The CAA Response to DfT's consultation paper on European Airport Charges Directive

June 2007

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Executive Summary

1. The CAA is responding to this consultation as the independent regulatory authority (IRA) for UK airports. The UK has over 20 years experience in the economic regulation of airport charges.

2. In general terms, the underlying purpose of economic regulation is to secure the best available outcome for end users over time. In considering the need for, and means of, regulation at airports, this translates into securing the best combination of price and service for passengers and freight shippers, and ensuring that incentives are in place to achieve the efficiency and investment necessary to secure this outcome in future. The Commission's stated aim to ensure that the entire aviation supply chain is as competitive as possible is to be welcomed with this priority in mind[1]. However, the CAA is concerned that as currently drafted, the Directive will not achieve this and could hinder development of Europe's aviation sector.

3. Liberalisation of the European airline market has encouraged airline expansion and new entry, and been accompanied by growth in competition between European airports. Airlines are informed purchasers of airport services and appear actively to compare alternative uses of their aircraft across a wide range of alternatives; airports can and do compete with each other for new services. Market conditions across Member States are diverse with Europe's airports serving markets at different stages of maturity, in different geographic regions each with their own specific socio-economic and population characteristics, offering airlines different service quality at different prices. Therefore, the nature of airports' market conditions, both within individual Member States and across Europe, exhibit significant variation.

4. In the light of this, and considering the principles of good regulation, a differentiated approach is likely to be necessary to ensure that regulation is properly targeted at real problems. This differentiation can be achieved either by prescribing different levels of regulation overall, to fit different circumstances, or setting the outcome to be achieved, leaving Member States – and their regulators – some discretion in how to achieve this. This response considers both of these options in suggesting improvements to the draft Directive.

5. However, this assumes that regulation, of the kind set out in the draft Directive is needed. The CAA agrees with the DfT that "competition is preferable to regulation" and that even where competition acts only as a weak discipline on behaviour, "regulation should only be preferred if it can deliver a clear net benefit."[2] Therefore, regulation should only be contemplated where existing safeguards (namely domestic and EU Competition Law) provide an insufficient discipline, and only then where there are clear incremental benefits to regulation that outweigh its costs. In

[1] The European Commission, Proposal for a Directive Of The European Parliament And Of The Council on airport charges, Explanatory Memorandum, 2007.
[2] Consultation on proposed designation and de-designation criteria for airports, DfT, 2007

fact, the current draft of the Directive, and accompanying documentation, does not contain an assessment of the nature and scale of the specific problems that the Commission is seeking to target or the extent to which they can or cannot be effectively remedied by existing safeguards in the form of EU or Domestic competition law.

6. Against this background, the CAA has concerns about the way in which the current Directive is targeted, its level of prescription and the scale of the overall regulatory burden that it would impose. In particular, the CAA has concerns with the following provisions of the Directive:

- *(Article 1) scope* – the proposed 1 million passenger threshold will catch 144 airports across Europe. A passenger share threshold will not necessarily bear any relation to the extent of an airport's market power and therefore the potential for it to act in an anti-competitive manner. Therefore, the CAA believes that this threshold would cast the net of regulation unnecessarily wide in most regions of Europe, and fail to focus regulatory action at airports where real problems may exist. The CAA would favour a much narrower scope that more clearly targets regulatory action where it is required. This could be better achieved by giving Member States the authority to target any regulation on the basis of a market assessment.

- *(Article 10) arbitration role for IRA* – the CAA has significant concerns with the focus of the IRA's role on dispute resolution, in particular the lack of criteria against which the regulator would make decisions and the likelihood that over time the regulator will be drawn inextricably into detailed economic regulation of airport charges. The CAA also believes that there is a risk that such a system would work to undermine the incentives for normal commercial dialogue, increasing the frequency of any airport / airline disagreements by prejudicing the incentives for parties to negotiate in good faith and could therefore introduce uncertainty that would cut across airports' investment incentives. This feature of the draft Directive sits oddly with the Commission's concern about a looming shortage of airport capacity across Europe. Were the Commission to retain this feature of the draft Directive, the CAA would favour an approach whereby, in order to submit a complaint to be adjudicated on by the IRA, an airline (or airport) would have to provide prima facie evidence that an airport has acted anti-competitively within the terms of European Competition Law;

- *(Article 5) transparency* – in no other sector of the European economy does the Commission require firms that operate under competitive conditions, or that are of such a small scale as many of the 144 qualifying airports, to set out details of the revenue and costs of each category of their charges, the productivity of their investments and the methodology by which they calculate their prices. It is not clear why airports should be treated differently. Airports in the UK have indicated that the proposed regulatory intervention could have implications for their competitive position and add a significant cost burden to

ensure compliance. It could also cut across incentives for investment and have the potential to undermine longer term deals with airlines that will provide the necessary future capacity. Depending on the eventual coverage of the Directive – and the case for greater information disclosure – it might be sufficient to require all airports captured by it to adhere to international standards for accounting transparency i.e. IFRS.

- *(Article 4) consultation* – the CAA accepts that consultation usually represents good practice and will often be required by competitive pressures. But the CAA can see no rationale for prescribing in detail a process of consultation for airports which do not possess substantial market power. The Directive should avoid imposing the same detailed requirements on all airports and all airlines regardless of the circumstances and commercial arrangements under which they operate. Rather, the Directive should be framed in sufficiently general terms that enable Member States through the IRA (or similar) to ensure a frequency and scope of consultation which fits the commercial conditions (i.e. the degree of market power) at airports in their territory, and encourages genuine interchange of views without imposing unreasonable administrative burdens.

