

Economic regulation at Gatwick from April 2014: Notice granting the licence



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Executive Summary

1. This document gives notice under sections 15(5) and (7) of the Civil Aviation Act 2012 (the Act) that the CAA is granting a licence to Gatwick Airport Limited (the Licensee or GAL) in relation to the core area of London Gatwick Airport (Gatwick). The CAA is issuing this notice pursuant to its powers and duties in the Act. This notice sets out the conditions included in the licence and the CAA's reasons for including those conditions.

GAL's licence

2. The licence consists of the following parts:
 - Part A: Scope and Interpretation. This part of the licence provides details of the airport, the airport operator, and the airport area for which the licence is granted. It also specifies the date on which the licence comes into force, as well as clarifying points of interpretation in the licence.
 - Part B: General Conditions (Payment of fees and licence revocation). This part of the licence requires GAL to pay to the CAA any charges that are set under a scheme made under section 11 of the Civil Aviation Act 1982 (the 1982 Act). It also sets out the circumstances under which the licence may be revoked.
 - Part C: The Commitments Conditions. These conditions make GAL's commitments part of the licence, allow the CAA to enforce GAL's commitments in passengers' interests, restrict GAL's ability to modify the commitments and places restrictions on the passthrough of second runway costs in the absence of a licence amendment.
 - Part D: Financial Conditions. This part of the licence sets out requirements for the certificate of adequate resources, restrictions on business activities, ultimate holding company undertakings and the banking ringfence.

The monitoring regime for GAL

3. The monitoring regime around the commitments will involve the following tasks.
 - Monitor the blended price actually charged under the various contracts to identify whether it is consistent with the CAA's view of a fair price of retail price index (RPI)-1.6% per year rather than GAL's commitment of RPI+0%.
 - Monitor service quality performance and undertake an investigation if GAL fails an individual metric for more than six months.
 - Require GAL to undertake a shadow regulatory asset base (RAB) calculation in case tighter regulation needs to be reintroduced (although there would be no presumption that the shadow RAB number would be used as the basis for a future price cap).
 - Undertake a review of the commitments and contracts framework in the second half of 2016 to identify whether as a whole they are operating in passengers' interests, including a request for stakeholders' views.
4. If the CAA identifies concerns during its monitoring, under the licence the CAA can undertake an investigation and undertake enforcement action or introduce additional licence conditions, as appropriate.

Delivering the CAA's statutory duties

5. The CAA considers this licence is best calculated to further its relevant statutory duties, which are found in the Act. The CAA's primary duty is to further the interests of users (passengers and owners of air freight) regarding the range, availability, continuity, cost and quality of airport operation services; where appropriate, by promoting competition. There is also a range of regulatory objectives and principles to which the CAA must have regard, including the need to be transparent, accountable, proportionate and consistent and to target only those cases where action is needed. The CAA also has a duty not to impose or maintain unnecessary burdens.

6. In assessing users' interests, the CAA has taken account of airlines' views (among others), recognising that airlines' interests often align with those of users. However, this is not always the case, and the CAA has also reviewed a wide range of direct research about users' views and preferences. The CAA has been advised by its Consumer Panel.
7. In assessing users' interests, the CAA must balance the interests of present users in lower airport charges with the interests of future users in GAL's ability to continue to be able to invest in modern infrastructure and services in a timely manner. (Of course, present and future users will often be the same people.) Under section 1(5) of the Act, if there is a conflict between the interests of different classes of users or between their interests in the various different parameters set out in section 1(1) of the Act, the CAA is directed to carry out its functions in a way that will further such interests as it thinks best.
8. The CAA considers that this licence, which incorporates GAL's commitments, together with a monitoring regime, is the most appropriate and proportionate way to further its duties, particularly the primary duty to users, for several reasons.
 - While the price in the commitments is higher than the CAA's view of a fair price, the CAA's monitoring and the threat of additional licence conditions create incentives for GAL to moderate price increases and deliver growth at the airport and further the interests of passengers.
 - Embedding the commitments within a licence provides a timely and effective backstop protection for users in the form of a licence enforcement regime, for instance if there are reductions in service quality or price increases that are against users' interests.
 - Licence-backed commitments will provide a better framework to diversify the service offering and to incentivise volume growth. This is because the commitments encourage bilateral contracts which can allow service quality, capital investments, operational practice, volume commitments and price to be better tailored on an integrated basis to the needs of individual airlines and their passengers. RAB-based regulation allows for bilateral contracts only on a limited basis, and cannot provide the same degree of tailoring.

- Licence-backed commitments should promote competition by facilitating innovation and diversity of the services offered. These are important, although not sufficient in themselves, for effective competition between airports. Although existing and future capacity limits reduce competition between London airports, it is nevertheless an expansion of choice for at least some users if airports are enabled to diversify their service offerings.
- Licence-backed commitments will encourage GAL to improve its efficiency as the airport operator can retain savings during the commitment period. The longer time period of the commitments should provide GAL with greater incentives to reduce operating expenditure and outperform commercial revenue assumptions.
- Licence-backed commitments will facilitate efficient investment as GAL will have flexibility to tailor its investment to the needs of airlines, while the licence will provide users with timely and effective backstop protection to ensure that investment is undertaken in users' interests.
- A specific licence condition has been inserted which requires the licence to be amended before the main costs of a second runway can be passed through to users. This will ensure that the development of any second runway is undertaken in a manner that furthers users' interests in the cost and quality of airport operation services (amongst other interests) and promotes competition in airport operation services.
- Licence-backed commitments will prospectively ensure that an efficient GAL has adequate financial resources and can finance its provision of airport operation services. The CAA has checked GAL's potential financial ratings and assumed that GAL would not have proposed commitments that it could not finance.
- Licence-backed commitments will provide protection on operational resilience, by allowing the CAA to undertake licence enforcement action if there are problems with operational resilience.
- Licence-backed commitments will provide protection on financial resilience through commitments and licence obligations.

9. The CAA considers that its final views are consistent with the better regulation principles, to which the CAA has a statutory duty to have regard. The licence obligations have been introduced in a proportionate manner, where they are necessary and the monitoring regime should ensure transparency, consistency and accountability.

Next steps

10. There are a number of steps before GAL's licence comes into force on 1 April 2014.
- 13 February 2014: publication of this notice and a copy of the licence under section 15(5) of the Act. The licence will come into force on 1 April 2014.
 - GAL and any provider of air transport services whose interests are materially affected by the CAA's decision has six weeks from the date of this notice to apply to the Competition Commission (CC) / Competition and Markets Authority (CMA)¹ for permission to appeal the CAA's decision. Applications are subject to the procedural requirements of Schedule 2 of the Act and the Airport Licence Condition Appeal Rules recently published by the CC. To assist in this process, the CAA would ask any applicant to submit an electronic version of its application to the CAA (in pdf format) at airportregulation@caa.co.uk.
 - 1 April 2014: the licence and, in the absence of a relevant appeal, the Q6 price control will come into force. If permission to appeal is sought and the applicant also applies, within six weeks of the date of this notice, for the suspension of one or more licence condition(s), those conditions will not take effect during the 10 week period after this notice. The CMA must determine the early application for suspension within that 10 week period.² That early procedure does not prevent the appellant making an application

¹ The CMA will take over the functions of the CC along with the competition and certain consumer functions of the Office of Fair Trading (OFT). The CMA is currently in operation as a shadow body but will take over any existing CC casework when it becomes fully operational on 1 April 2014.

² Section 10 of Schedule 2 to the Act.

for suspension at any other time before the determination of the appeal.

- April 2014: The CC/CMA has ten weeks from the date of this notice (not from the receipt of a stakeholder's decision to seek permission to appeal) to decide whether to give that stakeholder leave to appeal. The CC/CMA has 24 weeks (again, from the date of this notice) to determine the appeal. The CC/CMA may grant itself an 8-week extension to this deadline or an indefinite extension to this deadline if there is a relevant appeal to the Competition Appeal Tribunal (CAT) on the market power determination.

CAA

13 February 2014

CHAPTER 1

Introduction

- 1.1 This introduction sets out:
- the notice which the CAA is publishing under section 15 of the Act;
 - the steps before the licence comes into force;
 - the process that has shaped the CAA's licence conditions;
 - the statutory context to this process;
 - GAL's commitments proposals; and
 - the structure of the remainder of this notice.

Notice under section 15 of the Act

- 1.2 This document gives notice under sections 15(5) and (7) of the Act that the CAA is granting a licence to GAL in relation to the core area of London Gatwick Airport (Gatwick). The CAA is making this notice pursuant to its powers and duties in the Act. The majority of the provisions in Part 1 of the Act came into force on 6 April 2013 and replaced the framework for airport economic regulation under the Airports Act 1986 (AA86) that has governed all previous quinquennial reviews.
- 1.3 The airport area for which the licence is granted is located at Gatwick and comprises of:
- the land, buildings and other structures used for the purposes of the landing, taking off, manoeuvring, parking and servicing of aircraft excluding the aircraft maintenance facilities known as Hangar 6 Maintenance Area 1 and Hangar 7 Maintenance Area 2; and
 - the passenger terminals.
- 1.4 This notice sets out the conditions included in the licence and the CAA's reasons for including those conditions. The licence will come

into force on 1 April 2014.

- 1.5 On 10 January 2014, the CAA published a consultation notice under sections 15(1) and (3) on its proposal to grant a licence (the proposed licence).³ The CAA received five representations.⁴ This notice sets out how the CAA has taken account of those representations and gives reasons for any differences between the proposed licence conditions and the conditions set out in this notice. In accordance with section 15(6), the CAA does not consider any of these differences to be significant.
- 1.6 Prior to the consultation on the proposed licence, the CAA had already consulted on five separate occasions on the proposed licence conditions and the supporting analysis in its initial proposals in April 2013, in a letter to stakeholders in May 2013, in a consultation on a licence condition incorporating the commitments into a licence in July 2013, on its final proposals in October 2013⁵ and on specific amendments on licence conditions also in October 2013. The CAA has taken into account representations from all stakeholders in those consultations in developing the licence conditions specified in this notice. During this process stakeholders have provided extensive responses to the individual RAB-based calculations and the CAA's price control policies. While new information may always come to light on these issues, for example as outturns become available or forecasts are updated, the CAA is mindful that this could create a never ending process. The CAA was also clear in its initial and final proposals and with stakeholders individually that this notice would constitute the CAA's final decision on economic regulation and the licence conditions.
- 1.7 Alongside the proposed licence, on 10 January the CAA also published its market power determination (MPD) in relation to Gatwick.⁶ Under the MPD the CAA concluded that the market power test (MPT) was met by GAL in relation to the core area of Gatwick and

³ The notice of the proposed licence can be found at: <http://www.caa.co.uk/cap1139>

⁴ GAL, the Gatwick Airlines Consultative Committee (ACC), British Airways, easyJet and Virgin Atlantic Airways.

