effects of four other methods of price regulation would be uncertain, two methods would promote competition (pegging tariffs to comparator airports and price monitoring ex post), and one method of regulation (a regulatory default settlement) would promote competition subject to some uncertainty.

13.3. This is a useful first pass at the available options, but some qualifications should be made. These CAA appraisals are mostly about price, rather than about quality or variety of service. The appraisals say virtually nothing about risk, risk-bearing and risk-sharing, nor anything about possible contractual conditions such as volume commitments.

13.4. The appraisals are essentially concerned to assess whether each form of regulation is more likely to distort prices and hence investment and output at particular airports, or to remove or lessen the degree of distortion implied by existing forms of regulation. These evaluations thus reflect the conventional static approach to the analysis of competition.

13.5. There is nothing about the impact – positive or negative – of the different forms of regulation on the process of discovering what the preferences of the airlines are, nor on the process of trying to put together packages of price, quality, quantity, risk-sharing, etc, that will best meet these preferences. There is nothing, in other words, about competition as a dynamic process, nor about how the proposed method would or would not promote such competition.

13.6. Can it be argued that the discovery aspect of competition is relatively insignificant in the airport sector, and that regulatory policy should focus only on setting price to prevent distortions? That might be the case if the sector were characterised by a simple and uniform product provided by relatively similar suppliers, and also if the users of the service were relatively uninformed about the market and their own preferences, so that the regulator had to make decisions on their behalves. In fact, the airport sector is the opposite of this, as several pieces of evidence suggest.

13.7. First, the submissions to this CAA consultation, as well as the research by Starkie cited above, reveal that the requirements and priorities of different airport users (airlines and their passengers) can be very different one from another. The products and services provided to those users are correspondingly different.

13.8. Second, even a casual perusal of the submissions from and about the three major London airports reveals that they too are very different, one from another – as indeed the CAA recognises. They are different in history, size, role, the nature of their users, management policy, economic factors, and much else. "One size fits all" is not an option here. The regulatory approach needs to be sufficiently flexible that it can enable different types of provisions to emerge, as and where that is appropriate.

13.9. Third, the submissions from airports and their main airline users are well informed and well argued. And again, their ideas, concerns and proposals are different. There are not just criticisms of regulation or airports, or statements of what the submitters would like. The parties also make constructive ideas for how to go about this, for improvements that could be made. These include suggestions for mutually beneficial arrangements (eg benefit sharing) and the conditions under which such arrangements would or would not work.

13.10. Fourth, airports are now in separate ownership, so that a new competitive dynamic has been released. Airports will be seeking to differentiate themselves, and to offer increasingly refined and customer-specific products and services to the airline market. Airlines will be devoting more time to specifying and negotiating for the services that they want, and comparing what different airports can offer.

13.11. Thus, airports are not simple, similar and single-product entities with uninformed users, where regulation of price might, in principle, be relatively straightforward and helpful. On the contrary, they are complex, different and multi-product entities, with users that are better informed

than a regulator is ever likely to be. The CAA has indeed acknowledged this (eg in proposing constructive engagement, discussed below). The mode of regulation needs to reflect this complexity.

13.12. Furthermore, the mode of regulation needs to allow and encourage the competitive process to evolve at each airport. It is not clear that the CAA fully appreciates this, or how it is best achieved. For example, in its assessment of market power at Stansted, it draws a distinction between competition law acting ex post to remedy a harm that has already occurred and regulation acting ex ante to mitigate possible impacts of market power. Then it says "Even in the case where competition is unlikely to arrive, regulation should as far as possible mimic the conditions a firm would face in an effectively competitive market."[11] But the CAA does not have a duty to mimic the conditions a firm would face in a competitive market. It has a duty to promote competition, which is not the same thing. In a complex market, trying to mimic competitive prices and other conditions could deter, rather than promote, competition.

[11] *Stansted Market Power Assessment: developing our 'minded to' position*, Jan 2013 para 8.21

PART III THE MARKET POWER TEST

14. Test A: restructuring, the competitive process and market power

14.1. Test A is whether an airport has or is likely to acquire significant market power. Arguments as to the existence or otherwise of significant market power at Gatwick have been put forward by the CAA, GAL and others. I do not seek to assess these arguments. I comment here on only one aspect, in the light of the analysis of competition just set out.

14.2. For the most part the CAA's analysis focuses on static considerations. But occasionally it acknowledges the possibility of more effective competition arising as a result of the competitive discovery process. For example, it observes:

> Stansted airport has been consistently rated as a significantly less desirable airport than Gatwick, despite the fact that a large number of Gatwick's passengers are within both Gatwick's and Stansted's catchment areas, and despite the fact that Stansted's facilities are similar in nature to those at Gatwick. This could also be influenced by the lack of active promotion of Stansted as an attractive alternative to Heathrow and Gatwick. A new owner of Stansted might take a different approach in the future and, as Gatwick's new owners did, invest more resources in passenger awareness of Stansted as a suitable alternative to Heathrow or Gatwick.[12]

14.3. The CAA comments that this issue "can change over time, which would likely have an impact on Gatwick's market power". This is a plausible and important consideration. The CAA makes a similar point elsewhere.

> "Joint ownership of Stansted and Heathrow by BAA may have reduced Stansted's efforts to differentiate its service offering and to adopt innovative and aggressive strategies to raise passenger awareness of the airport and its relative strengths." (para 3.217)

14.4. The same consideration is true more generally. For example, the CAA suggests that "the capacity constraints in the South East of England are contributing to reduce competitive constraints faced by Gatwick" (para 3.158) and particularly instances "Heathrow's severe capacity constraints" (para 3.157). When these other airports were in the same ownership as Gatwick their interest in making available capacity to attract airlines from Gatwick was severely limited because they had to be concerned about Gatwick's loss as well as their own gain. In contrast, different owners now have more incentive to make capacity available. Even an airport like Heathrow with severe capacity constraints can compete - for example, by changing the structure of its charges to attract certain kinds of airlines that might make more efficient or profitable use of its facilities, rather than other airlines that might be costly and less profitable to serve.

14.5. In section 6.3 above I have cited other examples from the CAA's April 2013 documents of how the changes in ownership either have or may be expected to have, a positive impact on competition. There are similar quotations from the CC in sections 5.2 and 7.4. In general, assessing the extent of Gatwick's market power against the competitive options presently available in the market tends to underestimate the competitive forces that are unleashed by restructuring the sector and putting different

[12] CAA, *Gatwick - Market Power Assessments, The CAA's Initial Views*, February 2012, para 3.138

airports into different ownership, and hence to overestimate the extent of market power. Both Stansted and Heathrow now have stronger incentives to find better ways of competing with Gatwick, and this may be expected to evolve and strengthen over time.

14.6. The CAA sometimes acknowledges this, but questions how fast such competition will increase. However, the competitive market adjusts more quickly than regulatory mechanisms do. It would be unfortunate if a five-year regulatory straitjacket were to discourage the competitive market from responding where it could. Moreover, the speed and extent of market response is not independent of the prices and potential profits in the market. Restricting the extent of those prices is therefore likely to discourage or delay the emergence of stronger competitive pressures, and this needs to be taken into account in assessing the pros and cons of such price controls.

15. GAL's Contracts and Commitments proposal

15.1. GAL has proposed an approach that it calls "Contracts and Commitments". (*Gatwick Business Plan* ch 4) In view of the increasingly competitive framework within which operates, GAL postulates that airline-airport relationships will increasingly be defined through bilateral contracts. To facilitate this transition, and to accommodate those airlines that choose not to enter such contracts, GAL offers a long-term (seven years) commitment to maintain or improve service standards and to limit increases in charges for core airport services.

15.2. GAL's Commitments proposal is explicitly said (p 43) to be conditional upon the CAA not establishing a licence for Gatwick. Accordingly, in assessing the market power test for Gatwick, the CAA needs to compare two situations: (1) with no regulation but with the Contracts and Commitments in place, and (2) with regulation but without the Contracts and Commitments in place.

15.3. For simplicity, assume here that Test A – whether the airport has or is likely to acquire substantial market power – is independent of the Contracts and Commitments approach, which may be assumed to relate to how the airport might use any such power. I therefore focus on Tests B and C.

16. Test B: sufficient protection and Commitments

16.1. Test B is that competition law does not provide sufficient protection against the risk that the airport may abuse its substantial market power. The CAA doubts whether competition law would necessarily produce a sufficiently comprehensive solution to exclusionary behaviour, or would be swift enough to avoid irreparable damage to competition. It considers that the high evidentiary hurdle would limit the ability to discipline exploitative behaviour (excessive prices), and is not aware of any cases pursued with respect to product or service quality.

16.2. In its assessment of Stansted against Test B, the CAA provisionally fears that its response to emerging problems of market dominance would be slower if it had to prove dominance, and the remedies would take time

to formulate and implement. Some form of regulation would provide more effective protection than competition law alone.[13]

16.3. At Gatwick, the CAA's conclusion is if anything starker. "… the CAA has insufficient comfort that it would be able to successfully discipline behaviour through the use of competition law. These [vertical abuses] include abuse of excessive pricing and service quality based abuses." (*Gatwick MPA* para 61)

16.4. The CAA also "expects that GAL's ability to charge excessive prices may lead it to have less incentive to deliver the level of service quality demanded by users". (para 65) This concern is not persuasive. The provision of better or required quality may be a condition of a user being willing to pay more. Furthermore, a higher price will make a supplier more eager to secure the user's business, including by improving quality. Regulating to secure a lower price will have the opposite effect.