7. If the scope of the Directive were significantly narrowed to target airports with substantial market power, the CAA would have fewer concerns about the overall scale of regulatory burden that it would impose. However, the CAA would still retain significant concerns that detailed provisions of the Directive risk cutting across airports' incentives to invest and undermining normal commercial relationships between airports and airlines. This would jeopardise the likelihood that European airports will face the correct incentives to deliver the capacity necessary to secure the best combination of price and service over time for a growing number of passengers.

8. The CAA has been working closely with Government, stakeholders from UK airports and airlines, representatives of other Member States, the European Commission and European Parliament and will continue to do so to ensure that any Directive's regulatory proposals best meet the circumstances of the aviation industry.

Section 1. Background and the rationale for the regulation of airport charges

1.1 This section sets out the role of the CAA in regulating UK airports. It then discusses the rationale for regulatory intervention (over and above domestic and EU competition law) and assesses European Commission and UK Government statements on how the decision to impose additional regulation should be made and what "good" regulation should look like. Finally, it examines some of the characteristics of airport businesses, and the European airports sector, to assess how regulatory design should match the circumstances of the sector.

The role of the CAA

1.2 The CAA is the UK's independent aviation regulator. The UK has over 20 years' experience in the economic regulation of airports. The UK system of airport regulation was established by the Airports Act 1986 (the Act). Under the Act, UK airports are subject to three levels of regulatory intervention:

- no specific economic regulation for the smallest airports;
- the requirement to hold a "permission to levy airport charges" once an airport exceeds £1 million turnover; and
- the designation of certain airports for the purposes of price control.

Permission to levy airport charges

1.3 With limited exceptions, any UK airport whose turnover has exceeded £1 million in two of the previous three years should hold a permission to levy airport charges from the CAA. The majority of these airports (i.e. those that are not "designated") face no active regulation beyond a need for some to supply the CAA with certain limited financial information.

1.4 If an airport holds a permission, it is possible for the CAA to investigate complaints of unreasonable discrimination or other forms of anti-competitive behaviour, by the airport and, where necessary, to impose conditions (or accept undertakings) to remedy such behaviour.

1.5 The CAA recently reviewed its use of these powers (under section 41 of the Airports Act) and in December 2006, following consultation, published a document setting out its policy and processes for the application of section 41 and confirming that CAA would apply section 41 in a way that was in line with the application of the Competition Act and EC competition law[3]. Consequently, an airport would normally have to be found to be dominant within a relevant market before the CAA would consider possible remedies under the Airports Act.

[3] The CAA's use of section 41 of the Airports Act 1986, The CAA's policy and processes, December 2006

The designation of airports

1.6 The CAA has a statutory responsibility, under the Airports Act 1986, to set price caps for airports that are designated by the Secretary of State. There are currently four designated airports in the UK: Heathrow, Gatwick and Stansted (part of the BAA group) and Manchester (part of the wider Manchester Airport Group).

1.7 In setting price controls at designated airports (and with all aspects of the economic regulation of airports) the CAA is given a statutory duty to perform its regulatory functions in a manner which it considers is best calculated:

- to further the reasonable interests of users of airports within the United Kingdom;
- to promote the efficient, economic and profitable operation of such airports;
- to encourage investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports; and
- to impose the minimum restrictions that are consistent with the performance by the CAA of its regulatory functions.

1.8 The CAA must also take into account the UK's international obligations, as notified to it by the Government, relevant to the imposition of charges on airlines by airports.

1.9 No airports have been newly designated since 1986 and in February 2007 the DfT announced its intention to consult on the de-designation (removal from price cap regulation) of Manchester and Stansted airports[4].

Why impose regulation of airport charges?

1.10 Regulatory intervention is generally only justified where there are clearly identifiable and persistent problems with the operation of a market. The CAA agrees with the DfT that "competition is preferable to regulation" and that even where competition acts only as a weak discipline on behaviour, "regulation should only be preferred if it can deliver a clear net benefit."[5]

1.11 This is because regulation always imposes on an industry – and its end customers – both direct costs (in terms of the costs of compliance and oversight and the diversion of management time) and indirect costs (the potential to distort normal commercial decision making and undermine innovation, investment and the development of future competition). Imposing regulation on the way charges are set is unlikely to be justified when existing tools, notably EU competition law, already exist and are effective. Economic regulation should therefore only be considered where existing competition law is not an effective tool for remedying firms' behaviour.

[4] Consultation on proposed designation and de-designation criteria for airports, DfT, 2007
[5] Ibid

Principles of Better Regulation

1.12 Both the European Commission and UK Government have made clear statements on how the decision to impose additional regulation should be made and what "good" regulation should look like.

1.13 In the UK, the Government's better regulation policy requires an assessment of any new regulatory proposals by means of a cost benefit analysis to weigh up the expected gains from regulation against the likely costs and distortions of regulatory intervention. In such assessments, the burden of proof always lies with those seeking to impose new, or retain existing, regulation. A decision to regulate will therefore only be taken where the incremental costs and distortions of regulation will be outweighed by the incremental benefits it is expected to bring.

1.14 The Legislative and Regulatory Reform Act 2006 sets out five principles which should be met by any new regulation (and those exercising regulatory functions). These are that regulatory activities should be transparent, accountable, proportionate, and consistent and should be targeted only at cases where additional regulatory action is needed.