⁵ All consultations, responses and associated documentation can be found on the CAA website at: <http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15152>

⁶ This determination can be found at: <http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=12275>

so GAL would require a licence.

- 1.8 The CAA also carried out an operator determination⁷ on 10 January 2014 pursuant to section 10 of the Act that GAL is not the operator of the aircraft maintenance facilities as it does not have overall responsibility for the management of these facilities in respect of the type, cost and quality of the services provided or access to or development of those facilities. These facilities are therefore not included in the airport area in the licence. The CAA has also not included the cargo processing areas in the airport area in the licence as the CAA has not determined that the MPT was met by GAL in relation to cargo in these areas.
- 1.9 This notice sets out the CAA's reasons for the licence conditions. In coming to its decision on the licence conditions the CAA has taken into account the views of stakeholders based on their submissions to the CAA. The CAA has endeavoured to check the accuracy of all these attributed statements. Should any stakeholder consider that the attributed statement does not reflect their previous submissions to the CAA, it is open to the stakeholder to raise this with the CAA.
- 1.10 References in this notice to 'the airlines' mean views submitted to the CAA by the representative body for airlines for the purposes of Constructive Engagement (CE). In the case of Gatwick, it means the Airline Consultative Committee (ACC). The CAA acknowledges that the views of individual airlines may differ on particular issues.
- 1.11 This is a redacted version of the CAA's notice. Some information has been removed at the request of GAL and the airlines on the basis that it is commercially confidential. Redactions are clearly marked. In accepting redactions for the purposes of this notice, the CAA reserves its right to revisit its position for subsequent publications.
- 1.12 The price base used in this notice is 2011/12 prices unless otherwise stated.

⁷ This determination can be found at:
<http://www.caa.co.uk/application.aspx?catid=33&pagetype=65&appid=11&mode=detail&id=5913>

Next steps

- 1.13 There are a number of steps to the implementation of the Q6 price control on 1 April 2014.
- 13 February 2014: Publication of this notice with a copy of the licence that will come into force on 1 April 2014. GAL and any provider of air transport services whose interests are materially affected by the CAA's decision will then have six weeks from the date of the publication of this notice to decide whether or not to seek permission to appeal to the CC against any of the licence conditions.⁸ Applications are subject to the procedural requirements of Schedule 2 of the Act and the Airport Licence Condition Appeal Rules recently published by the CC.⁹
 - 1 April 2014: the licence and, in the absence of any application to seek permission to appeal, the Q6 price control will come into force. If permission to appeal is sought and the applicant also applies, within six weeks of the date of this notice, for the suspension of one or more licence condition(s), those conditions will not take effect during the 10 week period after this notice. The CMA must determine the early application for suspension within that 10 week period.¹⁰ That early procedure does not prevent the appellant making an application for suspension at any other time before the determination of the appeal.
 - The CC/CMA has 24 weeks (again, from the date of this notice) to determine the appeal. The CC/CMA may grant itself an 8-week extension to this deadline.

⁸ The Competition and Markets Authority will take over the functions of the Competition Commission along with the competition and certain consumer functions of the Office of Fair Trading (OFT). The CMA is currently in operation as a shadow body but will take over any existing CC casework when it becomes fully operational on 1 April 2014.

⁹ The Rules specify the information that must be included in any application. Applicants must submit both the required information in full and a version of it with any sensitive information excised. Copies of both the full and excised versions must also be sent to the CAA preferably at the same time as the application is made to the CC. As required by paragraph 1(4) of Schedule 2 to the Act, the CAA will publish the excised version of the application and send a copy to the persons listed in paragraph 1(5) of Schedule 2. It will aim to publish the application on its website no later than the working day after receipt.

¹⁰ Section 10 of Schedule 2 to the Act.

- Interested parties can also appeal the CAA's determination on whether the MPT is met to the CAT within 60 days of the publication of the CAA's reasons for the determination. The CC/CMA may extend the period for considering an appeal on licence conditions if there is an appeal to the CAT which it considers relevant to the appeal on licence conditions.

The process that has shaped the licence conditions

1.14 The licence conditions have been informed by a number of factors.

- Previous significant CAA consultations in July 2011 and May 2012 designed to establish the key issues of concern to stakeholders and explore the interpretation of the CAA's new duties under the Act.¹¹
- A process of CE between April 2012 and December 2012, overseen by the CAA, whereby GAL and the airlines discussed the main building blocks that could be used to calculate future charges. This process culminated in a report to the CAA approved by the Joint Steering Group (JSG).
- An initial business plan (IBP) (April 2012) and revised business plan (RBP) (January 2013) from GAL setting out its view on the main building blocks that could be used to calculate future charges in the period April 2014 to March 2019. The RBP included GAL's proposals for airport commitments as an alternative to licence regulation.
- The CAA's initial proposals for GAL published in April 2013 were based on a RAB-based price control but stated that GAL's commitments together with a basic licence could be the preferred form of regulation if issues associated with the terms of the commitments could be addressed.¹²

¹¹ CAA, July 2011, Setting the Scene for Q6, <http://www.caa.co.uk/default.aspx?catid=2162&pageid=12352> and CAA, May 2012, Q6 Policy Update, <http://www.caa.co.uk/docs/5/Q6PolicyUpdate.pdf>

¹² CAA, April 2013, CAP 1029: Economic Regulation at Gatwick from April 2014: Initial Proposals, <http://www.caa.co.uk/docs/33/CAP%201029%20Economic%20regulation%20at%20Gatwick>

- Written representations from stakeholders to the CAA's initial proposals, which included revised commitment proposals from GAL, which sought to address issues highlighted by the CAA in the initial proposals.¹³ Some stakeholders have shared with the CAA consultancy studies they have commissioned.¹⁴
- Further submissions from GAL and the airlines in response to a CAA request to reach agreement on key issues on the service quality and capital expenditure regimes.
- A stakeholder session with the CAA Board in July 2013 at which both GAL and representatives from the Gatwick airline community explained their respective positions on regulation at Gatwick.¹⁵
- A consultation in July 2013 on a draft licence that could be associated with GAL's revised commitment proposals, if the CAA considered that this was the preferred form of regulation.¹⁶
- GAL's commitment proposals received on 20 September 2013,¹⁷ which responded to issues raised by the CAA and stakeholders in the CAA's consultation on the draft licence which could be associated with GAL's revised commitment proposals.¹⁸
- A consultation in October 2013 on the CAA's final proposals, including proposed licence conditions.
- Written representations from stakeholders to the CAA's final proposals, which included revised commitments proposals from GAL. Further written representations from stakeholders

[%20from%20April%202014%20initial%20proposals.pdf](#)

¹³ The responses to the initial proposals are published at:

<http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14902>

¹⁴ These reports are published at:

<http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279>

¹⁵ CAA, July 2013, Minutes from Board stakeholder sessions for Gatwick,

<http://www.caa.co.uk/docs/78/CAA%20Board%20%20Gatwick%20Meeting17072013.pdf>

¹⁶ CAA, July 2013, GAL – proposed licence conditions in relation to price commitments,

<http://www.caa.co.uk/docs/78/GALProposedLicenceCondition.pdf>

¹⁷ GAL, September 2013, London Gatwick's Final Commitments proposal,

<http://www.caa.co.uk/docs/78/20SeptemberFinalCommitmentsProposals.pdf>

¹⁸ Responses to these commitments are at:

<http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15152>

responding to other stakeholder responses and highlighting new information on traffic growth, the CC's provisional decision on the Northern Ireland Electricity appeal and the progress of bilateral negotiations.

- A further iteration of GAL's commitment proposals in the conditions of use received on 5 December 2013 (as amended on 9 December 2013).¹⁹
- A consultation under section 15(1) and (3) of the Act on 10 January 2014 proposing to grant a licence to GAL, with a copy of the licence and reasons for the conditions included in that licence.²⁰
- Representations from GAL and the airlines on the proposed licence.²¹
- Several independent studies commissioned by the CAA on the efficiency and appropriateness of GAL's business plan projections and the form of regulation (see figure 1.1). In a number of cases the CAA commissioned updates to these reports to address the points raised by stakeholders in their responses to the initial proposals.
- Advice from the CAA Consumer Panel.²²

¹⁹ Gatwick Airport Conditions of Use, December 2013, <http://www.caa.co.uk/docs/78/13%2012%2011%20Conditions%20of%20Use%20UPDATED.pdf>

²⁰ The proposed licence is published at: <http://www.caa.co.uk/cap1139>

²¹ The representations on the proposed licence are published at: <http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15152>

²² The minutes of the CAA Consumer Panel meetings are published at: <http://www.caa.co.uk/default.aspx?catid=2488&pagetype=90&pageid=14123>

Figure 1.1: Independent consultancy studies commissioned by the CAA

Topic	Consultant
Cost of capital	PricewaterhouseCoopers
Scope for future efficiency gains at Heathrow, Gatwick and Stansted	Cambridge Economic Policy Associates
Q6 capital expenditure (capex) review	Davis Langdon
Assessment of maintenance and renewal costs at Heathrow and Gatwick	Steer Davies Gleave
Assessment of commercial revenues at Heathrow and Gatwick	Steer Davies Gleave
Potential framework for price monitoring at Gatwick and Stansted	First Economics
Advice on the calculation of long-run incremental costs	Europe Economics
Other operating expenditure at Heathrow and Gatwick	Steer Davies Gleave
Central support costs	Helios
Comparing and capping airport charges at regulated airports	Leigh Fisher
Employment cost study at Heathrow, Gatwick and Stansted	IDS Thomson Reuters
Q5 capex and consultation review, Gatwick	URS
Review of distribution of economic rents	SLG economics
Review of pension costs for Gatwick Airport	Government Actuary's Department

Source: CAA

Note: These consultancy studies have been published on the CAA's [website](#).