16.5. With GAL's Commitments in place, the possible *extent* of any such exploitation would be reduced. The remaining risk would be that prices might be somewhat higher or quality somewhat lower than a price control might have prescribed; the risk would no longer be that airlines might be vulnerable to completely unrestricted exploitation by the airport.

16.6. GAL itself argued that, in certain key respects, the Commitments provide a *better* deal for customers than regulation would. For example, the proposed price commitment was lower than GAL's estimate of a regulatory constraint, and GAL argued that it would better tailor its services to individual airline requirements than regulation could provide. If there were a serious question whether regulation provides *as much* protection for airlines as does competition law plus Commitments, then it would be difficult to argue that Test B has been passed.

16.7. The CAA's *Gatwick initial proposals* now includes a calculation that a RAB-based price control would be significantly lower than GAL's estimate, and lower than GAL's proposed price commitment. The CAA also argues that regulation would secure higher quality of service and other benefits relative to GAL's commitments, and that there are risks associated with the enforceability of GAL's commitments.

16.8. In light of the previous discussion of the nature of competition, the CAA is in effect prejudging the outcome of the competitive discovery process. I suggest below that the difference between the two proposals, properly interpreted, may not be so great as it presently seems. Second, insofar as the CAA imposes lower prices or higher quality of service than GAL would have offered, then it potentially restricts competition rather than promotes it. Such restrictions reduce GAL's incentive to provide better services, reduce the incentive of GAL's existing customers to look for potential alternatives, and reduce the incentives for other airports to develop potentially attractive counter-offers.

17. Test C: regulatory benefits and the substance of Commitments

17.1. Test C requires that the benefits of regulation are likely to outweigh the adverse effects. The CAA's initial analyses of Stansted and Gatwick

[13] *Consultation on Stansted Market Power Assessment, Summary*, December 2012, S23 - 25

identify four areas most commonly addressed by economic regulation: price, service quality, efficiency and investment. I take these four areas in turn.

17.2. The CAA finds that regulation will provide better protection against excessive pricing without a significant risk of enforcing underpricing or discouraging investment or introducing additional rigidities into the pricing process. Although GAL is offering Commitments in the event that Gatwick is not regulated, the CAA says that GAL's Commitments would still allow prices above a reasonable level (para 73) so licence regulation is likely to provide additional benefits. However, the CAA does not take into account the point just made, that higher prices by GAL provide greater incentive to airlines and potential competing airports to discover and provide better competitive options that, over the longer term, could lead to lower prices.

17.3. The CAA says that GAL's Commitments include much the same service quality regime as in the previous price control, but identifies some possible disadvantages and distortions of the Commitments. In contrast GAL envisages that the Contracts and Commitments approach would be better tailored to the requirements of individual airlines. I have argued that imposing lower prices via regulation will reduce the incentive to seek business by providing higher quality services.

17.4. At Stansted, the CAA runs through a variety of arguments as to why efficiency might be higher under regulation. In doing so it seeks to overturn its 2007 finding that price regulation was unlikely to have significant benefits in this respect.[14] At Gatwick, the CAA argues that the impact would be mixed. But the CAA's arguments and analyses look at the airport in isolation: they make no reference to the possibility of cooperative work between airport and airlines.

17.5. In contrast, GAL expresses "confidence that the flexibility afforded by the Commitments Framework will enable us, and our airline partners, to focus on increasing the overall value of activity at the airport". (p 43) Commitments can also offer lower prices than a RAB-based price control would yield for several reasons, including "improved incentives to cut operating costs and increase commercial revenue, as well as improved collaborative working with our airlines;" (p 51) In addition, "by enhancing our ability to incentivise growth in larger aircraft, we should be able to alter the traffic mix, thereby allowing Gatwick to offer lower prices to our airlines". (p 51)

17.6. For Stansted, the CAA concluded that "some form of licence regulation would create greater efficiency incentives for the airport than relying solely on competitive pressures". (para 9.58) To reach the same conclusion at Gatwick would be to overlook and/or undervalue the scope for enhanced efficiency if airport and airlines work together as envisaged under the Contracts and Commitments proposal.

17.7. Finally, in 2007 the CAA concluded that regulation could distort investment in various ways. Now, the CAA argues that, in practice, there has not been excessive investment at Stansted and that other concerns can

[14] CAA, *Developing our minded to position on Stansted*, December 2012, para 9.44

be addressed. However, "licence regulation will necessarily lead to some rigidity particularly in terms of investment consultation". (para 9.85)

17.8. GAL's proposed Commitment is to "undertake the capital expenditure necessary to deliver the planned service levels we have committed to. We propose full transparency over the capital expenditure programme, in order that airlines and the CAA have early sight of any proposals to alter the level of capital expenditure proposed in this business plan." (p 52) The CAA claims that, given GAL's market power, "there is a risk that some beneficial enhancements for users would not be taken forward" and that "users' interests may not be fully taken into account". (para 76) If users value certain enhancements, and are willing to pay for them, it is not clear why GAL would find it sensible not to take them forward and not to these take users' interests fully into account.

17.9. The CAA suggests that regulation provides additional benefits with respect to operational resilience. GAL has responded on this point and I do not comment further.

17.10. The CAA has concerns about consultation and transparency. Although the proposals for consultation are in line with those in the Airport Charges Directive, "This is unlikely to be sufficient for airlines to provide properly informed views on the capital programme and how decisions have been made. The commitments do not provide sufficient information to airlines to allow airlines to understand whether charges are reasonable." (*Gatwick initial proposals*, para 58)

17.11. However, the relevant benchmark here is what is normally available in a competitive market, not what a regulator would provide or require to be provided in setting a RAB-based price control. Airlines are naturally concerned to negotiate satisfactory terms for their own use, including as to the delivery of capital expenditure projects that directly impinge upon them. My understanding is that they do not normally focus on the costs and revenues and capex plans of the airport as a whole, or expect to be briefed on these in order to enter or conclude negotiations.

18. Test C: regulatory benefits and the enforceability of Commitments

18.1. The previous section has discussed the CAA's concerns about the substance of the Commitments offered by GAL. In addition, the CAA reports three airline respondents to the consultation as having expressed concerns about the enforceability of the Commitments (*Gatwick initial proposals* paras 12.12). But what are these concerns and how substantial are they? Surprisingly, the CAA has not made public the consultation responses referred to, so that evaluating the airlines' own concerns is not possible.

18.2. GAL has considered the issue of enforceability. It says "We propose that the Commitments Framework is given legal effect via the existing Conditions of Use which set the contractual framework for all the airlines operating at Gatwick….[This would] provide legal redress to any airline that considers that the Commitments made are not being adhered to. … In addition, the CAA will continue to have rights to investigate and make

compliance orders in relation to the airport operator's failure to comply with the Regulations."[15]

18.3. I now take in turn the CAA's concerns (*Gatwick MPA* paras 69-72) and suggest how they could be dealt with:

- "the Conditions of Use (including the commitments) would be unbalanced with insufficient clarity over the facilities that GAL would provide." This could be addressed by making the commitments clearer in the relevant respects.
- "It would allow GAL to undertake unilateral variation or contracting out." – However, the reputational consequences for GAL of doing so would be significant: it could provide a basis for the CAA to introduce regulation. And if the initially proposed conditions were important to users they could enter bilateral contracts with GAL that would protect them against changes in elements that they deemed important.
- "As they would be enforced by airlines they may not offer the same protection to passengers and cargo owners as compared to a licence enforceable by CAA which has a statutory duty to protect their interests." The CAA's general stance is that, in most respects, the interests of airlines protect the interests of passengers and cargo owners. If there are specific respects, related to the commitments, in which this is not the case, it would be possible for GAL to give an undertaking to the CAA related to these respects (see next paragraph). There would again be reputational consequences if GAL were to breach this undertaking, and again this could provide a basis for the CAA to introduce regulation.
- "Furthermore, the commitments commit parties to dispute resolution which could unduly delay airlines from taking enforcement action". This seems implausible insofar as GAL has proposed a dispute resolution procedure to speed up the process rather than delay it. If airlines have a concern on this score it would surely be possible to consider whether an alternative process would involve less delay.
- "they provide no explicit protection from repeated failure against service quality standards." If a particular service quality standard is important to an airline, this could presumably be incorporated into a bilateral contract and the airline could enforce the contract at law. And again, if GAL repeatedly failed to honour its commitments, this could provide a basis for the CAA to introduce regulation.
- "In addition, the CAA is concerned that in the absence of a licence, if there are repeated failures to comply with the commitments, then while this may constitute a material change in circumstances, the process of re-introducing licence regulation may take two to three years, allowing significant passenger detriment to occur during this time." Repeated failures to comply with licence conditions also take time to establish. And this is not necessarily a bad thing. Indeed the Productivity Commission in Australia emphasised that the ACCC should not base a call for a full inquiry on just a single year's results. Assessing the situation over a period of time would allow GAL and the CAA to

[15] *Gatwick Business Plans* ch 4 p 45

discuss the matter and enable either or both of the parties to take remedial action.