1.15 The European Commission issued revised Impact Assessment Guidelines in June 2005 as part of their continuing commitment to delivering better regulation in line with their Action Plan to simplify the regulatory environment[6]. This set out that Impact Assessments should accompany the preparation of all major policy proposals and involve answering a number of basic analytical questions:

- What is the nature, magnitude and evolution of the problem?
- What should be the objectives pursued by the Union?
- What are the main policy options for reaching these objectives?
- What are the likely economic, social and environmental impacts of those options?
- What are the advantages and disadvantages of the main options? and
- How could future monitoring and evaluation be organised?

1.16 Philip Lowe (Director General, DG Comp) has noted that as part of the Impact Assessment process, DG Comp will "undertake more systematic competition screening of EC legislation", so that "competition is not stifled through over regulation."[7] He also noted that the EC needs more advocacy of competition approaches and market based solutions. More recently, in a speech in June 2007, Neelie Kroes (European Commissioner for Competition Policy) said in the context of regulatory interventions to address anti-competitive conduct that "we should use

[6] COM(2002) 278, Action Plan for Simplifying the Regulatory Environment
[7] Philip Lowe, Preserving and promoting competition: A European response, DG Comp Policy Newsletter No.2, Summer 2006 – *based on a speech delivered at the St Gallen Competition Law Forum, 11 May 2006*.

the full range of policy tools available to intervene – but only where markets are not functioning properly." This speech also noted that "effective intervention requires an ever deeper knowledge of how markets function and a better understanding of the underlying economics. A sounder economics base will also bring a more consistent approach…the more complex markets and anti-competitive activity become, the more closely competition policy must interact in a coherent and mutually-supportive way with its sister policies – energy, transport, telecoms…[8]"

1.17 The current draft of the Directive, and accompanying documentation (including the Ecory's Impact Assessment), lacks an assessment of the nature and scale of the specific problems that the Commission is seeking to target.

Matching regulation to the characteristics of the airport sector

1.18 Over the last 20 years the aviation industry has experienced significant change including: the liberalisation of the European Aviation Area in the 1990s; the entry and subsequent rapid growth of no-frills carriers; an increasing trend towards commercialisation, including privatisation, of European airports; and, more recently, the agreement between the EU and US to liberalise the market for transatlantic travel from 1 April 2008. In addition, the downstream market for air services has become more sophisticated, as the internet has enabled consumers to compare alternative travel options (both end-destination and airline) more effectively. In general, today's passengers experience choice of destination and service quality as well as lower prices driven by strong competition in the airline market and increasing competition amongst airports.

1.19 In good part the recent development of the European aviation industry has been assisted by the ability of airlines within the liberalised European aviation area to exploit the availability of airport capacity in different places (e.g. capital cities and the regions), with different facilities (e.g. hub airports and secondary airports) and at different prices. Any new regulatory regime for airports must therefore recognise the need for continued investment in airport capacity to meet differing demands and to facilitate the continued development of the aviation sector.

1.20 There are a number of particular features of airports, and of relationships in their supply chain, that should be taken into account in the design and implementation of an appropriate regulatory framework:

- Unlike other infrastructure businesses, such as energy and water distribution companies, airports (in general) do not possess the cost characteristics (declining average costs across all volumes of output) associated with natural monopoly businesses[9]. Airports, therefore, can and do compete and there is significant evidence of increasing competition between airports in the UK and

[8] Neelie Kroes European Commissioner for Competition Policy European Competition Policy in a changing world and globalised economy: fundamentals, new objectives and challenges ahead GCLC/College of Europe Conference on "50 years of EC Competition Law" Brussels, 5th June 2007.

[9] Airports can face increasing, not decreasing, long-run costs (potentially from quite moderate levels of output).

Europe[10]. The CAA is aware from discussions with airlines that it is now typical for them to undertake a form of tendering for their business, encouraging airports to compete actively with each other for new services. Whilst the incentives for, and ability of, airlines to switch existing services, or divert growth, to other airports will vary by carrier type (with point to point short haul carriers having the most flexibility and long-haul carriers, particularly those that rely on a high proportion of connecting traffic, the least) airports can and do compete for airline business.

- Both airports and airlines interact with the final customer – the passenger – throughout the delivery process. From departure check-in, through to passport and security checks, on-site shopping, passage through terminal space and airport or airline lounges, finally ending with arrival, passport checks and baggage collection at the destination point, the customer's experience is affected by the service received from both the airline and the airport (as well as perhaps other third parties, such as handling agents).

- The efficient delivery of air transport services depends on close daily operational interaction between airlines and airports. It is therefore important for any regulatory framework to maximise the scope for airlines to take responsibility for the costs they incur, and the services they receive from airports, just as they would for other elements of their supply chain. Regulation should not necessarily act as a commercial surrogate. Rather it should reinforce normal commercial interaction, and wherever possible avoid interrupting it.

- The concentration of airlines at airports relative to network users in other industries (the more so with the continued development of alliances and mergers) means that airlines can have a strong position of countervailing buyer power. Moreover, many secondary airports represent very small businesses when compared to some of the major European carriers that operate from them.

- The lumpy nature of significant airport capacity expansion, the long lead time associated with airport investment and the long lived nature of airport assets mean that the costs and service quality at an airport today rely, to a very significant degree, on yesterday's investment decisions. So the effect of regulation on investment incentives – including any unintended impacts – is critical.