Statutory context to this process

Outline of the CAA's statutory duties

- 1.15 The Act creates a new framework to govern the application of economic regulation to the airport sector. In essence it modernises the previous arrangements and brings the CAA's duties and powers into line with modern regulatory best practice. This includes the CAA having a single primary duty focused on the interests of passengers and those with rights in cargo. The scope of this duty concerns the range, availability, continuity, cost and quality of airport operation

services²³ and the CAA must carry out its functions, where appropriate, in a manner that will promote competition in the provision of airport operation services. The CAA must also have regard to a range of regulatory objectives and principles (figure 1.2). The Act also enables the CAA to regulate through a flexible and proportionate licensing approach.

Figure 1.2: The CAA's general duties under the Act

S1	CAA's general duty
(1)	The CAA must carry out its functions...in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services.
(2)	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)	In performing its duties under subsections (1) and (2) the CAA must have regard to: <ul style="list-style-type: none"> (a) the need to secure that each holder of a licence...is able to finance its provision of airport operation services in the area for which the licence is granted, (b) the need to secure that all reasonable demands for airport operation services are met, (c) the need to promote economy and efficiency on the part of each holder of a licence...in its provision of airport operation services at the airport to which the licence relates, (d) the need to secure that each holder of a licence...is able to take reasonable measures to reduce, control or mitigate the adverse environmental effects of the airport to which the licence relates, facilities used or intended to be used in connection with that airport...and aircraft using that airport, (e) any guidance issued to the CAA by the Secretary of State..., (f) any international obligation of the United Kingdom notified to the CAA by the Secretary of State..., and (g) the principles in subsection (4).
(4)	Those principles are that - <ul style="list-style-type: none"> (a) regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent, and (b) regulatory activities should be targeted only at cases in which action is needed.

Source: The Act

²³ Airport operation services are defined in the Act at section 68.

Note: In performing its duties under sections 1(1) and 1(2) of the Act the CAA must have regard to any international obligations of the UK notified to it by the Secretary of State. On 12 April 2013 the CAA was notified of the following international obligations, as they affect charges on airlines: Article 15 of the Chicago Convention; air services agreements in force between the European Union (EU) and its member states and any third country or countries; and air services agreements in force between the UK and any third country or countries. These same obligations applied to the CAA in previous price control reviews conducted under the AA86.

1.16 The CAA is also under a duty, by virtue of section 73(2A) of the Regulatory Enforcement and Sanctions Act 2008, not to impose or maintain unnecessary burdens while performing its regulatory functions under Chapter 1 of Part 1 of the Act.

Who should be regulated?

1.17 The Act prohibits an operator of a dominant airport area at a dominant airport from charging for airport operation services unless it has a licence granted by the CAA. An airport area is dominant if the CAA determines (and publishes) that the MPT is met in relation to the area by the relevant operator. The MPT has three parts:

- Test A: the relevant operator has, or is likely to acquire substantial market power (SMP) in a market, either alone or taken with such other persons as the CAA considers appropriate;
- Test B: that competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that SMP; and
- Test C: that, for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects.

1.18 At the same time as publishing the proposed licence, the CAA published an operator determination for the purposes of section 10 of the Act as well as its determination on the MPT in relation to Gatwick.²⁴ The CAA considers that the MPT is met in relation to the core area²⁵ (except the cargo processing areas) of Gatwick and this is likely to endure over at least the Q6 period.

²⁴ The CAA's determination can be found at:

<http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=12275>

²⁵ These are defined in section 5(4) of the Act as the land, buildings and other structures used for the purposes of the landing, taking off, manoeuvring, parking and servicing of aircraft at the airport, passenger terminals and the cargo processing areas.

Licence regulation

- 1.19 Where the MPT is met, the CAA may include in a licence such conditions that it considers are needed to prevent the risk of abuse of market power as well as any other condition that it considers is necessary and expedient²⁶ to secure its statutory duties under section 1 of the Act, including those which further the interests of users of air transport services and (where appropriate) promote competition in the provision of airport operation services. The CAA must also have regard to a range of matters and regulatory principles.
- 1.20 A licence must specify the airport area and the airport for which it is granted and it must include any price control conditions that the CAA decides are required, as well as provisions for revoking the licence.²⁷ In addition, the licence may include obligations requiring payment of fees to the CAA.²⁸ Licence conditions can also include provisions relating to activities carried on outside the airport area for which the licence is granted.
- 1.21 In January 2012, and at the request of the Secretary of State to assist Parliamentary scrutiny of the Act²⁹, the CAA published an indicative licence setting out the types of licence conditions that it might include.³⁰ The CAA has subsequently consulted on potential licence conditions as part of the initial proposals, in the July 2013 consultation on the conditions to be included with GAL's commitments, in the final proposals and in the proposed licence. The reasons for the conditions the CAA considers are required in the GAL licence are set out in chapter 2. The licence itself is set out in chapter 3.
- 1.22 GAL and airlines have rights to appeal the CAA's final decision on the inclusion, or absence, of licence conditions to the CMA subject to certain qualifying criteria being met.³¹ In the event an appeal is made

²⁶ Section 18 of the Act.

²⁷ Sections 17 and 19 of the Act.

²⁸ Section 20 of the Act.

²⁹ Letter from Department of Transport to CAA, August 2011:
<http://www.caa.co.uk/docs/5/20110812S16Letter.pdf>

³⁰ CAA, November 2011, Indicative Airport Licence:
<http://www.caa.co.uk/docs/5/IndicativeLicence.pdf>

³¹ Section 24 of the Act. The appeal body is currently the CC but will be the CMA from April 2014.

that meets the qualifying criteria the CAA's decision will stand until the CMA determines the appeal – unless it has granted interim relief or the appeal relates to specific financial arrangements. While CMA appeals should normally be determined within 24 weeks, this can be extended if a relevant appeal to the CAT is ongoing.³²

GAL's commitment proposals

- 1.23 GAL put forward proposals for airport commitments as an alternative to licence-based regulation. These commitments, that GAL proposed to include in its Conditions of Use (COU), set out limits on airport charges, a service quality regime and commitments on consultation, investment, and operational and financial resilience.
- 1.24 Under Test C of the market power test, the CAA has determined that commitments alone would not provide sufficient protection for users and the benefits of a licence are likely to outweigh the adverse effects. In the final proposals the CAA consulted on its proposals for GAL's commitments to be backed by a licence and monitoring regime.³³ Appendix I sets out the CAA's further assessment of the form of regulation and confirms the CAA's view that commitments backed by a licence and monitoring regime are the most appropriate form of regulation for GAL. This notice therefore sets out the licence conditions to be associated with GAL's commitments, together with the CAA's monitoring regime.

Structure of the remainder of this notice

- 1.25 Following this introduction, the remainder of this notice is structured as follows:
- Chapter 2: Reasons for the licence conditions;
 - Chapter 3: The licence and conditions;
 - Chapter 4: The monitoring regime;

³² Details of the CMA appeal process are set out in Schedule 2 to the Act.

³³ See paragraphs 6.10 to 6.33 of, and Appendix J to the MPD at:
<http://www.caa.co.uk/docs/33/CAP%201134.pdf>

- Appendix A: Introduction to the calculation of the fair price;
- Appendix B: Traffic;
- Appendix C: Capital expenditure;
- Appendix D: Operating expenditure;
- Appendix E: Commercial revenues;
- Appendix F: Other regulated charges;
- Appendix G: Q6 RAB;
- Appendix H: Cost of capital, calculation of the fair price and financeability;
- Appendix I: Form of regulation;
- Appendix J: Rolling forward the Regulatory Asset Base;
- Appendix K: The December 2013 Commitments; and
- Appendix L: Glossary.

1.26 In addition, the CAA is publishing a Technical Appendix on the weighted average cost of capital (WACC) simultaneously with this notice.³⁴

1.27 The CAA received many responses to its consultation on the proposed licence. It has carefully read and considered all the points made in each response. This notice contains summaries of, and answers to, many of those points. Respondents should be assured that each point raised has been carefully considered, whether or not it is addressed specifically in this notice.

³⁴ Available from <http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=67#All>

CHAPTER 2

Reasons for the licence conditions

Introduction and structure of chapter

- 2.1 This chapter sets out the conditions included in the licence and the reasons for those conditions. It consists of the following sections:
- Part A: Scope and Interpretation;
 - Part B: General Conditions (Payment of fees, Licence revocation);
 - Part C: The Commitments Conditions; and
 - Part D: Financial Conditions.
- 2.2 In reaching its decisions on what licence conditions to include, the CAA has considered stakeholders' views in response to previous consultations. Where appropriate and for consistency the CAA has also taken into account responses to relevant consultations on proposals for the operators of Heathrow and Stansted airports.³⁵
- 2.3 The CAA received five responses to its proposed licence.³⁶

Part A: Scope and Interpretation

The scope of the licence

- 2.4 This part of the licence provides details of the airport, the airport operator, and the airport area for which the licence is granted. It also specifies the date on which the licence comes into force, as well as details on interpreting the licence.
- 2.5 The airport is London Gatwick Airport. The airport area covered by the licence consists of:

³⁵ Such as responses in relation to the revocation provisions. These responses can be found at: <http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15151> and <http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15153>

³⁶ GAL, ACC, British Airways, easyJet and Virgin Atlantic Airways.

- the land, buildings and other structures used for the purposes of the landing, taking off, manoeuvring, parking and servicing of aircraft excluding the aircraft maintenance facilities known as Hangar 6 Maintenance Area 1 and Hangar 7 Maintenance Area 2 (the aircraft maintenance facilities); and
- the passenger terminals.

2.6 The licence will come into force on 1 April 2014.

Reasons for the scope of the licence

CAA's proposed licence

2.7 The CAA is required under section 17 of the Act to include the details of the airport and airport area. These details are not licence conditions. All other details are included to provide clarity and certainty.

2.8 In setting the airport area for the licence, the CAA considers that, in line with its duties under section 1 of the Act to have regard to carrying out its functions in a targeted and proportionate manner, the airport area should be linked to the scope of the relevant market and limited to the area in which GAL is found to have SMP. The CAA has therefore taken the airport area considered in the MPT as its starting point.³⁷

2.9 The CAA concluded in Chapter 7 of the MPD that GAL has SMP in the market for airport operation services to passenger airlines and that these are delivered from the core area of the airport.³⁸ Therefore, in the proposed licence, the CAA included in the airport area covered by the licence all those parts of the core area of the airport, except for any specific areas where the CAA has made an operator determination, under section 10 of the Act, that GAL does not have overall responsibility for the management of that area.