18.4. If the CAA is concerned about its ability to enforce GAL's commitments, the concept of an undertaking given by GAL to the CAA is worth considering further. Examples of such undertakings are the correspondence between Ofcom and BT regarding commitments from BT about future wholesale broadband pricing in 2006.[16] The situations are remarkably similar. BT writes "Typically, BT believes that suitable regulation can provide protections for consumers in areas where competition is an inadequate constraint. However, regulatory mechanisms for price control can be inflexible and imprecise in an environment of rapid change. Against this background, BT has proposed to Ofcom a series of price ceiling commitments." For its part, Ofcom says "Our strategic view is that it is in the best interests of consumers if wholesale broadband prices continue to be determined by the market and not regulation. On the basis of the commitments to price floors set out in your letters, we propose to continue with this strategy and see no reason to intervene at this stage." Ofcom notes that this is its preliminary view of the commitments, and if there were evidence prompting a more in-depth investigation the letter does not fetter Ofcom's discretion to conduct an investigation.

18.5. The CAA has acknowledged that licence regulation will have both direct and indirect costs, for the CAA, for the airport and for airlines. It also notes two potential adverse effects: the crowding out of a more commercial approach, notably via commercial contracts, and management distraction. These are valid points, and the CAA rightly notes the benefits of an approach that encourages negotiation and agreement between the parties rather than imposes an outcome determined unilaterally by the regulator.

18.6. I would add another consideration. There is substantial economic analysis and evidence concerning the incentives and pressures on public decision-makers including regulators. If an airport is regulated by licence, then the regulator will have powers to introduce new licence conditions, including price controls. If a regulator has such powers, it will be pressed to use them. In practice, regulators find it difficult to respond to customer complaints by saying "there isn't in fact a problem". It is easier to respond by taking action of some kind against the regulated entity. Thus, an unintentional consequence of licensing an airport is that it increases the extent of regulation beyond what the regulator might otherwise intend. Insofar as this will tend to substitute regulation and regulatory processes for contractual and other conditions determined in the market, it will tend to undermine the competitive process rather than promote it.

19. Assessing GAL's proposed Commitments

19.1. GAL's proposed Commitments potentially reduce the extent to which GAL could or would exert market power and therefore raise the Test B hurdle that the CAA has to meet before finding that Gatwick passes the

[16] http://stakeholders.ofcom.org.uk/telecoms/policy/broadband-services/broadband-pricing

market power test. They also raise the Test C hurdle because they reduce the benefit and increase the adverse effects of regulation, since the Commitments would not apply in the event of regulation. Thus, if appropriate Commitments were in place, it is difficult to see that the prescribed tests would have been met for regulating Gatwick by licence.

19.2. However, while welcoming GAL's commitment proposals, "the CAA is not sufficiently convinced that the enforceability of, and the terms within, the current commitment proposals provide sufficient protection to passengers and cargo owners". (para 80) In the last two sections I have argued that, in various respects, the CAA's arguments on these issues are not convincing, either as to substance or as to enforceability.

19.3. The CAA's view is based, in important respects, on its calculation of an alternative building-block price control that determines what it calls a fair price. This calculation indicates prices remaining roughly constant in real terms compared to GAL's calculation of rising prices.

19.4. In comparing the CAA's price control calculation against GAL's calculation and proposed Commitments, certain points need to be born in mind.

- First, a regulator's opening position is invariably more severe than its final one. The regulated company always brings forward further information and arguments that deserve consideration and merit some adjustment of the regulator's initial position.
- Second, just as a regulator's initial proposal is likely to be modified over the course of subsequent discussions, so too regulated companies might be willing to modify their own business plans in response to cogent arguments.
- Third, if there remains an apparently unbridged gap between the regulator's final position and the company's, then the matter would be expected to go either to the CAT, in the event of a challenge to the CAA's market power assessment, and/or to the CC in the event of a challenge to the CAA's price control proposal. These bodies might well not support either case in its entirety.
- Fourth, in setting a RAB-based monopoly network price control, a regulator accepts that the various parameters (such as traffic, operating and capital costs, cost of capital) could develop in quite different ways, but has to choose a 'mid-point' level of revenue that provides a reasonable balance of risk and reward. The CAA has an additional consideration, not relevant in regulating a network monopoly: to promote competition. It can therefore – and arguably must - provide more latitude for the different possible outcomes of the competitive market process. The level of a 'safeguard' price cap to protect users against demonstrably excessive prices and inadequate quality of service might be a more appropriate comparator for GAL's price Commitments, rather than a mid-point price cap that might result from a RAB-based network price control. The use by other regulators of RAB-based price controls is further explained in the next section.

19.5. So, the relevant question is not whether GAL's present price Commitment is precisely consistent with the CAA's present RAB-based price-control benchmark. Rather, it is whether a possibly revised Commitment from GAL is so far adrift of the CAA's possibly revised

calculations, taking into account the uncertainties inherent in any competitive process and the CAA's duty to promote competition, that there is no way in which the CAT or the CC could find GAL's final Commitment more plausible than the CAA's final calculation. The CAA will also need to consider the reputational risk of arguing a case that the CAT or CC subsequently find implausible.

19.6. The potential modifications mentioned to GAL's Commitments and the CAA's price control might apply to the overall level of the CAA's price control or the backstop terms of GAL's proposed Commitment. They might refer to quality of service, or enforceability, or other matters. Or they might conceivably relate to the structure of charges that GAL might offer or be required to offer, so as to protect particular airlines or subsets of airlines. However, benefiting one set of parties is likely to be at the expense of others. The CAA will need to take care not to get drawn into determining the relative merits of different competitors in the market and the terms that each should enjoy, thereby distorting the competitive process. Not surprisingly, Ofcom found that position problematic when determining mobile termination charges, and has since sought to move away from that policy.

19.7. GAL's Commitments have sought to anticipate and address the concerns that the CAA might be expected to have in considering the three-part Market Power Test. Evidently they have not done so completely. It remains to be seen how far if at all either party might be prepared to move after a period of discussion. I have suggested here that the CAA's limited conception of competition has hitherto led it to underestimate the adverse impact of its regulatory proposals on the future development of competition, and thereby overstated its arguments with respect to GAL under Tests A, B and C. The case for regulating Gatwick by licence has not been clearly established.

PART IV REGULATION OF AN INCREASINGLY COMPETITIVE AIRPORT DEEMED TO HAVE MARKET POWER

20. RAB-based models and comparisons with other regulatory bodies

20.1. Now assume, for the sake of argument, that, for whatever reason, an airport in an increasingly competitive market is held to meet the three-part Market Power test. What kind of regulation, either a price control or otherwise, would best discharge the CAA's statutory duties? What would best promote competition in the airport sector? In particular, what form of regulation would be appropriate at Gatwick?

20.2. In discussing this issue, the CAA makes frequent reference to RAB-based models, particularly as used by other regulators. In *Setting the Scene for Q6* the CAA notes that the different airports have their own characteristics. It wishes to understand how the model of regulation can best reflect this. It says

> Many enhancements to the regulatory model can be accommodated within a RAB-based framework. Nearly all the other UK economic regulatory regimes adopt variants of the RAB-based framework, but seek to tailor it to the circumstances of their industries. This is because RAB-based price controls are a well understood construct that provide investors with confidence their capital will be remunerated with limited regulatory risk. (p 29)

20.3. A year later, in *Q6 Policy Update*, the CAA again makes reference to the lessons from other regulators and their use of RAB-based models (eg with respect to end-users at paras 3.43 – 3.45 and Figure 3.7; and the assessment of alternative forms of regulation at paras 5.12 – 5.17.) All the CAA's *initial proposals* make RAB-based calculations, not least for Gatwick. However, two points must be emphasised.

20.4. First, in terms of the aspects just discussed, many of these other regulatory sectors that use RAB-based models are at present significantly simpler than the airport sector. For example, electricity, gas and water are relatively homogeneous products. All retail suppliers take essentially the same products and services from the transmission and distribution networks. The distribution businesses in these sectors are sufficiently similar that, in each industry, they are regulated with the same type of price control. These are not characteristics of the UK airport sector, particularly not at Gatwick given the diverse nature of its airline customers.

20.5. Second, those aspects of these other regulated sectors that are characterised by an element of competition – which is often where greater variation in products and services arises - are not in fact subject to price controls. The various RAB-based models of other regulators discussed by the CAA apply to the monopoly aspects of the electricity, gas and water sectors, such as the transmission and distribution networks. They do not apply to the competitive or potentially competitive areas such as the wholesale and retail markets. In general, these other regulators have not tried to devise price controls or other regulatory devices in the competitive markets – on the contrary, these regulators have usually concluded that such intervention is not appropriate or helpful there.

Where they have persisted in such price controls, the effect may have been to discourage rather than promote competition.