- A significant proportion of the costs incurred by an airport do not vary with traffic volumes – once constructed the costs of terminals and runways are sunk and fixed. In addition, a significant proportion of the operating and security costs of an airport are invariant to passenger numbers. By contrast, airport revenues from both aeronautical and commercial activities (e.g. car parking and retail commissions) tend to vary more closely with passenger

[10]For regional airports see: UK regional air services', CAA, February 2005

numbers. Therefore airport profits are likely to be sensitive to small changes in traffic volumes. This sensitivity will tend to reduce the incentive faced by an airport to raise prices and / or limit supply to the market.

- The nature of airports' market conditions, both within individual Member States and across Europe, exhibit significant differences and are continually evolving. Europe's airports serve markets at different stages of maturity, in different geographic regions each with their own specific socio-economic and population characteristics, offering airlines different service quality at different prices. This suggests that, the most appropriate regulatory model for airports needs to take account of these differences while buttressing existing, and enabling future, competition *between* airport infrastructure providers, in the way the EU has sought to encourage competition in other sectors including those which were previously regarded as monopoly services.[11] In the light of this, a differentiated approach to regulation is likely to be necessary to ensure that regulation is properly targeted at real problems.

1.21 These factors, and the bearing they have on the ability of airports in general, and small secondary airports in particular, to exercise market power should impact the extent to which regulatory protection is needed in the first place. They also provide opportunities for the regulatory system to leverage any countervailing power that may exist and thereby maximise the extent to which more optimal commercial outcomes can be secured without unnecessary (and costly) regulatory intervention, the cost of which will ultimately be borne by passengers. The importance of long-term investment to further capacity and service provision also cautions against regulatory interventions which may introduce unnecessary uncertainty or distortions to commercial decision making.

Principles emerging from analysis

1.22 From the discussion of European Commission and UK Government principles of "good" regulation above, and what the CAA has learnt through its economic regulation and its considering of the characteristics of the aviation market, we can identify a clear process for how any decision to implement new regulation should be reached:

- identify the actual problem(s) and show clear evidence of where they arise;
- quantify the scale of the problem(s);
- establish whether competition law can deal with all or most of the problem(s) or whether additional regulatory intervention should be considered; and then
- assess whether the incremental benefits of regulatory intervention (over and above competition law) will clearly out-weigh both its direct and indirect costs.

[11] For example the liberalisation Directives for the European Energy and Electronic Communications markets.

1.23 The decision to impose any new regulation should only be taken once each of these steps has been followed[12]. Any regulatory action should then seek to secure the best available outcome in terms of price and service quality for end users over time.

Conclusion

1.24 Good regulation means ensuring that regulatory frameworks and processes fit the circumstances of the industry being regulated.

1.25 Regulation is associated with costs and potential distortions to commercial decision-making and future competition. Regulation should therefore only be contemplated where existing safeguards (e.g. domestic and EU competition law) provide insufficient discipline and where there are clear incremental benefits to regulation that outweigh its costs.

1.26 This is likely to require a differentiation of approach to regulation in view of the different market positions of airports across the UK and wider European Union, in order to ensure that regulation is targeted on real problems, is designed to secure the best available outcome in terms of price and service quality for end users over time, and has sufficient flexibility to enable the continued development of airport competition – falling away when airports operate under competitive market conditions.

1.27 The next section of this response sets out the CAA's view on the draft Directive in the light of the principles and approach set out in this section.

[12] The DfT's recently published "*Decision on proposed designation and de-designation criteria for airports*" criteria embody these steps – DfT , 2007.

Section 2. CAA assessment of the Commission's draft Directive

Introduction

2.1 This section considers the articles of the Commission's proposal in the order set out in the DfT's consultation document, addressing in turn the consultation questions raised by Government. It assesses the key provisions of the draft Directive against the principles and objectives for good regulation and the aviation industry context identified in section 1.

2.2 The CAA supports the stated aim of the draft Directive, to ensure that the entire aviation supply chain is as competitive as possible. This overarching aim, for a well functioning market, will provide the right incentives for airport operators to bring forward necessary investment in new airport capacity, and most importantly deliver service quality for passengers and freight shippers (end consumers) at a reasonable price over time. However, the CAA is concerned that as currently drafted, the Directive will not achieve this and could hinder development of the aviation sector.

CAA Assessment of the Commission's proposed draft Directive

Article 1 (Scope)

Question 1: Do you think that a passenger share threshold is an effective way to establish which airports should fall within the scope of the Directive? If so, is the proposed 1 million passenger threshold appropriate?

Question 2: Can you suggest any alternative ways to establish which airports in a Member State should be subject to the measures proposed in the Directive?

CAA response

Regulatory action is only likely to be justified where it is clearly targeted. The proposed 1 million passenger threshold would cast the net of regulation unnecessarily wide in most regions of Europe, and fail to target regulatory action where real problems exist.

The CAA would favour a Directive with a much narrower scope that more clearly targets regulatory action at airports with substantial market power on the basis of a market assessment.

CAA assessment

2.3 The Commission has stated that it wants to ensure that the entire aviation supply chain is as competitive as possible. The CAA supports this overarching aim that would be of benefit to airports, airlines, and most importantly passengers. But the

CAA is concerned that the current draft Directive in making use of an airport size threshold will unfairly single out the aviation sector for special treatment by requiring regulation even where airports operate in competitive market conditions – a position where regulation is seen as unnecessary for the rest of the European economy. The proposed 1 million passenger threshold will catch 144 airports across Europe. Yet such a threshold has no link to the diversity of market conditions that will be faced by such a large group of airports. Stakeholders from both UK airports and airlines have raised concerns that such a threshold is an inappropriate way to target the Directive. Such diverse market conditions are likely to require differentiated regulatory approaches.