2.10 In its response to the CAA's initial proposals in April 2013, and again following the final proposals, GAL said it did not consider that it was

³⁷ See the notice of determination under section 8 of the Act at <http://www.caa.co.uk/docs/33/CAP%201134.pdf>

³⁸ The core area is defined in section 5(4) of the Act as the land, buildings and other structures used for the purposes of the landing, taking off, manoeuvring, parking and servicing of aircraft at the airport, passenger terminals and the cargo processing areas.

the operator of the cargo processing areas or the aircraft maintenance areas for the purposes of the Act.

- 2.11 The CAA did not find that GAL has SMP in the cargo market and, as the airport area is linked to the scope of the relevant market and limited to the area in which GAL is found to have SMP, the cargo processing areas are not included in the airport area covered by the licence.
- 2.12 With regard to the aircraft maintenance areas, the CAA has published an operator determination (dated 10 January 2014) for the purposes of section 10 of the Act.³⁹ An operator determination assesses whether an operator has overall responsibility for the management of an area including the extent of control over the type, quality and price of services offered in that area, access to that area and development of the area. The CAA found in Chapter 6 of the operator determination that GAL does not have 'overall responsibility for the management' of the aircraft maintenance facilities, in the sense that it does not have control of the type, price, quality of services provided there nor sufficient control over access to or development of those facilities.⁴⁰ Consequently, in the proposed licence, the aircraft maintenance facilities were not included in the airport area for the purpose of the licence. The reasons for this decision are set out in the operator determination.
- 2.13 The CAA noted that under section 18 of the Act, as well as the conditions it considers necessary or expedient to guard against the risk of abuse of SMP, it may include in the licence other such conditions as it considers necessary or expedient having regard to its general duties under section 1 of the Act. Under section 21(1)(f) of the Act it may also include provisions relating to activities carried on outside the airport area for which the licence is granted. These give the CAA the power, where appropriate and necessary, to go wider than the relevant market and the airport area when including conditions in the licence.

³⁹ This determination can be found at:
<http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15152>

⁴⁰ See the matters listed in section 9(4) of the Act.

Representations on the proposed licence

2.14 GAL provided a representation on the expiration of the licence under condition A1.5. It requested that the CAA established an expiration period for the licence, after which the licence could be renewed, but only on further action from the CAA. GAL considered that this was consistent with the intention of Parliament and the Act for the requirements of a licence not to exist in perpetuity, and follows regulatory precedent. It suggested that the relevant period covers the 7 years of the Commitments, to allow for a new MPD in year 5. GAL suggested that the CAA includes the following drafting:

A1.5: This Licence shall come into force on 1 April 2014 and shall continue in force until the earlier of:

- a) It being revoked in accordance with Condition B2 of this Licence; or
- b) 31 March 2021 unless prior to such date the CAA has made a further market power determination under section 7 of the Act and finds that, for the purposes of section 3 of the Act, the Licensee is the operator of a dominant airport area at a dominant airport.

CAA's response and final decision

2.15 The CAA does not consider that a time-limited licence is consistent with the Act; section 17(6) is clear that a licence continues in force until it is revoked in accordance with its provisions. The revocation provisions in the licence provide for it to be revoked if the airport and/or the airport area are no longer considered dominant, for example if the CAA makes a negative MPD. The CAA considers that there is sufficient flexibility in the Act; specifically section 21(6) provides that licence conditions will not have effect if the airport area or the airport ceases to be dominant. The Act also requires the CAA to undertake a MPD if requested by GAL or any person whose interests are materially affected unless it has previously made a determination and there has not been a material change in circumstances. Consequently, the CAA does not consider it appropriate to commit to conducting a further MPD at a specific date. Including an expiry date in the licence now would pre-empt any decisions on whether a new MPD was required. The CAA will conduct a new MPD if there is a material change in circumstances. However,

should the CAA decide that a new MPD is not appropriate, the 7 year time limit will require the CAA to undertake a periodic review of GAL's airport charges before the next control period at the end of that 7 years.

- 2.16 The CAA has therefore not made any changes to the condition included in the proposed licence.

Part B: General Conditions

Payment of fees

The licence condition

- 2.17 The licence condition requires GAL to pay to the CAA any charges that are set under a scheme made under section 11 of the Civil Aviation Act 1982 (the 1982 Act). GAL must pay these charges from the date on which the licence comes into force.
- 2.18 Payment of fees would be enforceable using civil sanctions as well as the enforcement powers in the Act.
- 2.19 Under the 1982 Act the CAA has an obligation, before making a charging scheme, to consult persons affected by the scheme and the Secretary of State.

Reasons for the licence condition

CAA's proposed licence

- 2.20 In the proposed licence the CAA explained that the Act allows the CAA to require the licence holder to pay charges to the CAA in respect of its functions under Chapter 1 of the Act. These charges are required to enable the CAA to recover the costs of carrying out those functions. The CAA has general powers to determine charges under a scheme or regulations made under section 11 of the 1982 Act. The CAA noted that it had not received any evidence through the consultation process that a scheme of charges under the 1982 Act would not be appropriate and it therefore proposed to continue to rely on that scheme.
- 2.21 The CAA included the same condition on the payment of fees in the proposed licence as consulted on in the final proposals. The CAA

stated that it was consulting separately on its scheme of charges from 1 April 2014, including charges to be paid by holders of a licence issued under the Act. The consultation closed on 13 February 2014 and the CAA will publish its decision on charges during March 2014.

Representations on the proposed licence

2.22 There were no representations on this condition.

CAA's response and final decision

2.23 The CAA has not made any changes to the condition included in the proposed licence.

Licence revocation

The licence condition

2.24 The licence condition specifies that the grounds on which the CAA can revoke GAL's licence would be:

- where the licence is no longer required, including:
 - the Licensee requests or agrees to revocation;
 - the Licensee is no longer the operator of all of the airport area; or
 - either the airport and/or airport area is no longer dominant; or
- where the Licensee has materially failed to comply with regulatory requirements such as a failure to comply with an enforcement order⁴¹ or to pay a penalty⁴² (following any appeal proceedings under the Act and allowing at least 3 months for the Licensee to comply before starting revocation proceedings under section 48 of the Act).

Reasons for the licence condition

CAA's proposed licence

2.25 The CAA included the same licence condition on revocation as consulted on in the final proposals. The CAA is required under section 17(4) of the Act to include provisions about the circumstances

⁴¹ Within the meaning of section 33 of the Act, or an urgent enforcement order within the meaning of sections 35 and 36 of the Act.

⁴² Within the meaning of sections 39, 40, 51 or 52 of the Act.

in which it may be revoked. The licence is issued in perpetuity so provisions are needed to revoke it if it is no longer required, for example because the airport or the airport area is no longer considered to be dominant.

- 2.26 The CAA considered that licence revocation was a serious matter as the prohibition on charging in section 3 of the Act meant it would not be lawful for GAL to charge for any airport operation services if it did not hold a licence. In all likelihood, this would mean that GAL would have to cease operations.
- 2.27 The CAA also considered that it should have the ability to revoke the licence if GAL's behaviour with regards to its regulatory obligations was such that the CAA no longer considered it fit to hold the licence. However, the CAA considered that this should be treated as the ultimate sanction for a licence breach by a regulated company and should be used only as a last resort when all other channels had been exhausted. Other than in extreme circumstances, the CAA did not consider that revocation as a sanction was likely to be in the best interests of passengers and cargo owners. The CAA noted that there were checks built into both the Act and the licence that provide several opportunities for GAL to correct any failures and that GAL was able to appeal the CAA's decision at each stage.

Representations on the proposed licence

- 2.28 The ACC suggested that conditions B2(b)(i), (ii), (iii)⁴³ should include references to the specific provisions of the Act regarding the MPD and operator determinations, so that it was clear how these matters would be established.

CAA's response and final decision

- 2.29 The CAA does not consider it is necessary to include further clarification in this area as the relevant parts of the Act are clearly set out in the scope of the licence at A1.1. The CAA has therefore made no changes to the condition that was included in the proposed licence.

⁴³ Relating to revocation when the Licensee is no longer the operator of all of the airport area or when the airport and/or airport area is no longer considered to be dominant.

Part C: The Commitments Conditions

The Commitments Condition

The commitments as licence conditions

The licence condition

- 2.30 The commitments condition requires GAL to include its December 2013 commitments in the Gatwick COU, but makes clear that they are also licence conditions, subject to the enforcement and modification powers in the Act. The commitments are defined in the licence in relation to where they are set out in the COU.
- 2.31 GAL is required to comply with the commitments in a manner which, so far as reasonably practicable, furthers the interests of passengers.
- 2.32 The condition specifically excludes any obligations on third parties from the definition of the commitments in the licence because GAL's licence cannot impose obligations on third parties. This means that these elements of GAL's commitments are not considered to be licence conditions and therefore can only be enforced by GAL through contractual mechanisms.
- 2.33 In addition, the licence makes it clear that if the CAA makes a licence modification under section 22 of the Act which impact on the commitments, GAL must make any necessary consequential changes to the COU.

Reasons for the condition

CAA's proposed licence

- 2.34 In the proposed licence, the CAA said the commitments condition would ensure that the commitments remain in the COU until such time as the CAA makes a licence modification under section 22 of the Act to modify or remove them. It explained that including the commitments in the COU meant they would be directly enforceable by the airlines through normal contractual processes. Specifying that the commitments were also licence conditions would mean the CAA would be able to intervene if necessary through the enforcement mechanisms in the Act. For example, the CAA could modify the licence if the commitments approach was not working as intended. The CAA could also enforce the conditions in the commitments,

including through an urgent enforcement order, if there was detriment to passengers that was not being addressed by GAL or being challenged by the airlines. The CAA also made it clear in the proposed licence condition that it would not consider obligations on third parties or GAL's pricing principles to form part of the licence obligations.