20.6. For example, Offer, Ofgas and Ofgem removed price caps in the energy markets soon after retail competition was allowed. Despite recent criticisms, the GB retail energy markets have been as competitive as anywhere in the world. In contrast, the initial RPI-X price cap on BT, which was introduced "to hold the fort until competition arrived", was retained and repeatedly tightened for 22 years. That may have brought about lower prices but at the expense of discouraging the growth of competition. Similarly, the introduction of a price cap on the major generating companies, again intended to provide some short-term reassurance while divestment took place, had the effect of distorting the structure of prices and undermining the contract market. Finally, UK postal regulation for many years kept a firm lid on prices – but at the expense of discouraging new entry. When regulation was transferred from Postcomm to Ofcom, the latter's first step was to remove almost all the Royal Mail retail price controls that had previously been in force.[17] Of course, allowing higher prices is never popular with customers. But if regulation had continued to hold them down, it would not have been economic to continue to provide postal services, let alone enable competition, as the CAA itself has noted.[18]

21. Assessment of alternative forms of regulation in *Q6 Policy Update*

21.1. The CAA's *Q6 Policy Update* sets out its initial thoughts, with respect to promoting competition, on the options so far identified.

21.2. The CAA accepts that two options - volume regulation and separate regulation of different airport assets - could distort competition. It decides not to pursue them further.

21.3. The CAA says that the standard RAB approach can also distort incentives and adversely affect competition, and that a flexible RAB approach can have similar effects. I have noted above that other regulators have decided not to adopt RAB-based price controls in competitive markets. So the CAA's reservations are understandable. However, the CAA's initial proposals return to RAB-based controls, as discussed below.

21.4. LRAIC-based price caps are said to better reflect competitive outcomes in theory. No evidence is presented for this claim. Indeed, it is not clear what it means. Does it mean that, in theory, such price caps better reflect competitive conditions, implying that in practice they don't? Or does it mean that such price caps better reflect the outcome of a theoretical concept of competition as opposed to a practical one? Either way, the claim does not seem to be based on a documented comparison of an actual price cap with actual outcomes in actual competitive markets. It has no obvious reference to competition as a process. Cost-based rules,

[17] For a brief summary see First Economics, *Price Monitoring as an Alternative to RAP-based Price Cap Regulation, A reported prepared for the CAA*, December 2012, Annex 3.

[18] "Ofcom considered that Royal Mail's prices were below the competitive level and therefore offered more commercial freedom with regular reporting to allow prices to rise". (CAA, *Stansted initial proposals* fn 52 p 87)

especially those related to long-run cost, are likely to be at variance with how real markets operate in practice. In any case, the CAA identifies "significant practical difficulties in application to the airports to be relied on as the sole method". (para 5.19)

21.5. The next option - pegging tariffs to comparator airports - is scored positively in terms of promoting competition, on the grounds that it could remove distortions from a RAB-based approach. However, three problems are noted: the choice of comparator airports that "reflect similar levels of service quality, economies of scale and passenger demand"; the lack of a link between resulting prices and costs; and the danger of encouraging competing airports to act in a coordinated way. (*Q6 Policy Update* para 5.22)

21.6. The first problem is likely to be most acute at those two airports where the CAA presently considers regulation might be most needed, viz Heathrow and Gatwick. The CAA claims that average per passenger charges are higher there than elsewhere (*Q6 Policy Update* Fig 5.5) - but it is precisely at airports where capacity may be restricted that higher (scarcity) prices may be most appropriate and would indeed be observed in a competitive market, higher than the prices that would be found at airports with spare or unrestricted capacity. The second "problem" is arguably an advantage rather than a problem: in competitive markets charges are not set on the basis of an explicit cost-based calculation, and explicitly recognising this could facilitate rather than distort competition. The third problem seems more a problem in theory than in practice: now that the SE airports are in separate ownership, all airports seem to be keen to attract more customers and to expand capacity wherever possible, regardless of the consequences for other airports.

21.7. I agree with the CAA that comparing tariffs with comparator airports has some merit and could be useful, but not to set "precise and appropriate price caps". Rather, it could be a cross-check on the terms offered by an airport, perhaps in the event of dispute, or to inform evaluation of a commitment offered by an airport in lieu of a price control. The subsequent research papers by Leigh Fisher (*Comparing and capping airport charges at regulated airports*) and First Economics (*Price Monitoring*) come to essentially the same conclusion.

21.8. *Q6 Policy Update* finds that price monitoring "may have merits as a transition strategy to deregulation" (para 5.27). I consider this option below.

21.9. The next option is a regulatory default price-cap. It is described as not an alternative form of regulation, but can be used in combination with other options. The discussion is not entirely clear, and perhaps reflects more than one concept of a default cap.

21.10. For example, at first the present Q5 price cap is said to be an example of such a cap. It is difficult to see how such a cap is different from the present approach, how it responds to the new and more competitive circumstances of the industry and the proposed new regulatory framework, and how it promotes competition. It is claimed that a default cap can be used in conjunction with other options, for example to set a benchmark index of comparator airport prices. However, such a cap looks

more like a continuation of RAB-based regulation, from which a competitive market process will struggle to escape.

21.11. Later in the CAA's discussion, it seems that the default cap might be essentially a (rack rate) tariff, or a specification of the standard terms and conditions available to all airlines that wish to use the airport without having to negotiate a detailed bilateral contract. As a concept, such a tariff is likely to be central to a competitive airport's approach. But does it need to be set by the regulator? The CAA notes that the service level could be discussed during Constructive Engagement (CE). (para 5.34)

21.12. An alternative approach, more consistent with the competitive process, would be for the airport to propose a default (rack rate) tariff, as indeed GAL has done with its proposed Commitments in the absence of price regulation, though it has not offered this a part of a regulatory framework. Such a voluntary default tariff would be finalised after discussion with airlines likely to be interested in using it, who could negotiate individually or collectively if they wished to do so. To reassure the airlines, the airport could offer undertakings as to how the tariff would evolve in future. If the airlines were dissatisfied they could appeal to the CAA for a view. How the CAA would reach a view is for discussion. But the CAA would not embark on this process with a pre-commitment to determining a regulatory default cap regardless of the airport's views and the airport-airline negotiating process.

21.13. Yet another interpretation of default price cap seems to be used by First Economics (see below). Its option B for price monitoring involves a switch to a default price cap as part of a transition back to price cap regulation if the airport does not perform adequately on a set of annual performance indicators.

21.14. The final option is in fact airport-airline negotiations, again "not a separate form of regulation, but … relevant to a range of potential outcomes for the form of regulation at the three airports". (para 5.37) Again, CE is mentioned as part of the process.

21.15. Since the CAA has used CE in this and previous price control reviews, it is appropriate to consider more explicitly whether this is the way forward for the present review. Moreover, since CE involves airlines negotiating collectively with each airport, does it mean that bilateral negotiations and contracts are inappropriate?

21.16. Appendix A to this paper reviews the achievements and prospects of CE. It notes that CE has made significant contributions to setting a RAB-based price control, and collective negotiations have proved very effective in many US contexts. Nonetheless, as a market becomes more competitive it is appropriate to switch to bilateral contracting. A case study shows how this was done in a Canadian gas market.

22. Assessment of alternative forms of regulation in *Gatwick initial proposals*

22.1. The previous section explains how, in its *Q6 Policy Update*, the CAA evaluated a number of options for the form of regulation at each airport, having regard to the various statutory criteria in the new Act. In its *Gatwick initial proposals* it repeats the exercise, but with a significant difference. As noted in section 7 earlier, the CAA devotes over 120 pages

to calculating its "fair price", which is essentially the price that its former RAB-based approach would yield. It now says "The CAA has used its calculation of a fair price to assess the most reasonable and effective form of regulation …" (para 52)

22.2. This illustrates dramatically the difference between the two approaches to competition set out earlier. The first approach basically defines competition as "price equal to cost". Hence promoting competition means "ensuring that price is equal to cost". Hence the form of regulation that best discharges the duty to promote competition is the one that best ensures that price is equal to cost. And if there is any hint of possible market power that might lead to price above cost, then all forms of regulation, as well as non-regulation, are inferior to regulation that actually sets price equal to cost.

22.3. In accordance with that approach, the CAA's has calculated what price equal to cost would mean – its fair price – and judges the various alternative forms of regulation according to whether they would deliver that fair price. Thus for example

- a disadvantage of GAL's commitments approach is that "the price in the commitments is significantly higher than that which the CAA considers to be a fair price" (Fig 12.3)
- commitments plus a licensing framework would be acceptable if it included a fair price and a fair price would not distort competition (Fig 12.3)
- "a RAB-based approach can help to ensure that any commercial agreements are fair" (Fig 12.5)
- for price monitoring with commitments, "the terms in the commitments would need to be fair to airlines and users" (Fig 12.10)

22.4. The alternative approach to competition, endorsed by the CC, sees competition as a rivalrous discovery process taking place over time, as suppliers and customers seek to discover mutually acceptable combinations of prices, quality, contractual terms and conditions, duration of contract, and so on, that best suit each individual supplier and customer bearing in mind the costs and alternative competitive options available to each of them, in constantly changing market conditions.

22.5. From this second perspective, promoting competition means allowing and encouraging this discovery process to work rather than preventing, hindering or second-guessing it. Requirements on prices, quality of service and other terms can restrict and distort the competitive discovery process. The CAA sometimes seems to accept this: for example it says "A RAB approach could discourage commercial agreements, although it does not prevent such agreements." (Fig 12.5) The extent of restriction will depend on the nature of the control. The CAA is probably right to suggest that "The presence of a licence condition [limited to enforceability conditions on a set of commitments proposed by GAL] should not prevent bilateral contracts from being more likely under commitments" (Fig12.4) However, the CAA is surely rather disingenuous to deny that its regulatory process impacts on the prospect of signing bilateral contracts. (para 71) Airlines surely realise that their ability to argue for greater regulatory protection is compromised once they sign a bilateral contract.