2.4 Airport size is not necessarily related to its market power. As such, the current proposal raises the prospect that the same regulatory framework, and common tools, for remedying abusive behaviour will be applied to smaller airports, e.g. Dortmund (1.7 m), Verona (2.6 m), and Liverpool (4.9 m), as to very large airports with over 50 million passengers e.g. Frankfurt (52.2 m), Charles de Gaulle (53.7 m), and Heathrow (67m). This is likely to result in the disproportionate and unfair regulation of many smaller airports which do not posses market power. Such an approach risks imposing unnecessary costs on airlines and passengers for no consequent benefits, which in tandem with the other provisions could undermine investment incentives, the development of airport competition and normal commercial relationships.

2.5 As discussed in section 1, the principles of good regulation require a clear identification of the nature and scale of the problem to be addressed before developing a regulatory solution. The draft Directive and accompanying documentation lacks an assessment of the nature of any specific problems or the extent to which they can or cannot be effectively remedied by existing EU competition law.

2.6 In the UK, the Government has recently set out criteria for determining which airports should be subject to price control regulation[13]. In summary, price control regulation applies where:

- an airport (or group of airports) possesses substantial market power such that it would have the ability to raise prices above competitive level and /or withhold capacity to reduce service quality below competitive levels; and
- EU (and domestic) competition law will provide an insufficient tool to remedy abuse of anticompetitive behaviour by airports; and
- the incremental net benefits of regulation can be shown to outweigh its costs.

2.7 Against this background the CAA would favour a much narrower scope that more clearly targets regulatory action where it is required. This could be better achieved

[13] Consultation on proposed designation and de-designation criteria for airports, DfT, 2007

by giving Member States the authority to target any regulation on the basis of a market assessment.

2.8 There is no reason to believe that Member States – or their regulatory authorities – would not have the competency to assess market power. All Member States are required to assess dominance when undertaking competition analysis in relation to concentrations that affect inter-state trade[14]. Moreover, all Member States are required to assess the market power of network providers in their Electronic Communications sector under the 2002 EC Electronic Communications Directive. An equivalent assessment (taking account of competition law and potential regulatory costs) for airports, could be carried out within agreed guidelines, and could be subject to peer review and/or other scrutiny by the Commission.

2.9 The CAA is aware of an alternative proposal from ACI Europe that would target the Directive at those airports with a 1% or greater share of European passengers. This proposal has significant advantages over the current 1 million passenger threshold as market shares can be indicative of market power. However, it is widely acknowledged that market shares *alone* are not always a reliable guide to market power. Indeed, a 1% European passenger share threshold would catch two UK airports – Manchester and Stansted – on which the DfT intends to consult about the need for continued regulation[15].

2.10 The CAA would therefore argue that any market share threshold would need to be complemented by an enabling provision for Member States to exempt an individual airport above the threshold on the basis of a market assessment.

2.11 The CAA would be happy to work with the DfT and the European Commission to set out the relevant factors that any market assessment would need to take into account. The CAA recognises that such a test would require some effort by Member States. However, we believe that this would lead to a more proportionate and targeted Directive and Member States should already have the necessary systems and expertise in place to undertake such assessments. Such an approach would also encourage a greater focus on the real competition issues faced at European airports.

Article 4 (Consultation process)

Question 3: Do you agree with the requirement for a mandatory process of consultation between the airport management and airport users, at all qualifying airports?

Question 4: Do you think the proposed timescale for agreeing changes to charges would work in practice?

[14]The European Court has defined a dominant market position as: "a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of consumers". Case 27/76 United Brands v Commission [1978] ECR 207, [1978]1 CMLR 429.
[15] "Decision on proposed designation and de-designation criteria for airports" DfT , 2007

CAA response

The CAA can see no rationale for prescribing in detail a process of consultation for airports which do not posses substantial market power. The CAA accepts that consultation usually represents good practice and one which competitive pressures will often require. But the Directive should avoid imposing the same detailed requirements on all airports and all airlines regardless of the circumstances and commercial arrangements under which they operate.

Rather, the Directive should be framed in sufficiently general terms that enable Member States through the IRA (or similar)[16] to ensure a frequency and scope of consultation which fits the commercial conditions at airports in their territory, and encourages genuine interchange of views without imposing unreasonable administrative burdens.

CAA assessment

2.12 The CAA supports the principle that dialogue and consultation between commercial parties in a supply chain usually represents good practice. However, the CAA can see no rationale for prescribing in any detail a process of consultation for airports which do not possess substantial market power. Airlines and passengers are, at least to some degree, able to respond where airports do not offer what they want. Many airlines, in particular for intra EU traffic which constitutes the greatest proportion of passenger movements, need not restrict their operations to any airport or catchment area. We would therefore favour removing the requirement, as currently drafted, from the Directive.

2.13 If the current provision on consultation were to remain in the Directive, the CAA considers that the large number of qualifying airports poses significant risks of an unworkable process, given the 144 airports across the Europe that would be caught by the Directive. As the DfT's stakeholder symposium revealed, a number of airlines feel that the cost of participating in all consultations relevant to their route networks would be prohibitive, diverting resources from running the airline business[17]. Airlines have also raised concerns about the timescale for agreeing airport charges as certain carrier types (e.g. Charter carriers) sell significant volumes of tickets a traffic season or more in advance. Two months notice is therefore insufficient. This suggests that the provision has not fully taken into account the needs of different carrier types.