- 2.35 In its response to the CAA's final proposals, GAL said it considered that the CAA could fulfil its statutory duties by relying on the commitments without a licence. However, the CAA stated in the proposed licence that it did not agree with GAL for the reasons set out in detail in Test C of the CAA's MPT in relation to Gatwick and in Appendix I of the notice of the proposed licence. The CAA did not agree that the commitments alone would fully protect the interests of passengers in the range, availability, continuity, cost and quality of airport operation services and where appropriate promote competition. GAL, as an operator with SMP, would not have the same competitive incentives as an operator in an effectively competitive market. As a commercial operator, it could not be wholly relied on to always have the interests of passengers at the heart of its decision-making over and above the interests of its shareholders. Similarly, the CAA did not consider that the interests of the airlines would always align with those of their passengers.
- 2.36 In the proposed licence the CAA considered that its duties under section 1 of the Act to further the interests of passengers and cargo owners required it to ensure that those users had the ability to seek redress, either directly or through a third party whose interests were wholly aligned with those of the end users. The CAA reiterated that it considered it was best placed to take on this latter role through step-in rights in a licence to enforce the commitments. The CAA did not consider that individual passengers would be able to enforce the commitments as they were not privy to those contractual arrangements. The CAA considered it was best placed to enforce passengers' interests pursuant to the general duty that it was given by Parliament in the Act. Furthermore, the use of commitments in lieu of regulation was an untried and untested mechanism for the regulation of an airport operator with SMP and the CAA considered it would not be fulfilling its own statutory duties if it did not ensure that it had the ability to step-in quickly and proactively to protect the interests of passengers if the commitments were not working as intended. The

CAA therefore included a requirement for GAL to comply with the licence and the commitments in a manner designed to further passengers' interests.

- 2.37 The CAA considered that the requirement to comply with the licence in the interests of passengers was an essential element of the licence condition that allowed the CAA to intervene on passengers' behalf if the airlines choose not to do so. Without this obligation, the terms of the commitments would only be enforceable as a contractual arrangement between GAL and the airlines through the dispute mechanisms in the COU and through the courts. This obligation was therefore necessary to provide a direct route of enforcement by the CAA, including through the use of its powers to modify, impose interim relief and penalties in order to add value in terms of enforcement in the interests of passengers.
- 2.38 However, the CAA has not found that GAL has SMP in the cargo market. In 2012 there were only 8 dedicated cargo flights operating out of Gatwick⁴⁴ and most cargo was carried as bellyhold on passenger flights. Consequently, the CAA considered that the interests of passengers and those of cargo owners were likely to be aligned.⁴⁵ Given this overlap, the CAA did not include the cargo processing areas in the licensed airport area in the proposed licence and considered that it would be disproportionate, in the absence of a positive MPT for cargo, to hold GAL to account for cargo through the licence. The CAA therefore did not include cargo in the requirement for GAL to comply with the licence and the commitments in a manner designed to further passengers' interests.
- 2.39 The CAA noted GAL's concerns following the final proposals that it was not reasonable to impose part of the CAA's primary duty onto GAL in the licence without qualifying this with the other duties, particularly regarding promoting competition and having regard to the need to secure that GAL is able to finance its provision of airport operation services in the airport area included in the licence. The CAA remained of the view that these elements were encompassed in the requirement that GAL must comply "so far as reasonably practicable".

⁴⁴ CAA statistics.

⁴⁵ In 2012 there were 98,000 tonnes of freight at Gatwick, 99.9% of which was carried on passenger aircraft, CAA statistics 2012.

In any investigations into potential non-compliance, the CAA must take a proportionate and targeted approach and will balance all of its duties, including GAL's ability to finance its activities, when considering whether GAL has furthered the interests of passengers.

- 2.40 The CAA also noted the airlines' concerns following the final proposals that the condition only required GAL to comply with the licence conditions in a manner designed to further the interests of passengers, without explicitly including a requirement to comply with the commitments in the same manner. The CAA considered that as the commitments were licence conditions as well as conditions of the COU, they were subject to the full powers of the Act, including the enforcement provisions in sections 31-47 of the Act and the modification provisions in section 22 of the Act. However, for the avoidance of doubt, the CAA included a requirement that GAL must comply with the commitments in the same manner as it would the licence (for those commitments that were also licence conditions). The CAA considered it would add greater clarity to include explicit obligations in the licence in relation to compliance with, and modification of, the commitments. In line with this the CAA included a specific obligation in the licence that requires GAL to make any necessary amendments to the contractual terms in the COU to transpose any modifications made to the licence conditions under section 22 of the Act.
- 2.41 The CAA noted that, since the final proposals, GAL had made a number of amendments to the commitments in response to the airlines' comments. The licence therefore required GAL to comply with the revised commitments submitted to the CAA on 5 December 2013. The CAA stated that it would review the performance of the commitments in the second half of 2016 to ensure they were furthering passengers' interests.

Representations on the proposed licence

- 2.42 GAL requested that the definition under condition C1.11(x) should be changed to Gatwick Airport Core Service Standards Handbook, as the name of the Manual has now changed at the airlines' request.

CAA's response and final decision

- 2.43 The CAA notes the change of name to the Core Service Handbook and has made the change to ensure clarity and accuracy. The CAA

does not consider this is a significant change requiring re-consultation as it reflects the correct document which has been agreed by all parties.

- 2.44 The CAA has made a number of other drafting changes to Condition 1. The CAA considers these drafting changes are needed to ensure the licence reflects the CAA's policies, the commitments and the Act correctly and that they are not significant changes. The CAA has amended:
- the cross-references in Condition C1.11 to correctly refer to Conditions C1.4 to C1.7;
 - the cross-references in Condition C1.11(a)(iii) to correctly refer to Conditions 2.1.11 to 2.1.20 of the December 2013 version of the Conditions of Use (Dispute Resolution);
 - the titles of Part C to "The commitment conditions" and Condition 1 to "Commitments" as these better reflect the content of the licence; and
 - Condition C1.7 to clarify that any changes made to the licence under section 22 of the Act are subject to the outcome of any appeal to the CMA.
- 2.45 The CAA continues to consider that the licence conditions are appropriate for the reasons set out above and has made no further changes to the condition set out in the proposed licence.

A self-modification provision

The licence condition

- 2.46 The licence condition includes a self-modification provision which allows GAL and the airlines to agree and make changes to the specified parts of the commitments in accordance with the change mechanisms set out in the COU, without having to rely on the CAA making a modification under section 22 of the Act.
- 2.47 The specified mechanisms in the commitments are provisions that allow changes to the indicative gross yield price profile (at paragraph 6.1 of Schedule 2 to the COU) and changes to the airline service standards and core service standards (at paragraph 5 of Schedule 3 to the COU). In both cases, the changes must be agreed by GAL and

airlines that represent at least 67% of passengers and which are paying charges under the published tariff or under bilateral contracts which use the gross yield profile as a reference point (or for changes to service standards, those airlines which have not waived or replaced core service standards) and representing at least 50% of airlines responding to the consultation.

2.48 In addition, the commitments allow for changes to be made to:

- the gross yield price profile for the recovery of costs of any second runway (paragraph 6.2 of Schedule 2 to the COU). These changes do not require the agreement of the airlines but the CAA has included an additional provision in the licence that limits this automatic pass through to £10 million per year;
- the gross yield price profile for increases or decreases in security costs and the cost of installing new hold baggage screening equipment (at paragraph 1.17 of Schedule 2 to the COU) (these are automatic changes that do not need the agreement of the airlines); and
- the “Gatwick Airport Core Service Standards Handbook” which is annexed to the COU where changes are agreed between GAL, the Gatwick Airline Operators Committee (AOC) and the Gatwick ACC (Appendix 1 to Schedule 3 to the COU).

Reasons for the condition

CAA's proposed licence

2.49 In the proposed licence the CAA stated it was broadly content that GAL's self-modification proposals set out within the commitments would allow GAL and the airlines to make specified changes to the commitments efficiently, thereby reducing the regulatory burden for both GAL and the airlines of making changes where the majority of parties were in agreement. However, the CAA considered that a self-modification provision was also required in the licence itself to meet the requirements of the Act. This was because, as the commitments were licence conditions, the Act requires that any modifications to them must be made either under the modification provisions in section 22 or under a self-modification provision included in the licence condition under section 21(3). The CAA considered that, where changes were properly debated and agreed already, the procedural

requirements of section 22 were unnecessary and would place additional burdens on all parties. The CAA also considered that it was not necessary to retain the right of appeal for changes that were agreed by all parties.⁴⁶

- 2.50 The CAA noted that the Act was prescriptive about what must be included in self-modification provisions: it must set out the types of modifications that can be made and the circumstances and periods in which they can be made. The provision included in the proposed licence condition fulfilled these requirements by only allowing modifications to be made in accordance with the modification provisions set out in the commitments. The CAA considered that it would add clarity to include links to the specific self modification provisions in the COUs. The condition therefore included links to:
- paragraph 6.1 of Schedule 2 (price commitments);
 - paragraph 6.2 of Schedule 2 (pass through of any second runway costs (up to a limit of £10 million per year – see section on second runway costs below);
 - paragraph 5 of Schedule 3 (service commitments); and
 - the final paragraph in Schedule 3 Appendix I (core service standards).
- 2.51 In its response to the final proposals, Virgin considered that requiring the agreement of airlines representing only 67% of passengers could lead to a single sector (i.e. the low cost carriers) imposing changes on all carriers at the airport. Instead, it suggested that consensus should be reached with all airlines at the airport⁴⁷. GAL suggested that, in its experience, 100% agreement was unachievable. Instead, it added an extra requirement to the commitments that, as well as requiring the agreement of airlines representing 67% of passengers, the changes must also be agreed with at least 50% of airlines responding in writing.
- 2.52 In response to Virgin's concerns the CAA did not consider that it would

⁴⁶ GAL and any airline operating at Gatwick have the right of appeal to the CC against a modification under section 22 of the Act but this would not be possible under the self-modification provision.

⁴⁷ Earlier in the process in its response to the August 2013 commitments, Virgin suggested that agreement should be reached with 90% of airlines responding and airlines in favour needed to represent at 90% of passengers.

be efficient or effective for GAL to have to obtain the agreement of all, or nearly all, airlines at the airport as one minority stakeholder could hold up or veto changes that all other airlines needed and that, overall, were in the interests of passengers. The CAA considered that the additional requirement in the commitments that support was required from at least 50% of airlines responding to a modification consultation offered a suitable safeguard against Virgin's concerns. Therefore, the CAA considered that the overall threshold for airline support included in the December commitments for making changes to the price and service quality regimes would be sufficient to prevent one or two airlines being able to push through changes to the regime that would not be in the interests of passengers in general. The CAA considered that the modification provision should therefore not act against passengers' interests and therefore did not make any further changes to the modification provision beyond those for a second runway.

Representations on the proposed licence

2.53 The ACC provided representations on condition C1.7 relating to the requirement to make consequential changes to the Conditions of Use if the CAA modified the licence under section 22 of the Act. It supported the need for this condition which it considered could be used by the CAA if the commitments and contracts failed to deliver outcomes in the interests of passengers, including the fair price. However, it considered that if the monitoring provisions were excluded from the licence, as the CAA proposed, there would be some uncertainty about the circumstances in which the CAA would intervene and use this provision. It therefore considered that the price monitoring provisions should be robustly clear so that the airport operator, the airlines and the CAA are certain about how the fair price will be delivered.