It is another example of how regulation can promote or hinder the competitive market process.

22.6. From the perspective of competition as a rivalrous discovery process, it is unrealistic to assume that the regulator knows in advance the answers that the competitive process seeks to discover, especially in a complex market. The CAA accepts that Gatwick is characterised by more different types of airlines and passengers than any other UK airport. Consequently, discovering the most appropriate prices, quality of service and other contractual terms and conditions for each airline will be more challenging than at any other airport. It is unrealistic to assume that the CAA knows the answers when the parties themselves have yet to discover them. Yet its calculation of a "fair price" at Gatwick makes precisely this assumption. The CAA's use of this fair price to choose the form of regulation is therefore putting the cart before the horse: whereas the form of regulation needs to be chosen to promote competition – that is, so as best to discover the pattern of competitive prices and other terms - the CAA is deciding what the answer is first, then choosing a form of regulation to give the answer it wants.

23. Commitments and licensing at Gatwick

23.1. The CAA's review of alternative forms of regulation at Gatwick suggests that a "commitments plus limited licensing framework" would be its preferred form of regulation there:

> The CAA hopes that a commitments and limited licensing framework could be the preferred form of regulation for GAL. This would be on the basis that the enforcement concerns about the commitments concept was addressed through enforcement under the licence, and that the commitments were amended to address the other concerns identified by the CAA, so that they are reasonable and effective. (para 12.80)

23.2. Whether GAL is willing to modify its Commitments in this way, and to accept a licensing framework, is a matter for GAL. Insofar as revised commitments would replicate the CAA's RAB-based price control calculations, and like them be embodied in a licence, it is not clear that this approach offers much advantage over the RAB-based price control.

23.3. My own reservations, based on the previous analysis, are threefold. First, the CAA's substantive requirements in terms of its fair price and associated terms of service are some way from what GAL has offered. It is not clear that these additional demands are consistent with what a competitive market would provide and they may unduly constrain the development of competition, to the detriment of users of Gatwick airport. Second, there are alternative ways of enforcing the Commitments without a licence, for example via bilateral contracts for those users to whom particular elements of the contract are important or via GAL undertakings to the CAA. Third, the licensing of Gatwick would encourage GAL and other parties to intervene more frequently, which again would not be conducive to the development of competition.

24. The possibility of monitoring

24.1. The CAA has proposed the use of monitoring at Stansted, and suggested that "voluntary undertakings could, in principle, be part of an appropriate form of regulation".[19] I have therefore considered the possibility of regulation at Gatwick by means of monitoring plus Commitments from GAL, where these commitments are not included as part of the licence. For the sake of argument I assume that GAL is willing to propose modified Commitments that are acceptable in substance to the CAA. I first explore the general question whether monitoring is an advantageous approach.

24.2. Appendix B to this paper reviews the CAA's various discussions of monitoring. It notes the CAA's view that monitoring alone has potential benefits in reducing the burdens of regulation but a potential drawback in that there would be uncertainty about acceptable prices. This drawback would be overcome by the price undertaking in GAL's Commitments. I note an additional advantage of price monitoring, that it promotes competition via negotiation between airports and airlines.

24.3. Appendix B also reviews the First Economics report on price monitoring, which identifies two options B and C and finds them equally acceptable. The CAA recommends price monitoring at Stansted using option B, with annual reports and an ability in the license to impose a price freeze. However, I argue that option B involves greater regulatory burden via annual and more detailed reports, and also fetters the regulator's discretion by committing to a particular remedy viz a price freeze.

24.4. First Economics reviews Australian experience, where there is an annual monitoring review and no price control. Experience is that this approach is on balance working well, and has been continued following successive reviews by the Productivity Commission.

24.5. There has been discussion in Australia of a possible "show-cause" procedure, designed to enhance the threat of airport re-regulation. If the ACCC's reviews did not find satisfactory performance, should it be able to require the airport to show cause why it should not be subject to a full review, and possible action to bring about re-regulation? First Economics was concerned that such process might cause possible delays. The CAA nonetheless proposed a show-cause procedure at Stansted, whereby it would require STAL to show cause (explain and justify its actions) if its airport charges breached a threshold set by the CAA, viz an increase of half the rate of inflation. Appendix B notes that the Australian Government twice considered the recommendation to establish a show cause procedure, and twice decided against it.

24.6. Appendix B also notes a significant difference between Australia and GB. In Australia it is the ACCC that carries out the annual review but the Australian Government that would need to impose any reregulation if a problem were identified. In GB the CAA would be responsible both for carrying out the review and for deciding on any subsequent regulation.

[19] *Stansted initial proposals* para 3.74

This makes the CAA more vulnerable to lobbying, and might influence the nature of its reviews.

24.7. In summary, Australian experience suggests that monitoring has been a generally successful approach, certainly preferable to price control. There is no show-cause procedure, and the Government has twice rejected a proposal to introduce one. And the annual review is carried out by a regulator that does not have power to bring about reregulation or impose additional licence conditions.

25. Commitments and monitoring at Gatwick

25.1. The CAA sees merit in a monitoring approach where the risk of exploitation of market power is low, as at Stansted. But it has two main objections to applying the approach at Gatwick. First, it considers that Gatwick has more market power than Stansted, and GAL's proposed Commitments are significantly in excess of the CAA's view of a fair price. Second, GAL would be able to change the terms of the Commitment and the CAA would have a problem of enforceability.

25.2. These are basically the two same concerns that have just been discussed. On the enforceability point, I have argued that there are alternative ways of enforcing the Commitments, for example via bilateral contracts for those users to whom particular elements of the contract are important and/or via GAL undertakings to the CAA in relation to elements of the Commitments that are of more importance to smaller airlines who are not willing to enter into bilateral agreements or who would be unable to enforce them, or to passengers who are not party to such contracts.

25.3. What are the comparative merits of acceptable Commitments embodied in a limited license, which the CAA would prefer at Gatwick, compared to monitoring plus acceptable Commitments without a licence? The substantive Commitments are assumed to be the same. I have argued that there are various ways of achieving enforcement without licensing.

25.4. Monitoring would be more flexible than a licence condition, a step closer to an unregulated competitive market, and therefore more consistent with promoting competition, compared to Commitments written into a licence which rather smack of price control and a regulatory approval process. Moreover, licensing would unduly encourage regulatory intervention, which would not be conducive to the development of competition. While not preventing the CAA from taking an active role and proposing a licence if it considered that GAL was exercising market power, the monitoring approach would reinforce the expectation that issues and differences should be resolved by means of commercial negotiations and contracts rather than by regulatory intervention and a revised licence condition.

25.5. The CAA comments that price monitoring would have additional costs. This is true, and for that reason I preferred First Economics' option C in which "the review of prices and outcomes is less frequent and more high level than in option B". The CAA also says

> Price monitoring might, if combined with GAL's commitment proposals, be a more effective form of regulation than price monitoring alone. The annual report under price monitoring would allow transparency on the main information that airlines

might need to negotiate on behalf of users. It would also allow a quicker enforcement route for airlines compared to the commitments alone. (*Gatwick initial proposals* para 12.76)

25.6. It would therefore be open to the CAA to determine the frequency and detail of monitoring that balanced these benefits and costs. For example, it would not seem necessary to monitor annually: with a seven-year set of Commitments and many airlines signing multi-year bilateral contracts, a monitoring report every two or three years would seem to suffice.

26. Conclusion: the transition from licensing, regulation and price control

26.1. The CAA might feel that continuing to licence an airport, and to regulate it by a RAB-based price control or equivalent, is a safer course. However, in practice the limitations, vulnerabilities and greater involvement of regulation in an increasingly competitive market lead to unintended consequences that can have adverse effects. During a transitional period, Commitments and monitoring can provide enforceable assurances. Less regulatory involvement is more conducive to promoting competition and protecting the longer-term interests of customers.

26.2. Admittedly it is difficult for a regulator to draw back from regulation once entered into. Arguing that regulation is no longer needed because the market is now sufficiently competitive can seem a risky position to take. It is may seem easier to argue that any existing regulation should be continued, just in case - as the CAA's initial proposals have hitherto suggested, in apparent contrast to its 2007 position.

26.3. However, if licensing and price regulation continue, arguments about the consequences of withdrawing from licensing and price regulation will continue to be based on hypothetical conjectures about what an unregulated major airport would be like. There will never be any empirical evidence – at least from the UK - of how an unregulated major airport would actually operate. This will prevent the learning from experience that is necessary for improving any regulatory framework.

26.4. The CAA presently faces the first major regulatory decision after the most significant changes in airport sector conditions and statutory conditions for nearly three decades. For the foreseeable future, any changes in such conditions will be relatively marginal. A window of opportunity that is open today will gradually close. If it is not possible to remove licensing and price regulation now, as the new Act clearly envisages, when will it ever be?

APPENDIX A

CONSTRUCTIVE ENGAGEMENT AND BILATERAL CONTRACTS

27. Constructive Engagement: experience to date

27.1. Given the CAA's several references to constructive engagement (CE), this Appendix considers the achievements and prospects of that technique in the future conduct of airport regulation. It also summarises a case study showing how market participants in a Canadian gas market moved from collective negotiations to bilateral contracting as the market became more competitive.