2.14 The CAA also questions the need for annual consultations. It is not clear from the Commission's draft proposal why this frequency has been adopted. It is important that the Directive reflects current commercial practices. For example, many airports and airlines have entered into long-term contracts on airport charges to both parties' mutual benefit given the greater degree of certainty they provide for

[16] see para 2.18 for further details.
[17] Many airlines operate from a large number of European airports that would be caught by the Directive with the result that they would need to participate in 50 – 80 consultations a year.

both airlines' business planning and airports' investment plans. It would seem inappropriate, therefore, to require annual consultation on charges where long-term contracts have already been agreed – such a provision risks cutting across a positive market development.

2.15 Where airports possess substantial market power (at a level that may justify additional regulation), any regulatory intervention should recognise the potential for the commercial relationships between airports and airlines to be harnessed to facilitate regulatory decisions. As part of the current price control reviews for the designated UK airports the CAA has introduced a new approach, termed constructive engagement, designed to delegate elements of the review to be taken forward through negotiation between airports and airlines – within a clear regulatory context – so that outcomes more fully reflect users' needs.

2.16 So while the CAA accepts the merits of consultation in principle, it is concerned by the imposition of the same detailed requirements on all airports and all airlines regardless of their circumstances and commercial arrangements. Instead, the diverse market conditions call for differentiated regulatory approaches. The Directive should, therefore, be framed in sufficiently general terms so that in implementing it Member States through the IRA will be able to ensure a frequency and scope of consultation which fits the commercial conditions at airports in their territory, and encourages genuine interchange of views without imposing unreasonable administrative burdens, all within the narrower scope proposed in para 2.7 above. For example, some form of consultation is likely to be required whenever there is a significant change in the structure of airport charges for those airports where the market assessment suggests the need for regulation. On the other hand, airports operating in competitive markets should not generally face a mandatory requirement to consult on changes to their airport charges. However, there may be merit in providing for the IRA to have the discretion to impose on such airports the requirement to consult where the appellant provides evidence that such an airport has acted abusively within the meaning of European Competition Law, and where this is upheld following regulatory scrutiny.

Article 10 (Independent Regulatory Authority, dispute resolution and arbitration)

Question 5: Would you be content for the CAA to take on the role of IRA in the UK? If not do you have any alternative suggestions?

Question 6: Do you think that arbitration by an IRA would be an effective method of resolving disagreements between airports and airlines for all or any of the directives provisions?

Question 7: How do you think this would work in practice if, for example, an airport proposed a change of x and the airport users preferred x-5? In practice, would the IRA need to follow a process similar to a price cap review?

Question 8: Are you content that the IRA's decisions in matters of arbitration would have binding effect?

CAA response

The CAA notes the benefits of independent regulatory bodies and acknowledges that it would be well placed to take on such a role. However, the CAA has significant concerns that as drafted article 10 would be costly and could cut across incentives for investment, and undermine normal commercial dialogue between airlines and airports, by establishing an automatic right for airlines or the airport to call on the regulator where disagreement occurs. The CAA also has concerns that the Directive establishes no criteria for settling disputes and that over time the regulator will be drawn inextricably into detailed economic regulation of airport charges.

The CAA would favour an approach whereby, in order to submit a complaint to be adjudicated on by the IRA, an airline (or other airport) would have to provide prima facie evidence that an airport had acted anti-competitively within the terms of European Competition Law.

CAA assessment

2.17 The CAA notes the benefits of independent regulatory bodies (independent from Government as well as air carriers and airport owners / managing bodies). In particular, independence has the benefit of avoiding short-term political control of critical decisions on pricing and investment, so providing greater certainty and consistency of regulatory decisions. This is important for attracting investment capital to regulated sectors; the more stable the regulatory environment, the lower investors' perceptions of risk and the associated cost of capital and the cheaper and easier it is for regulated utilities to bring forward investment. Stability is also important in attracting potential new entrants into the industry.

2.18 The CAA has been the UK's independent economic regulator for airports for over 20 years so it would be well placed to take on any new role in addition to its existing duties. However, whilst the establishment of an independent regulatory authority may make sense in many larger Member States, for other members the small scale of their aviation sector may argue for such functions to be dealt with by existing National Competition Authorities (minimising any cost and resource duplication).

2.19 As discussed in section 1, the efficient delivery of air transport services depends on close daily operational interaction between airlines and airports. It is therefore important for any regulatory framework to maximise the scope for airlines to take responsibility for the costs they incur, and the services they receive from airports, just as they would for other elements of their supply chain. Any regulatory framework should not seek to act as a commercial surrogate. Rather, wherever possible it should reinforce – rather than interrupt – normal commercial interaction.

2.20 The CAA has significant concerns that, as drafted, article 10 could work to undermine the incentives for normal commercial dialogue between airlines and airports by establishing an automatic right for airlines or the airport to call on the regulator where disagreement occurs. The CAA believes that there is a risk that such a system could prejudice the incentives for parties to negotiate in good faith and in the worst case serve to magnify the extent of any airport / airline disagreements by providing incentives for one or more of the parties to adopt extreme negotiating positions in the hope of ultimately influencing the regulator to favour them.