CAA's response and final decision

2.54 The CAA does not consider that the monitoring provisions need to be set out in the licence and that it should instead rely on its general information gathering powers in section 50 of the Act. One of the main benefits of a monitoring regime is the ability to react to circumstances as they arise and the section 50 powers allow for a more flexible approach than fixing a regime in the licence. The CAA also does not consider that setting out in prescriptive detail the monitoring regime in the licence would be consistent with the requirement not to impose or

maintain undue burdens. The CAA does, however, agree that it would be useful to set out further details of the regime and has therefore set out further details of the monitoring provisions in chapter 4 of this notice.

- 2.55 The CAA continues to consider that the licence conditions are appropriate for the reasons set out above and has made no further changes to the condition set out in the proposed licence.

Recovery of second runway costs

The licence condition

- 2.56 The commitments include a provision that allows for the recovery of the reasonable capital, operating and financing costs of developing a second runway and associated infrastructure (including applying for planning permission). There are two caveats in the provisions on the recovery of costs that commit GAL to:
- only recover costs if, following the final report of the Airports Commission, the government supports a second runway at Gatwick; and
 - follow any policy guidance issued by the CAA with regards to amending the gross yield profile in relation to the recovery of these costs.
- 2.57 As noted in the section on the self modification provision above, the licence includes a condition that would only allow the automatic recovery of costs associated with a second runway, up to a maximum of £10 million per year (the recovery of such costs would also need to follow CAA guidance and the second runway would require government support). The licence also includes a requirement that any amendments to the gross yield profile for the recovery of any second runway costs over that £10 million per year threshold would need to be made by means of a modification under section 22 of the Act.
- 2.58 This condition also clarifies that the CAA may issue guidance on the recovery of second runway costs and sets out the process for GAL to seek modifications under section 22.

Reasons for the condition

CAA's proposed licence

- 2.59 The commitments offered at the time of the final proposals were limited to having regard to CAA policy on second runway costs rather than follow CAA policy. The CAA had concerns that this could allow GAL not to follow CAA guidance if it considered it had reasons not to. Airlines also objected to the proposals on the grounds that they had no right of appeal against any changes.
- 2.60 The CAA considered that the potential costs of a second runway could increase airline charges significantly. GAL had estimated the total cost of a second runway and associated infrastructure to be £5 billion to £9 billion and has indicated that the second runway could be open by 2025. This compared to annual revenue from airport charges of around £300 million. The CAA therefore considered that GAL should not be able unilaterally to pass those costs on without any right of challenge from either the CAA or the airlines. The CAA therefore concluded that the bulk of the planning and development costs should only be added to charges through a section 22 modification made by the CAA, giving airlines and GAL the right of appeal to the CMA.
- 2.61 The CAA allowed for the automatic recovery of costs of up to £10 million per year (subject to following CAA policy and the other requirements of the commitments). The CAA considered that was a reasonable amount to allow GAL flexibility, particularly in the early stages of development of the second runway, without having to seek a series of section 22 modifications for smaller amounts.
- 2.62 In the final proposals the CAA noted that any guidance it issued relating to the financing of new runway developments would be consistent with its duties to further passengers' interests and also have regard to the ability of a licence holder to finance its provision of airport operation services in the licence area. The CAA would consult all interested parties before issuing the guidance. In the notice of the proposed licence the CAA included a provision in the licence that it may, following consultation, publish the guidance that GAL has committed to follow. This gave greater certainty that this guidance was a regulatory requirement and clarity about the need for consultation before it was issued.
- 2.63 The CAA also included the key requirements for GAL to request the

CAA to make the necessary section 22 amendments, ensuring that GAL's reasons for any changes are in line with the guidance. This would give greater clarity and certainty to GAL on how the CAA would assess whether to take its request forward.

- 2.64 The CAA considered whether it should specify that any modifications under section 22 to change the gross yield profile must be made before the design had been locked in through the planning process. The reason for this would be because it might be harder for the CAA and airlines to challenge the efficiency of the design and development plans if the section 22 modifications were sought after the design had been finalised.
- 2.65 However, the CAA did not include such an obligation as it considered that there are too many uncertainties at this stage to be sure of the optimum time for making any amendments. The CAA considered that, if the change to the gross yield profile was made too early, GAL could be constrained unnecessarily by the amount assumed in early plans or, conversely, the true efficient costs might not be apparent at the time.
- 2.66 The CAA considered that there would be sufficient opportunities for airlines and the CAA to express their views on the efficiency of the design and subsequent costs before they became locked in, including, but not limited to, the planning enquiry stage itself. Furthermore, requiring GAL to seek the CAA's intervention to make section 22 changes and the additional right of appeal to the CMA would incentivise GAL to engage with the CAA and the airlines to ensure its proposals would be acceptable and costs could be recovered. The CAA stated that in 2014 it would consult on and publish guidance on the treatment of second runway costs. Such guidance could include more detailed requirements for early engagement with stakeholders on design and costs.

Representations on the proposed licence

- 2.67 GAL considered that there was no reason for the addition of a £10 million cap when the COU include a commitment to follow CAA policy guidance.
- 2.68 The ACC welcomed the CAA's decision in condition C1.5 (b) that GAL may only pass on any second runway cost under £10 million but required further clarification on two issues where the proposed licence

and condition remained unclear.

- Firstly, it should be made clear that the allowance is a per year cap that cannot transfer across successive years and is therefore not a cumulative sum of £70 million over 7 years. Accordingly, the ACC suggested that condition C1.5(b) is amended to reflect this with the following wording “...up to a limit of £10m in any one charging year”.
- Secondly, more certainty was needed on the drafting of the licence condition to deliver the CAA’s decision that GAL may pass through up to £10 million of second runway costs. The ACC’s current understanding was that the CAA refers to the pass through of up to £10 million of *capital* spending on the second runway, which would translate into an allowed annual revenue increase of approximately 10% of any capital spending (reflecting the return on capital invested and its depreciation). It considered that this needs to be made expressly clear in the wording of the licence and conditions. It suggested that ‘capital spending’ is directly referenced, and the rate at which this can be capitalised into the core service price (i.e. the cost of capital and the depreciation rate) are clarified. It also proposed that the cost of capital is that set out by the CAA in its fair price calculation, and that the depreciation rate is the rate used by GAL in its accounts for that specific item of spend.

2.69 The ACC provided representations on condition C1.8 and C1.9, requesting that the phrase “pass through” be changed to “recovery” to improve clarity. For further consistency with its comments on condition C1.5, the ACC also requested the replacement of the phrase “...to allow for the pass through of second runway costs, any such amendments over and above the £10m allowed under Condition C1.5(b)...” with “...to allow for the recovery of second runway costs, any such amendments necessary to recover expenditure by GAL above the £10m allowed under Condition C1.5(b)...”.

2.70 The ACC also requested that the guidance issued by the CAA on the recovery of second runway costs addresses three particular issues:

- the efficiency tests for any such expenditure and the process to be followed for demonstrating that the costs were incurred efficiently;

- where costs are capitalised by GAL, the tests the CAA would apply before including them in any future RAB, or shadow RAB, to ensure that the airport operator bears and manages risk appropriately; and
- expectations of consultation with airlines over the design, timing/phasing, operational matters, associated developments and costs of a second runway.

CAA's response and final decision

- 2.71 The CAA remains of the view that the potential costs of a second runway are so significant in relation to the current airport charges that these must be subject to full regulatory scrutiny, including a right of appeal. The CAA considers that allowing recovery of up to £10 million, subject to CAA guidance (and after an Airport Commission recommendation and if there is government support for a second runway at Gatwick), gives GAL sufficient flexibility to develop its proposals, particularly in the early stages of development of the second runway, without having to seek a series of section 22 modifications for smaller amounts.
- 2.72 The CAA does not agree with the ACC's suggestion that the recovery of costs is limited to capital spending. The commitments are clear that the recovery of costs can include capital, operating and finance costs. This has not been raised as an issue in previous consultations and any such amendment to the proposed licence would be a significant change that would require consultation. The CAA considers that it would be inappropriate at this stage to limit the pass through to capital spending. However, if the CAA were to consider in the future that recovery of these costs should be limited to capital spend only, it could include this in its policy guidance on the treatment of second runway costs.
- 2.73 The CAA also notes that the recovery of costs only applies to costs incurred after 2015, once the Airports Commission has made its recommendations and the government has indicated its support for the project, so the total cost recovery would be less than the £70 million suggested by the ACC. However, the CAA agrees with the ACC that it would be helpful to clarify that the £10 million limit is per year and any "under-spend" cannot be carried over into subsequent years. This reflects CAA's policy intention in the proposed licence and

the absence of any explicit reference to the annual cap was not meant to exclude it. The CAA therefore does not consider this is a significant change requiring re-consultation. The CAA also considers that changing the term “pass through” to “recovery” better reflects the intentions of the condition and does not consider this to be a significant change. The CAA has therefore amended the licence in Conditions C1.5(b), C1.8, C1.9 and C1.11(d) to include these clarifications.

- 2.74 The CAA continues to consider that the licence conditions are appropriate for the reasons set out above and has made no further changes to the condition set out in the proposed licence.

The provisions in the commitments

Price of core services

The condition as set out in the December 2013 commitments

- 2.75 The December 2013 commitments include an indicative gross price profile based on published charges of RPI+1% per year and a net yield profile based on the blended charges (taking into account published charges and bilateral contracts) of RPI+0%. GAL will ensure that the difference between the indicative and actual yield profile is zero after seven years. Given the difference between the fair price (which is RPI-1.6% per year over five years) and the commitments blended price, the CAA considers that it should monitor the price in the commitments and if it is not consistent with the fair price of RPI-1.6% per year, then the CAA will consider additional licence conditions to cap prices or prevent GAL from altering the structure of charges. Further details of this are set out in chapter 4.
- 2.76 GAL has also included a pass through of changes in security costs above a threshold of £1.75 million per year and the pass through of costs of hold baggage screening following agreement with airlines.