27.2. In May 2004, the CAA introduced the then-novel concept of CE. The fact that the CAA saw the need to resort to something as radical (at the time), and that the parties were willing to try it (albeit reluctantly at first) indicates the problematic nature of the previous type of regulation of UK airports.

27.3. CE turned out to be helpful in setting the price controls for Q5, and better than the previous price control process. The CAA continued CE in modified form, and very successfully, in setting the price control on air traffic control. CE was effective in temporarily extending the Q5 controls at Heathrow and Gatwick. The CAA has used more flexible (albeit more structured) variants of the CE approach as an initial part of the process of setting the airport price controls for Q6.

27.4. In considering a future form of regulation for designated airports, does the CAA need to look further than CE? Should CE be a component of whatever form of regulation is adopted?

27.5. There have been criticisms of CE, expressed most fully by the CC. The main ones are perhaps threefold. First, the CC was critical of the relatively hands-off process adopted by the CAA, and suggested a more structured approach. To my mind this criticism was a little harsh, given that this was arguably the most important and constructive innovation in UK utility regulation since it was first put in place, and the CAA was understandably concerned not to stifle this baby at birth. Nonetheless, the CAA took a more structured approach to the air traffic price control and this appeared to work well.

27.6. The second criticism, related to the first, is that the airline parties appeared to be focused on getting their own preferred investments incorporated into the airport's plan, without adequate focus on the implications for "the bottom line" and for prices. And, moreover, that the "bottom line" kept changing (and increasing), apparently out of control. How far the airlines actually had no appreciation of the implications of their investment proposals for price is perhaps questionable. Nevertheless, later processes have done more to clarify the implications of investment for prices, and to stabilise the timetable. However, it must be questionable whether competing airlines requiring different services and service qualities at different prices can reasonably be expected to agree on a set of differential charges, or on total revenue to be raised, or even on a baseline (or rack rate) tariff that will apply to only some of them.

27.7. The third criticism is that while the CE process had some success at LHR and LGW, it failed at Stansted, at least initially, because agreement was not reached between the airport and airlines. I disagree: in my view it succeeded there too. CE, and negotiated settlements generally, should not be judged according to whether or not agreement is reached. The more correct claim is that this process will better and sooner identify and secure mutual gains where such gains are to be made, and will better and sooner identify where this is not the case. At Stansted it soon became apparent that there was no common ground between the parties, essentially because the airport was proposing an extension that the users did not want. This conclusion was reached sooner and more clearly than would have been the case if the price control approach followed the normal dialogue between company and regulator, with users commenting from the sideline. It is notable that once the disputed extension was off the table, the parties were able to come to some agreement on other matters.

27.8. The CAA's various experiences with CE show that airports and major airlines have been both able and willing to negotiate some mutually acceptable arrangements at the designated airports. Experience has borne out the CAA's view that, in an increasingly complex market, airlines and airports are more knowledgeable than the regulator about their own preferences and about the opportunities open to them. In some respects they can agree better (mutually preferred) specifications than the regulator can specify. If a relatively simple and relatively uniform RAB-based price control has to be set, they can provide many of the inputs better than the regulator can.

27.9. Thus, the issue is not that CE has failed to work where it has been applied: on the contrary it has worked well. Moreover, similar approaches have long been successful elsewhere, as I have documented.[20] At the Federal Energy Regulatory Commission (FERC) a high and increasing proportion (now some 95%) of standard rate cases are settled by negotiation between the participants rather than litigated.[21] FERC staff in fact play an active role in facilitating these settlements. Some state regulatory commissions such as Florida have seen many settlements.[22] In Canada the National Energy Board (NEB) has successfully encouraged settlements by oil and gas pipelines and their customers.[23] Since the mid-1990s such settlements have essentially replaced litigated hearings. In almost all jurisdictions where settlements are common, not only have the parties demonstrated their preference for such an approach, there are also reports of better, and better informed, relationships between the parties.

27.10. Variants of this approach are now being adopted by other regulators in the UK. Ofgem and Ofwat have both required companies in their sectors to set up arrangements for customer engagement, and have said that they

[20] Negotiated settlements: the development of legal and economic thinking, (with Joseph Doucet), *Utilities Policy* 14, December 2006, 266-277.

[21] The process of negotiating settlements at FERC, *Energy Policy*, 50, November 2012: 174-191.

[22] "Stipulated settlements, the consumer advocate and utility regulation in Florida", *Journal of Regulatory Economics* 35(1), February 2009, 96-109. "The bird in hand: stipulated settlements in Florida electricity regulation", *Utilities Policy*,17 (3-4), September – December 2009, 276-287.

[23] "Negotiated settlements and the National Energy Board in Canada", (with Joseph Doucet) *Energy Policy*, 37, November 2009, 4633-4644.

will take account of customer support or otherwise in assessing company business plans. The Water Industry Commission for Scotland (WICS) has taken the lead in formally setting up a Customer Forum to negotiate with Scottish Water. To date, these developments have been viewed positively by the main parties involved, and offer the prospect of better discovering and meeting the preferences of customers.

28. Constructive Engagement going forward?

28.1. The CAA's use of CE has thus been a significant step forward with respect to the implementation of a regulatory-determined RAB-based price control at a set of airports presumed to have market power. But will it be equally applicable in future, to an airport that is increasingly subject to competition? The CAA rightly has reservations.

28.2. In Section 5 of *Setting the Scene for Q6*, the CAA discussed the principles and practice of CE. Its Figure 5.1 sets out some operating principles for CE, and its Figure 5.2 gives more detail of an "Illustrative CE process within a RAB-based approach". However, the CAA also recognised that an undue or continued focus on CE could jeopardise the development of individual negotiating and contracting where a RAB-based approach was not necessarily appropriate.

> The CAA appreciates that expectations about its stance and how it might regulate will influence both sides' incentives and commitment to strike commercial deals and outcomes. Unless the regulatory stance is finely judged, it risks either failing to take into account the degree of market power at the airport to the disadvantage of the airlines or it could go too far the other way and crowd out the possibility for commercial settlements. In addition, the CAA appreciates that not establishing a framework for commercial discussions risks unhelpful regulatory uncertainty. (*Setting the Scene for Q6*, Section 5, p 21)

28.3. In its *Q6 Policy Update* the CAA discussed CE in the context of its aim to ensure that Q6 is passenger focused. It proposed to facilitate CE "based on a working assumption that in the context of economic regulation of airport operation services, the commercial interests of airlines generally align with the interests of their passengers, but this may not always be the case". (para 3.20 p 26) The CAA continued "It also means that some form of CE, which facilitates effective discussion and trust between airports and airlines is desirable regardless of the specific form of regulation that is adopted." (para 3.26)

28.4. However, it is clear that "some form of constructive engagement" does not necessarily mean collective negotiations, involving a unified customer view agreed by all. Thus the CAA writes

> "Given the inevitable competing commercial objectives for price regulation outcomes, the CAA is not requiring or expecting that airports and airlines can reach universal agreement, though it would welcome this eventuality if the outcomes demonstrably further the interests of passengers.
>
> Building on the process of CE for Q5, the CAA considers that there is considerable benefit from a process whereby the airport and airlines discuss both the required outputs for the period beyond April 2014 and their costs. …CE does not preclude bilateral commercial discussions." (paras 5.37, 5.38)

28.5. The CAA's various *initial proposals* document some further contributions that the CE processes have made to setting the price controls for Q6. It is apparent that they have been useful as far as they have gone,

but for various reasons they have not established complete price control proposals, or indeed sought to.

28.6. Experience in the presently competitive and unregulated UK airport sector, and in much of the EU, is not characterised by a collective approach to bargaining. The airlines at each airport do not negotiate as a single entity. Accordingly, requiring constructive engagement in the sense of collective negotiations is not the best way to replicate or develop an increasingly competitive market. Increasingly, airlines will wish to negotiate differentiated service qualities and terms and conditions at each airport that best enable them to compete with other airlines. The provision of such differentiated arrangements is also a means by which airports compete with other airports. What is needed now is a transition to a market in which airlines at each airport negotiate individual terms, with a standard tariff as backstop for those airlines that do not find it worthwhile to negotiate individual terms. Bilateral negotiations rather than collective negotiation will thus be the norm. This will be the most effective way to discover and implement the packages of price, quality of service, volume, risk-sharing and other arrangements best suited to the needs of airlines and airports.

28.7. Thus, CE, in the form that it took in Q5 and immediately thereafter, played a valuable role in facilitating a sensible airport price control. There is scope for the application of similar approaches in other sectors where competition is not an issue. However, it is no longer a suitable basis for regulating an increasingly competitive airport market in future.

28.8. This conclusion is consistent with experience elsewhere. An obvious example, mentioned in First Economics Report for the CAA and discussed in Appendix B below, is the removal of price control regulation from airports in Australia. Such regulation had been found to be unsatisfactory, it was believed that the airport sector was becoming more competitive and price control was removed. After more than ten years' experience, and after two Reports by the Productivity Commission, there is widespread agreement with the Productivity Commission's conclusion that on balance the arrangements are working well.