2.21 These concerns were echoed in a recent report by the Australian Government Productivity Commission (April 2007). This argued against introducing arbitration between airlines and airports on grounds that it would undermine incentives for commercial negotiations. The report stated, "it seems likely that arbitration would come to be viewed by airlines as the default option."[18]

2.22 As posed by the example in question 7, the CAA has concerns that were an IRA to be faced with a disagreement on charges with the airport calling for a charge of x and airlines seeking x-5 the Directive's requirement for the IRA to "examine the justifications for the modification of the level of airports charges" could in effect require the IRA to conclude on the appropriate level of charges and so in effect set them. From its own experience, the CAA knows that to set an airport charge is a complex and costly undertaking which has the potential to result in a range of unintended consequences for investment decisions and competition between airports.

2.23 As drafted, while the Directive requires the IRA to "examine the justification for" airport charges and service quality in order to "reach a binding decision" it does not set out the basis (or criteria) on which such judgements are to be made. It is difficult to understand, therefore, on what basis IRAs are meant to reach decisions, the timescale for such decisions is also likely to be insufficient for them to do the job properly. In the UK, decisions of the CAA are subject to judicial review by the High Court. This will have implications for the nature of the decision making processes and weight of evidence that the CAA would need to take into account when acting in the role of as a dispute resolution body required to reach a binding decision on the "justification for the level" of airport charges.

2.24 The CAA therefore believes that the concept of dispute resolution is flawed. In practice, it will be costly, and over time will effectively become economic regulation. The omission of clear criteria for decision making by multiple regulatory bodies is a serious weakness with practical implications for the development of airport capacity.

2.25 There is a particular and important concern about the impact of "dispute resolution" for airports' incentive to invest. As set out under para 1.20, airport investment

[18] http://www.pc.gov.au/inquiry/airportservices/finalreport/index.html (see section 4.5 - Why airport specific arbitration os not warranted).

tends to be lumpy and long-lived. This puts a premium on the certainty and predictability of any regulatory process whereas what is proposed would entail regulatory intervention at the behest of individual parties that could cut across the commercial basis of investment already undertaken. This risk is heightened in the absence of clear criteria for regulatory decision making. This feature of the draft Directive sits oddly with the Commission's concern about a looming shortage of airport capacity across Europe.

2.26 The CAA would therefore favour an approach whereby, in order to submit a complaint to be adjudicated on by the IRA, an airline (or airport) would have to provide prima facie evidence that an airport had acted anti-competitively within the terms of European Competition Law. The CAA believes that these criteria should also be based on those established by European Competition Law under Article 82.

Article 5 (Transparency)

Question 9: Do you believe that these transparency requirements are required at all airports with over 1 million passengers per annum? What costs and benefits would ensue?

Question 10: Will the transparency requirements affect your normal commercial relationships? Addressed to airlines and airports. But also see comments below.

Question 11: How do the proposals compare with the current arrangements at UK and other Member State airports?

CAA response

In no other sector of the European economy does the Commission require firms operating in competitive conditions, or as small as many of the 144 qualifying airports, to set out details of the revenue and costs of each category of their charges, the productivity of their investments and the methodology by which they calculate their prices.

The CAA believes that the individual elements covered in Article(5) need to be scrutinised to ensure that requiring such transparency would not inhibit current or potential competition, or cut across investment incentives.

Depending on the eventual coverage of the Directive, it might be sufficient to require airports captured by it to adhere to international standards for accounting transparency i.e. IFRS.

CAA assessment

2.27 In no other sector of the European economy does the Commission require firms that operating under competitive conditions, or that are of such as small scale as many of the 144 qualifying airports, to set out details of the revenue and costs of

each category of their charges, the productivity of their investments and the methodology by which they calculate their prices. It is not clear why airports should be treated differently. Airports in the UK have indicated that the proposed regulatory intervention would have implications for their competitive position and would add significantly to compliance costs.

2.28 The CAA understands that for airports listed on their national stock exchanges, such information could not be released only to airlines but would need to be made publicly available, meaning that for some airports detailed cost and revenue data would be freely available to their main competitors. This is not a normal situation in competitive markets and the CAA has concerns that it would undermine airport to airport competition where it already exists and stifle its future development. It could also cut across incentives for investment and have the potential to undermine longer-term deals.

2.29 This provision also extends to airlines, prescribing a set of information that they must provide to airports, which may appeal to the IRA where such information is not forthcoming. This requirement, when seen alongside Article(10) on dispute resolution, increases the risk of the Directive undermining normal commercial relationships.

2.30 The CAA believes that the individual elements covered in Article(5) need to be scrutinised with great care to ensure that in each case requiring transparency would not inhibit current or potential competition. As a starting point for consideration, it might be sufficient to require all airports to adhere to international standards for accounting transparency i.e. IFRS. IRAs could also be provided with the discretion to require additional financial reporting (to the IRA) as a sanction in the event that an airport has been found to have acted anti-competitively.

Article 7 (Quality Standards)

Question 12: Do you think that compulsory service level agreements are needed to guarantee quality standards effectively? How should any trade-off between higher standards and the cost of quality improvements be taken into account?

Question 13: Do you have any other ideas how quality standards could be maintained between airports and airlines?