Reasons for the condition

CAA's proposed licence

- 2.77 The CAA set out in detail its response to stakeholders' concerns following the final proposals on the calculation of the fair price in Appendices A to H of the proposed licence. The CAA made clear that it continues to consider it is appropriate to compare the blended price

in the commitments with the 5-year fair price, as a 5-year RAB-based price is the most likely counterfactual and the blended price reflects the average price to all passengers. The CAA acknowledged that the terms of a RAB-based price control and the commitments differed, although the CAA considered that with the addition of a licence, both approaches provided adequate protection to passengers. The 5-year fair price of RPI-1.6% per year was below the December 2013 commitments blended price of RPI+0%. The CAA did not consider it appropriate to introduce licence conditions to cap charges as the bilateral contracts currently being discussed with airlines had the potential to deliver a blended price in line with the fair price. The CAA said it would monitor prices and if they were above the CAA's fair price benchmark then the CAA reserved the right to introduce licence conditions to restrain charges or place constraints on GAL from altering its structure of charges.

- 2.78 In response to the final proposals, airlines raised concerns that the passthrough of security costs was too one-sided, allowing for increases in security costs to be passed through but not decreases. GAL has now amended the commitments to allow for both increases and decreases in costs from changes in security requirements to be passed through.
- 2.79 The airlines also stated in response to the final proposals that changes in security requirements should only be passed through if security costs were higher than the 2013/14 base year. The CAA did not consider that this was justified. GAL's security costs will vary year by year, in particular as a result of changes in the level of efficiency. The security cost pass through allows security requirement cost increases and decreases to be passed subject to a deadband. The CAA considered that this was the correct approach and was consistent with the approach used for the Heathrow price control. If only cost increases were passed through which were above the base year then GAL would be exposed to the risk that it would lose some of the efficiency gains that it had made since the base year as these would be used to offset the increased cost of security requirements. The CAA therefore considered that no further action was needed.

Representations on the proposed licence

- 2.80 The ACC noted that it set out in its response to the CAA's final

proposals what the appropriate price level should be.⁴⁸ The CAA's fair price of RPI -1.6% was significantly above this. Furthermore, it related to a 5-year period rather than the 7 years commitments period. Moreover, the ACC considered that there was scope under the proposed regime for GAL not to comply with the fair price.

- 2.81 The ACC also noted that there was no change to the commitments regarding the passthrough of increased security costs. It considered that the current arrangement did not share the risk in the way intended and provided opportunities for GAL to make a windfall if it could reduce security costs early in the period. The ACC considered that, given the CAA's conservative approach to opex efficiencies and the investment in security made in Q5, early outperformance seemed quite possible. The ACC considered that the formula should only allow an increase if the costs assumed by the CAA are exceeded in a particular year because of security changes. GAL should not be permitted 90% of the increase compared to the previous year.

CAA's response and final decision

- 2.82 The CAA's response on the fair price calculation is set out in detail in Appendices A-H and on the comparability of the fair price to the commitments price in Appendix I to this notice. In summary, the CAA considers that no new evidence has been submitted that would require it to amend its view and it has sought no further changes to the commitments to those included in the proposed licence. The CAA therefore continues to consider that the five year fair price is RPI-1.6% per year and the five year (RAB-based) fair price is the most appropriate comparator to the blended price in the commitments (not least as a five year RAB based price control is the most likely comparator). As set out in chapter 4 the CAA will monitor prices against the fair price benchmark of RPI-1.6% per year and if prices are above will consider amendments to the licence.
- 2.83 With regards to the pass through of security costs, the CAA remains of the view that the security cost pass through in the commitments was the correct approach for the reasons given in the proposed licence and repeated above. In particular the CAA does not consider that the security cost pass through should provide windfall gains to GAL. The

⁴⁸ In its response to the initial proposals, the ACC suggested that the fair price should be -9%, but this was not recalculated following the final proposals.

CAA has taken into account the impact of Q5 security investments in the opex forecasts. GAL will therefore benefit from outperformance on security and will bear the costs if it does not achieve the forecast efficiencies. Furthermore the security cost pass through will ensure that GAL will benefit from outperformance, rather than using this to offset any cost increases from increased security requirements in the future (as in the airlines proposals).

- 2.84 The CAA continues to consider that the licence conditions are appropriate for the reasons set out above and has made no further changes to the condition set out in the proposed licence.

Premium service charges

The condition as set out in the December 2013 commitments

- 2.85 GAL must provide Core Services to all operators at the Core Service Charges rate (both defined in the COU). GAL has also included a provision at paragraph 10 of Schedule 2 to the COU that allows it to offer enhancements or additions to the Core Services either under bilateral contracts or at charges separate from the Core Service Charges.

Reasons for the condition

CAA's proposed licence

- 2.86 The September 2013 commitments offered at the time of the final proposals included a provision allowing GAL to levy Premium Service Charges for commercial passenger flights receiving Premium Service Products, although neither of these terms was defined. The CAA considered that for most airport operation services any premium charges would be covered by the non-discrimination provisions in the Airport Charges Regulations (ACRs) and the Groundhandling Regulations (AGRs) or the fair, reasonable and non-discriminatory provisions for ancillary services under the commitments. However the CAA acknowledged that the scope of premium service was unclear and in the absence of a licence there may be potential for GAL to introduce charges that act against passengers' interests.
- 2.87 Following the final proposals, the airlines raised concerns about GAL's proposals for Premium Service Charges and suggested these should be better defined. In response, GAL said it would normally offer such services under bilateral contracts but wished to retain the flexibility to provide additional services under a published tariff to those airlines

that did not have a bilateral contract. GAL clarified in the December commitments that any premium services will be offered in addition to Core Services either in bilateral contracts or under the COU. It also amended the definitions of Core Services and Core Service Charges to ensure that these services cannot be considered premium services in the future. The CAA considered that the changes proposed by GAL in the December 2013 commitments offered adequate protection to airlines with regards to Core Services and Core Service Charges, whilst retaining the flexibility for airlines to opt for additional services either within a bilateral contract or at a published price.

Representations on the proposed licence

- 2.88 The ACC noted that GAL had changed this condition but not as the ACC had requested. It still considered that GAL could tweak an existing service (for example, provide the service from a different part of the airport) and then seek to argue that it is a new service falling outside the Core Services. It suggested that this should be resolved by including additional text to ensure that this did not happen: “a service shall not cease to be a Core Service merely because substantially the same output is achieved through a different process (e.g. provision from a different location at the airport)”.

CAA’s response and final decision

- 2.89 The CAA does not consider that this clarification is necessary: in relation to the ACC’s example, moving the service to a different location in the first place could amount to removal of the service contrary to the definition of Core Services in paragraph 1.4 of Schedule 2 to the COU. The CAA continues to consider that the licence conditions are appropriate for the reasons set out above and has made no further changes to the condition set out in the proposed licence. However, should there be evidence in the future that GAL is trying to make changes of this nature without the agreement of the airlines, the CAA will consider making a change to the licence under the modification powers in section 22 of the Act.

Investment and consultation

The condition as set out in the December 2013 commitments

- 2.90 GAL has included in the commitments a minimum capex spend of £100 million per year on average for each year of the contract term to

ensure compliance with all applicable safety and environmental requirements and to maintain and develop the airport infrastructure to achieve the promised service standards. GAL retains sole responsibility for managing the capital investment and there is no binding programme of specific work and no triggers for non-expenditure on specific projects.

- 2.91 GAL will consult with airlines at a number of levels through appropriate groups and the Gatwick Passenger Advisory Group (PAG). The capex programme will be split into three main groups:
- major development projects over £10 million;
 - minor development projects under £10 million; and
 - asset stewardship programme – airfield, commercial, IT, facilities and compliance/risk.
- 2.92 GAL has committed to publishing five-yearly revisions to its 2012 Masterplan with timing dependent on government airport policy consultation or decisions. GAL will also publish annually a rolling five yearly capital investment programme (CIP), setting out the principal business drivers for the airport operator’s strategy, the forecast traffic demand and the capacities the airport operator intends to provide, as well as the forecast cost of the programme and the resulting effect on the airport operator’s asset base.
- 2.93 In forecasting the cost of the programme, GAL has committed to summarise expenditure on each major development project, minor development project and the aggregate expenditure on the asset stewardship programme, at a level of detail that reflects the planning horizon and status of each project. It will also provide an explanation of any material differences between the latest forecast compared to the previous year’s forecast and the CAA’s price review forecast.

Reasons for the condition

The proposed licence

- 2.94 The CAA noted in the final proposals that the September 2013 commitments did not include a commitment to any outputs from the capital plan apart from a maintenance of the service quality regime and a commitment to a minimum spend of £100 million per year over the term of the commitments. GAL's proposed spend under a RAB-

based framework is around £200 million per year and many of the schemes in that programme produce outputs that are not reflected in the service quality regime, for example the early bag store will provide the ability for early check-in; the international departure lounge (IDL) schemes will provide increased circulation space and new children's and outside areas; the check-in schemes will provide new bag drop facilities; the north terminal arrival scheme provides a much enhanced arrival area etc. While GAL has committed to provide an explanation as to any material differences between the latest CIP forecast and both the prior year forecast and the forecast incorporated in the CAA's price control review, it has not committed to any programme of specific capex. The CAA was therefore concerned that GAL could significantly reduce capex and not deliver the outputs that the CAA considers are in passengers' interests.

2.95 GAL responded that it was highly incentivised to deliver the CIP that it had set out in its business plan to help it compete for passengers and airlines. It noted that it has committed to maintain the airport to comply with all relevant environmental, health and safety standards and committed at least £700 million over the course of the commitments to deliver the core service standards. It also noted that its programme included a range of projects that were necessary to deliver the commitments, and that were agreed with airlines to deliver benefits to passengers and airlines, as well as other projects that were commercial revenue generating projects that did not require increases in charges.

2.96 The CAA acknowledged that the commitments provided GAL with some flexibility with regard to the investment programme and considered that provisions in the commitments, together with the licence requirement to comply with the commitments in passengers' interests should help to ensure that GAL undertakes its CIP in passengers' interests. However, the CAA remained concerned that the commitments did not include specific outputs from the capex programme beyond those in the service quality regime. The CAA said it would review GAL's capex performance to assess whether it is operating in passengers' interests, including seeking views on GAL's consultation processes, as part of its review of the commitments regime in 2016.

2.97 In response to airlines' concerns following the final proposals, GAL

included a consultation process in Schedule 4 to the COU covering a long term Masterplan, a rolling 5-year CIP and individual major developments. The CAA welcomed GAL's commitment to consult with airlines at different levels and with the Passenger Advisory Group (PAG). The CAA said it would expect GAL to carry out any consultation to ensure that stakeholders were fully informed of its plans and how it had taken their views into account.