28.9. The following less familiar example of deregulation, from the Canadian gas sector, is of particular interest because the regulated company and its customers actually brought it about themselves.

29. Example of a negotiated transition to a more competitive market

29.1. Canadian oil and gas pipelines and their customers still make extensive use of negotiated settlements for the use of the pipelines. However, one gas pipeline (Westcoast) and its customers (notably the Canadian Association of Petroleum Producers or CAPP) crafted an innovative five year (1997-2001) settlement that radically changed the nature of the

regulation of the pipeline's gas gathering and processing activities.[24] The driver was the emergence of an increasingly competitive market.

> The stated motivation for this settlement was the changing economic and commercial environment. This included significant development of gas resources in the adjacent Northeast BC; Westcoast's declining market share in the face of competition, resulting in higher tolls as costs were spread over a lower demand; shipper dissatisfaction with the rigidity and uncertainty of the existing toll structure; and the inability of Westcoast, under the current regulatory environment, to quickly develop new capacity and respond to customers.

29.2. The settlement had two stages. The first provided choice between some specified contractual alternatives.

> The first stage of the settlement [in 1997] embodied a much greater flexibility in pricing. For Westcoast's increasingly competitive gas gathering and processing activities, it provided users with a choice of fixed tolls for 1, 3 or 5 years, adjustments tied to the price of gas, a bidding process for interruptible tolls, a revenue deferral account for differences between actual and base level toll revenues, and tolls for available and incremental capacity to be determined through individual negotiations.

29.3. However, this was just a brief transitional stage towards individually negotiated contractual arrangements.

> The settlement also foreshadowed a new development, namely, a transition to freely negotiated market based arrangements subject to a lighter (i.e. complaint-based) form of regulation. This second stage took effect in 1998, from which point Westcoast's tolls for gas gathering and processing services were based on *individually* negotiated arrangements. The goals of the Framework document include to provide shippers and Westcoast the opportunity to negotiate service requirements as in a competitive market, and where possible to rely on commercial arrangements instead of regulatory oversight. The Introduction recognises that shippers are knowledgeable and have information and other options. The Fair-Dealing Policy requires Westcoast not to discriminate (interpreted as a requirement to charge similar tolls to similarly situated customers) and to make information about capacity available to all on a monthly basis. The Contracting Practice provides that terms will be governed by contracts negotiated with individual shippers. "The goal is to permit negotiations to include any item of value that could be the subject of bargaining in a competitive market."

29.4. Certain additional provisions were put in place to facilitate the competitive process and to provide regulatory reassurance.

> The parties recognised the need for commercial confidentiality, but also "the need for a reasonable degree of price discovery to assist in the operation of a functioning market". To that end they propose that Westcoast would either file all contracts with the Board or indicate the maximum and minimum range for the tolls in each tariff; allow the Board access to contracts for mediation or complaint purposes; and make available quarterly summary data on contract terms. There is provision for a detailed Complaint Process, including optional mediation, arbitration and adjudication by the Board. The Board still has a role in terms of complaints, and can intervene if needed,

[24] Extracts below from Joseph Doucet and Stephen Littlechild "Negotiated Settlements and the National Energy Board in Canada", *Energy Policy*, 37, 2009, 4633-4644. For further detail on the Westcoast arrangements, see N J Schultz, "Light-handed regulation", *Alberta Law Review*, 37 (2), 1999, 387-418.

hence the term "light-handed regulation" meaning 'market regulation' rather than 'deregulation'.

29.5. These arrangements were of course geared to the specific circumstances of the gas gathering and processing sector on the west coast of Canada, and to a transition from the specific form of regulation that had been practised there hitherto. They were put in place some 15 years ago, and I understand are working well. They are not suggested as a model for airport regulation in the UK. Nonetheless, they demonstrate that, as a hitherto regulated market became increasingly competitive, both sides of the market found it preferable, and possible, to transition from a situation where the regulator set or endorsed prices, to a lighter form of regulation. This is essentially complaint-based, with some periodic provision of pricing information to the regulator, but without price control or revenue restrictions or the required provision of cost and profit data.

APPENDIX B

PRICE MONITORING AND AUSTRALIAN EXPERIENCE

30. The CAA on price monitoring in *Q6 Policy Update*

30.1. In its *Q6 Policy Update* the CAA explained that price monitoring would not involve the CAA in setting an explicit price cap. The form of the monitoring was for discussion: it could be quite reactive, essentially complaint-based, or the CAA could specify a threshold for price levels above which it would expect to review the airport's actions. It said

> This approach has potential benefits in reducing the burdens of regulation. However, it has potential drawbacks from creating uncertainty over what an acceptable level of prices would be and how the CAA would respond in the event of a complaint being received or a threshold being met. It also implies the initial price in April 2014 is a reasonable starting position." (*Q6 Policy Update* para 5.26)

30.2. The benefit of reducing the burdens of regulation is valid. However, it does more than that: it actually promotes – indeed requires – the development of competition via negotiation between airports and airlines. One can appreciate that there might be initial uncertainty, but one would expect that such uncertainty would reduce over time as the regulatory stance became clearer.

30.3. Despite its reservations, the CAA concluded

> "The CAA's initial view is that this option may have merits as a transition strategy to deregulation where, although the airport is found to have substantial market power, increasing competitive pressure over time can be broadly relied on to restrain prices." (para 5.27)

31. First Economics on price monitoring

31.1. The CAA then commissioned a report from First Economics describing "the different ways in which the CAA could build a regulatory regime around a system of price monitoring."[25] In general this is a useful report which brings out the implications of different methods of price monitoring and establishes the general plausibility of this approach. I comment here on just a few of the arguments used in that report.

31.2. The report says (section 2.1) that a price monitoring regime should identify abuses of market power ex post, and also act as an ex ante deterrent against such abuse. There should be measures in place to protect users from harm in the event an airport abuses market power, and the regime should encourage self-regulation by the airport. "It is only if these conditions are satisfied that the CAA should move on to consider the benefits that price monitoring brings as regards greater flexibility, reduced regulatory specification and reduction of the regulatory burden." (p 21)

31.3. This last proposition surely goes too far. In considering what form of regulation to put in place, the CAA needs to consider all its statutory duties, not least the duty to promote competition where appropriate. The CAA must therefore consider the benefits of price monitoring, including

[25] First Economics, *Price Monitoring as an Alternative to RAP-based Price Cap Regulation, A reported prepared for the CAA*, December 2012. In the next few sections this is referred to as "the report".

in promoting competition, along with possible disbenefits. The CAA cannot impose pre-conditions that price monitoring must meet before the CAA considers the possible benefits.

31.4. The report then describes and analyses three options for price monitoring against four criteria: credibility, promotion of competition, protection of users and financeability.

31.5. Option A is the most heavy-handed: "the level of an airport's charges is monitored against an external price benchmark and automatically capped in the event that the airport increases prices beyond a predefined monitoring threshold." (s 2.2 p 4) The report finds that this option scores less well than Options B and C on three of the four criteria. The CAA does not take up this option, and I do not consider it further.

31.6. Option B is "a more flexible process involving ex post annual review of prices and outcomes at an airport, without any sort of prescriptive ex ante price cap". It also has a "short-term default price cap [that] would automatically switch on in the event that the CAA finds that self-regulation isn't working and there is a need to re-regulate". (p 12) Option C is "a very light-touch approach, in which the review of prices and outcomes is less frequent and more high level than in option B". (s 2.2 p 4) The report scores these two options B and C equally highly. They tick all but one of the boxes that the CAA used in its *Q6 Policy Update* paper.

31.7. The exceptional box is the CAA's last criterion – Practical implementation and stakeholder confidence - where First Economics gives both options a question mark. The explanatory comment is "This option requires all stakeholders to believe that an airport will behave responsibly. We cannot guarantee that all stakeholders will have this belief." (pp 21-2) This seems a rather bizarre interpretation of the CAA's criterion: if regulatory policy depended on guaranteeing stakeholders' beliefs then would any policy pass the test? The CAA's own assessment of price monitoring against this criterion is more sensible and positive:

> As it encourages prices and service quality to be agreed, price monitoring should strengthen the relationship between the airport and airlines and stakeholders have been keen to explore this option further. The main concerns with implementation are associated with the process and timing of regulatory involvement. (*Q6 Policy Update* p 103)

32. Choosing between options B and C

32.1. Since the report ranks them equally, how to choose between Options B and C?

32.2. The report identifies one main difference between Options B and C with respect to the CAA criteria. Option B provides protection on prices, service quality and operational efficiency via a switch to a default price cap (or price freeze) during a transition back to price cap regulation if the airport does not perform adequately on these annual indicators. Option C relies more on competitive constraints, third-party arbitration and a more discretionary regulatory approach to provide these protection on these matters.

32.3. The report notes that "Option B has quite small set-up costs but requires a reasonably significant amount of outgoing resource from the CAA." (p 10) The report makes no mention of the resource from the

airport. Given the long list of possible monitoring indicators (Box 4.1 has 18 headings, some of which imply multiple measures), Option B will impose a very substantial burden on the airport as well as on the CAA.

32.4. Option B goes further than Option C in committing the regulator to specific remedial action, viz imposition of a default price cap or price freeze. This too will require regulatory resources to define. Since it may not be appropriate simply to freeze a set of prices that are believed to be excessive, Option B may necessitate setting a default price cap that may almost be tantamount to carrying out a whole price control review.