CAA response

The CAA does not believe that compulsory service level agreements are justifiable for airports operating in competitive conditions

The CAA would favour an approach whereby the Directive provided discretion for the IRA to require an airport to consult on service quality in order to protect users' interests where there is evidence that the airport in question has acted anti-competitively within the meaning of Article 82

CAA assessment

2.31 The CAA does not believe that compulsory service level agreements (SLAs) are justifiable for airports operating in competitive conditions. For such airports, the need to attract and retain airlines and passengers will provide a strong incentive to take account of their reasonable interests. In such circumstances, compulsory SLAs would only serve to add unnecessary costs and regulatory burdens on to airports (and airlines) for no additional benefits. In addition, compulsory SLAs are inevitably a blunt and inflexible tool that could present a barrier to innovation and competition between airports and between airlines.

2.32 As discussed in section 1, the specific features of the airport industry should be taken into account in any regulatory design. With respect to service quality, the long-lived nature of airport infrastructure means today's service quality is in large part determined by investment undertaken up to 20+ years ago. Given the dynamic nature of the airline industry and continually evolving airline business models, airports are unlikely to be able to satisfy the service quality requirements of all carrier types either today or in the future. Therefore, the requirement that airports and airlines are able to call on the regulator where there are service quality disagreements raises major concerns for the CAA. First, the diversity of airlines' service quality demands is likely to result in a significant volume of appeals to the regulator at significant cost to industry. Second, it is not self evident that the regulator would be better placed to judge appropriate levels of service quality than an airport operating under competitive conditions seeking to retain and to attract business. Furthermore, IRA examination of service levels would inevitably entail examination of associated costs, as well as operational and investment issues – which further underlines the way the Directive exposes the airport to uncertainty associated with future regulatory treatment of investment.

2.33 This article is also likely to place unmanageable costs and burdens on airlines. By requiring SLAs to be discussed at 144 airports at least every two years (in combination with charges consultations at 144 airports annually) airlines would face a position where the airports they use are continually consulting on charges and service quality even where long-term contracts exist. The CAA is doubtful whether airlines would have the capability to devote appropriate resources effectively to engage with such a large and continuous burden of consultation.

2.34 In a competitive market service levels should form part of the commercial interaction between parties. However, where airports possess substantial levels of market power, SLAs may be more appropriate. The CAA has for example implemented a formal scheme of service standards and rebates at Heathrow and Gatwick, and there is a less formalised approach at Manchester. These are intended to discourage some of the adverse behaviours that might otherwise occur if price is regulated but service quality is not.

2.35 The CAA would therefore favour an approach whereby the Directive provided discretion for the IRA to require an airport to consult on service quality in order to protect users' interests where regulation appeared necessary (with reference to a

market assessment) or where there was evidence that the airport in question had acted anti-competitively within the meaning of Article 82[19].

Articles 8 and 3 (Differentiation of charges and non-discrimination)

Question 14: Do you agree that airports should be able to differentiate charges based on the quality of service offered? Will the proposals affect any charging policies you currently have?

Question 15: In your view, will the provisions ensure that airlines get fair access to the terminals they want to use if demand for a particular facility exceeds capacity?

Question 16: We would be grateful to receive from airlines in writing any examples where they consider that they have been treated unfairly at Member State airports with respect to airport charges?

CAA response

The CAA recognises non-discrimination on grounds of nationality as a principle consistent with ICAO guidelines.

The CAA believes that it would be sufficient for the Directive (and provide greater clarity) to refer to compatibility with the Treaty of Rome (or to import the wording of the relevant Treaty articles).

CAA assessment

2.36 These questions are best addressed by airlines and airports. The CAA will be interested to see their responses.

2.37 The CAA recognises non-discrimination as a principle consistent with ICAO guidelines. A provision in the Directive is not strictly necessary as the non-discrimination provision on the grounds of nationality, and competition rules set out in the Treaty of Rome always apply. Attempting to be more specific would be fraught with potential problems, and the CAA believes that it would be sufficient for the Directive to refer to compatibility with the Treaty (or to import the wording of the relevant Treaty articles).

2.38 In order to provide clarity and avoid scope for further confusion the CAA would favour the amendment of these two articles to reflect the wording of relevant articles of the Treaty of Rome.

Article 9 (Security Charges)

[19] i.e. it had profitably sustained prices above the competitive level or had restricted output or service quality below the competitive level.

Question 17: Do you think that it is reasonable for security charges to meet security costs exclusively?

2.39 In the CAA's view, the structure of airport charges should be left as far as possible to commercial discussions between airports and airlines. Airports should be free to introduce charges for specific purposes subject to compliance with Competition Law and International agreements.

General

Question 18: Do you think the Commission's proposals to regulate airport charges are targeted at, and proportionate to, the problems it has identified?

2.40 In section 1 the CAA set out the following set of objectives, based on those published by the European Commission and the UK Government, for how any new regulation should be defined:

- identify the actual problem(s) and show clear evidence of where they arise;
- quantify the scale of the problem;
- establish whether competition law can deal with all or most of the problem(s) or whether additional regulatory intervention should be considered; then
- assess whether the incremental benefits of regulatory intervention (over and above competition law) will clearly out-weigh both its direct and indirect costs.

2.41 Any decision to impose any new regulation should only be taken once each of these steps has been followed. The CAA is concerned that, to date, the Commission has identified only *perceived* problems with the way that airport charges are set across Member States. It does not appear to have assessed how far there are real problems for airlines or the extent to which existing EU competition law could be used effectively to remedy them.

Question 19: Are there any other issues in connection with the airport charges which you think need to be addressed within the scope of the Directive?

2.42 The CAA has included its broader observations on the Commission's draft proposal within its responses to the questions above.