32.5. Option B ties the regulator's hands: it fetters its discretion as to how to respond to any situation, even though the regulator might find that the specified default price cap is not the most appropriate one in some circumstances. Whether this option provides more certainty and credibility is perhaps debateable, since the regulator still has scope for interpretation of the conditions, and may wish to exercise its discretion.

32.6. In its discussion of the credibility criterion, the report says

> "We have been concerned to ensure that all stakeholders see the 'rules of the game' as fixed and so focus on working within the new rules rather than put their efforts into continued lobbying of the CAA for a switch to whatever happens to be their preferred form of regulation. Such behaviour could, if not given short shrift by the CAA, cause the regulatory regime at an airport to collapse into total uncertainty and as such is to be avoided at all costs." (p 16)

The report does not think there is any reason to choose between the three options on this criterion.

32.7. However, there will be a greater incentive for airlines and airports to lobby the CAA for a switch to their preferred form of regulation, and in particular for a switch between regulation and non-regulation, the greater is the difference between the form of regulation and what would happen if the airport were not price regulated. Where the extent of market power is great, it might be important to ensure that a quite different pricing policy is imposed from what an unconstrained airport would implement. But the less the extent of market power, the stronger is the case for adopting a regulatory regime that is broadly consistent with what an unregulated airport would do, at least from the perspective of reducing the incentive to lobby the CAA for further changes to the regulatory regime.

32.8. To summarise, the case for option B seems to me stronger than for option C because option B is more onerous and costly, it fetters the regulator's discretion more, and it makes the regulator more vulnerable to lobbying.

33. The CAA's approach to price monitoring at Stansted

33.1. The CAA's initial proposals now suggest price monitoring as the appropriate approach at Stansted. In contrast to my arguments in the last section, it chooses option B rather than C. It also specifies a threshold level at which it would step in, and provides for a price freeze while it evaluates a show-cause procedure. However, the CAA's discussion of the pros and cons of options B and C is remarkably brief, and its reason for preferring option B consists of only two points, neither of which is convincing.

33.2. The first point relates to market power. "[First Economics] suggested that option C … would require the airport operator to face meaningful competitive constraints across a significant proportion of its revenue base ….The CAA's market power assessment for STAL indicates that it is not likely that it will face competitive constraints across the majority of its revenue base". (*Stansted initial proposals* paras 3.55, 3.56) But if the market power assessment did indicate that Stansted would face such competitive constraints then Stansted would not be regulated by licence in the first place. The logic of the CAA's argument seems to mean that no airport can ever be price monitored according to option C.

33.3. The second point relates to working relationships. "The CAA would also need to be convinced that the airport operator is committed to working with its customers in a normal commercial manner and can reach agreement with them without regulatory involvement. Option B would avoid this by having greater CAA involvement through regular reporting and monitoring of performance." (para 3.55) Quite what "this" is that Option B would avoid is unclear. Is the CAA saying that greater regulatory involvement would avoid the need for greater regulatory involvement? Or is it saying that regular as opposed to irregular reporting would suffice to ensure that an airport is committed to working with its customers in a normal commercial manner? That would be quite an achievement, suggesting that regular reporting could replace price controls generally.

33.4. The discussion in the previous section suggests that there is more to be said against Option B and in favour of Option C than the CAA allows, particularly with respect to the costs of implementation, the CAA's scope for discretion and its vulnerability to lobbying.

34. Australian experience

34.1. Since Option B "draws heavily on the Australian approach to airport regulation". (p 9), it will be useful to examine that experience in more detail. The most important lesson from Australia is that the absence of airport price controls has on balance worked well, and has done so for over ten years, as the Productivity Commission's last two reports have indeed found. It has noted that investment has been easier and prices do not appear to have been excessive, though some non-price terms have been less satisfactory. Commercial agreements between airports and airlines have been signed, though there are still some strained relationships. Almost no one wants to bring back the previous mechanism of price control.

34.2. The Productivity Commission's initial proposal for removing airport price controls was based in part on the argument that there was significant competition between airports in Australia. The Productivity Commission has since conceded that the competition between most of these airports has not been as strong as it had originally assumed. But this has not changed its view that this was the appropriate policy to adopt. This is of particular relevance in Great Britain, where airports are much closer than in Australia, and the degree of competition between them (and with some airports in continental Europe) is much greater. So if deregulation worked

with the limited extent of airport competition in Australia it could be expected to work in Britain.

34.3. Option B draws on the Australian approach insofar as it proposes an ex post annual review of prices and outcomes, without any prescriptive ex ante price cap. In Australia the ACCC carries out the annual review, and can if appropriate decide upon a further investigation. But any decision to reregulate an airport would be for the Australian Government, not for the ACCC. In the UK, by contrast, the regulatory entity carrying out the review and any further investigation is also the entity responsible for any reregulation, viz the CAA. This has an important implication.

34.4. If the CAA has the ability to act, it will be under pressure to do so. The First Economics report notes that "The worst outcome that these options could produce is one in which the CAA uses, or comes under pressure to use, the threat of re-regulation to exert soft influence over day-to-day airport-airline negotiations." (p 19) This pressure will be greater the greater the role that is assigned to the CAA, which is in Option B rather than C.

34.5. This pressure may therefore lead the CAA to modify its assessments. Under Option B the CAA is expected "to state clearly in its annual reports whether it has identified evidence that there might have been an abuse of market power". (p 12) The CAA will find it difficult to separate this from the decision whether it wishes to put in place the default price cap and move to reregulation.

34.6. At the CAA's request, First Economics has now prepared some *Further Insights* into Australian experience. It notes that there has been discussion on two main possible weaknesses of the regime. The first is what if any ex ante guidance to provide as to what constitutes unacceptable outcomes. "The Productivity Commission and the Australian government have stuck rigidly to a policy of describing the dividing line between acceptable and unacceptable in high-level qualitative terms". (p 1) I note that this should be taken along with the Government's guidelines on airport pricing, which it has updated over time in the light of experience and in response to points made by the Productivity Commission. First Economics conjectures that the decision not to specify quantitative rules may be to avoid creating a price cap by another name. It may also be because neither the ACCC nor the Government know in advance precisely what would constitute an unacceptable outcome, and are reluctant to fetter their discretion.

34.7. The other question that First Economics examines is the sanctions that an airport should face if the annual monitoring report finds unacceptable outcomes. First Economics notes the proposals in Australia that an airport should be required to "show cause" why it should not be the subject of a full inquiry. First Economics suggests that a show-cause provision could lead to quite a drawn-out process of claims and counter-claims, hence to not the swiftest resolution of abusive behaviour.

34.8. The CAA's *Stansted initial process* proposes to proceed in the opposite direction on both issues. It specifies a show-cause trigger at half the rate of inflation. This is effectively a price cap, albeit with scope for STAL to argue the case for exceeding it.

34.9. It is worth expanding upon the First Economics *Further Insights* report on the show-cause proposal in Australia. The two latest reports of the Productivity Commission have both recommended making more explicit the threat of re-regulation, in order to put greater pressure on airports to act competitively. This has been the reasoning behind the proposed "show cause" process. The interesting point is that the then-Government initially accepted the first recommendation then (at the time of the financial crisis) changed its mind and rejected it, primarily on the basis that the process would add to uncertainty, with likely adverse consequences for investment. Five years later the then-Government rejected the second recommendation, on the grounds that there was no need for such additional threat of re-regulation.

34.10. In other words, the Government of Australia has taken the view that, in the light of experience there, not only is the system of no price regulation working well, there is also no need to strengthen the threat of airport re-regulation. In effect, the Government of Australia has endorsed an annual ex post review of airport performance, and has made some changes to the guidance to airports, but has rejected as unnecessary and unhelpful a pre-determined threat or procedure for re-regulation. This puts the Australian approach closer to First Economics' Option C than B, albeit with annual monitoring. It should be noted that the ACCC, which is responsible for carrying out the annual monitoring, said that the benefits were unlikely to outweigh the costs, and should be discontinued. As noted above, the extent of competition between UK airports – and indeed between UK and some continental Europe airports – is much stronger than between Australian airports. This suggests that the case for an explicit threat of re-regulation procedure, over and above that afforded by the Market Power Test framework, is even weaker in the UK than in Australia.

34.11. First Economics notes that, in parallel with the show-cause mechanism, the Productivity Commission encouraged the development of dispute resolution procedures. I participated in a minor way in the most recent Productivity Commission (PC) investigation, on this particular issue.[26] The airports, airlines and PC all endorsed my proposal that the parties agree to independent dispute resolution as an alternative to a "show cause" procedure. First Economics is right to suggest that "This should interest the CAA, not least because it shows that there are alternatives to regulation as the means for solving disagreements between airports and airlines." (*Further Insights* p 2)

[26] "Australian airport regulation: exploring the frontier", *Journal of Air Transport Management*, 21, July 2012, 50-62. "Economic regulation of airport services: some comments on the Productivity Commission Draft Report of August 2011", 29 September 2011, and "Economic regulation of airport services: further comment on the Productivity Commission Draft Report of August 2011", 6 October 2011, published as DR116 30/9/11 and DR123 10/10/2011 at http://www.pc.gov.au/projects/inquiry/airport-regulation/submissions