Representations on the proposed licence

2.98 There were no further representations on this condition.

CAA's response and final decision

2.99 The CAA continues to consider that the licence conditions are appropriate for the reasons set out above and has made no further changes to the condition set out in the proposed licence.

Service quality rebate scheme

The condition as set out in the December 2013 commitments

2.100 The commitments include a service quality rebate (SQR) scheme based largely on the one used in Q5, but with a new outbound baggage measure and reweighting of attributes (both agreed with airlines). Total monthly rebates will be the same as those in Q5⁴⁹ and would be increased by 25% if service quality failures persist for more than six months, although they would fall to zero if there are more than six failures for a metric in one financial year. The commitments also allow for airline service quality penalties on check-in and arrivals bag performance, which would be funded by netting off airport rebates.

Reasons for the condition

CAA's proposed licence

2.101 The SQR scheme included airline service quality penalties on check-in queues and arrivals bag performance. The CAA supported coordination on service standards across the airport campus where this would not distort the functioning of an effective market, but noted that it does not have the locus in the Act to set standards on airlines.

2.102 The CAA made clear in its final proposals that, as part of its regime for

⁴⁹ Weights have changed for individual services but the overall total monthly rebate is the same as Q5.

monitoring the performance of the commitments, it would expect GAL to publish its performance against airport wide standards, including rebates paid. The CAA also said it would expect GAL to measure service quality in a way that furthered passengers' interests and to consult airlines on any changes to the approach taken in Q5.

- 2.103 The SQR scheme in the September 2013 commitments included monthly rebates at the overall level of those included in the Q5 settlement. The CAA was concerned that the limits placed in the commitments on the total rebates payable, the absence of rebates if failures continue for more than six months in a financial year and the offsetting impact of airline service quality failures might reduce GAL's liability for repeated service quality failures, which may act against passengers' interests. The airlines also objected to the GAL proposal that core service rebates would not be paid to airlines that fail to achieve airline standards and that future rebates will not be paid if there are outstanding rebates from such airlines to GAL. The CAA noted that GAL had not amended the December commitments regarding these rebate issues. The CAA considered that, as it does not regulate the airline service standards, it should be up to the parties involved to resolve this issue themselves, using the dispute mechanism if necessary. However, the CAA said it will monitor the impact of these provisions as part of its monitoring regime, in particular whether they are reducing GAL's liability for repeated service quality failures. Should the CAA's concerns be realised, it could take further action either through its enforcement powers or through a section 22 licence modification.
- 2.104 The CAA accepted GAL's December 2013 commitments on service quality. Many of the parameters of the core service quality were either based on Q5 or had been agreed with airlines. The CAA reiterated its plans set out in the final proposals to monitor performance of the SQR scheme as part of its review to ensure that the commitments are working in passengers' interests. The CAA said it will not hesitate to take action if it considers that there is detriment to passengers that is not being addressed through contractual mechanisms. As rebates can fall to zero if there are six or more failures of a service quality metric in a financial year, the CAA also said it will investigate any repeated service quality failures of this duration and take enforcement action if required.

- 2.105 At the time of the proposed licence, GAL and the airlines had agreed the outstanding core service levels apart from the pier service levels.⁵⁰ The CAA considered it was important for GAL and the airlines to agree the pier service levels as quickly as possible, otherwise there is a risk that performance in this service will suffer. If this could not be agreed by the time the licence comes into force, the CAA said that it would consider imposing a pier service level using its powers under section 22 of the Act.
- 2.106 The airlines also stated that they did not agree with GAL's proposals on the publication of passengers with reduced mobility (PRM) and pre-notification figures. They considered they should not be judged on pre-notification figures as passengers can request assistance without pre-notification and that it would be better to publish performance against the service level agreement negotiated with GAL. The CAA noted that the PRM service is primarily an airport operator's responsibility. It also noted that GAL, as with many other airport operators, might choose to adopt two standards: one for the performance of its PRM service where passengers pre-notify; and one for where passengers do not pre-notify.

Representations on the proposed licence

- 2.107 The ACC noted that there were still some outstanding issues.
- It continued to oppose what it called arbitrary airport operator-imposed airline standards which interfered with airline competition. These are included in GAL's Airline Standards Calculation Guide. There remains significant disagreement both with the standards unilaterally set by GAL and with measurements issues they wish to incorporate. The ACC considered that Appendix II to the COU and the Guide should be left blank and adopted by agreement in due course.
 - It had still not agreed the pier service levels with GAL and it remained of the view that the standard for each terminal should be 95% and changes to this number must be agreed on a case-by-case basis when major project works impact on the deliverable pier service levels.

⁵⁰ Outbound baggage service levels had been agreed but not included in the December commitments.

- It also noted that although it had agreed the outbound baggage metric with GAL, it has not yet seen an updated COU with the agreed metric included. Whilst target measures had been agreed, there was still some disagreement on the exemptions that GAL would like to include.
- GAL had now supplied the Gatwick Airport Core Service Standards Handbook but there continued to be outstanding disagreements between the ACC and GAL.

CAA's response and final decision

2.108 The CAA remains of the view that these service quality issues should be resolved by agreement between GAL and the airlines as soon as possible and included in the COU through the self-modification provisions as soon as the licence is in force. The CAA considers that any action by the CAA to include service quality standards where there currently are none in the licence at this stage could be a significant change to the proposed licence and may require re-consultation. However, if there is no agreement on these matters when the licence comes into force on 1 April 2014, the CAA will begin the process to make any necessary modifications to the licence under section 22 of the Act. The CAA reiterates its position that it does not regulate the airline standards and so would not expect to get involved in this area unless there was evidence that this was distorting the functioning of an effective market. Any modifications relating to this would concentrate on whether the airline standards were reducing GAL's liability for repeated service quality failures and, if so, on actions required to redress that situation.

2.109 The CAA continues to consider that the licence conditions are appropriate for the reasons set out above and has made no further changes to the condition set out in the proposed licence.

Dispute resolution

The condition as set out in the December 2013 commitments

2.110 Airlines will be able to obtain remedies as part of the contractual arrangements in the COU, including recourse to the courts. Airlines will also have rights of redress under the ACRs where GAL has failed to set airport charges in accordance with those regulations. The CAA can also investigate and give compliance orders under those

regulations.

- 2.111 GAL has also included a provision allowing faster resolution of disputes through non-binding adjudication by independent experts. The process proposed for this adjudication follows that set out in section 108 of the Housing Grants Construction and Regeneration Act 1996 (the 1996 Act). The findings of the dispute resolution process are binding until determined by legal proceedings or are agreed by the parties and do not prevent either party from seeking urgent relief from the court.

Reasons for the condition

CAA's proposed licence

- 2.112 The CAA considered that the dispute resolution provision offered in the commitments addressed the CAA's previous concerns around the airlines' rights of redress and offered a suitable alternative to seeking redress through the courts for the adjudication of disputes.
- 2.113 Following concerns raised by the airlines regarding the requirement to follow the dispute mechanism, GAL amended the provisions in the December commitments to clarify that the dispute mechanism is optional. The CAA welcomed GAL's amendment.
- 2.114 In response to the final proposals, the airlines considered that the time limit of 90 days for bringing disputes to court after expert determination was unreasonable, given that, in normal contractual relationships, the limit would be 6 years. They stated that it would be very difficult to coordinate the airlines' position and bring a dispute in such a short time period. The CAA considered that the limit on parties bringing disputes to court after expert determination was not unreasonable, ensuring that once disputes have started they can be resolved in a timely manner. In such cases, the CAA considered that the facts of the case will have been gathered and the airlines would have already coordinated their position with regards to the dispute. A 90-day period was similar to the period in which parties must seek a Judicial Review so the CAA did not consider this was an unreasonable time limit. The CAA also noted that this provision did not limit the period in which the dispute can be referred to either the expert or the court in the first place, but only limited the ability to continue a dispute once it had started.

Representations on the proposed licence

2.115 There were no further representations on this condition.

CAA's response and final decision

2.116 The CAA continues to consider that the licence conditions are appropriate for the reasons set out above and has made no further changes to the condition set out in the proposed licence.

Operational resilience**The condition as set out in the December 2013 commitments**

2.117 GAL has committed, in consultation with relevant parties, to developing, publishing and maintaining an operational resilience plan setting out how it will operate an efficient and reliable airport to the levels required by the Core Service Standards or otherwise agreed with service providers and, in particular, how it will secure the availability and continuity of airport operation services, particularly in times of disruption. In developing this plan and associated documents, GAL will have regard to any relevant guidance issued by the CAA.

2.118 GAL will, so far as reasonably practical, coordinate and cooperate with all relevant parties to deliver this operational resilience commitment, including at least two meetings a year to discuss any issues pertinent to this commitment.

2.119 GAL also requires all airlines and groundhandlers to use all reasonable endeavours to cooperate in implementing the plans during periods of disruption. Under the provisions of the commitments condition in the licence, these obligations on third parties are not considered to be licence conditions and as such are not enforceable by the CAA.

Reasons for the condition*CAA's proposed licence*

2.120 The CAA considered that a licence condition on operational resilience was necessary as part of a wider industry framework for dealing with disruption, which could best be managed effectively through collaboration by all parties with clear leadership and coordination from GAL as the central hub organisation. The CAA's reasons for including

an operational resilience condition in the licence were set out in detail in chapter 14 of the CAA's initial proposals published in April 2013. In summary, examples of poorly managed events at airports generally over the last few years have shown that operational resilience is necessary as part of the wider industry framework for dealing with disruption. There needs to be a much more coordinated approach with the airport operator having a central role in planning and coordinating the industry's response. To achieve this, GAL should be required to plan for, and coordinate the wider industry response to, disruption. The CAA considers that, with good collaboration, clear expectations and plans setting out relevant roles and responsibilities, coupled with effective application of the denied boarding regulations, this will be a significant step forward towards a more efficient whole industry response. This is likely to be an on-going process that will need time to develop fully.

- 2.121 In the final proposals, the CAA was concerned that the commitments included a requirement to have regard to, rather than comply with, any guidance issued by the CAA when developing operational resilience plans. The CAA considered that this could allow GAL to develop operational resilience plans that were not in passengers' interests.
- 2.122 In the proposed licence, however, the CAA said it was generally content with GAL's December 2013 commitments on operational resilience which, in setting out how GAL intends to run an efficient and reliable airport to the levels required by the Core Service Standards or otherwise agreed with service providers and how it will secure the availability and continuity of airport operation services, particularly during disruption, is consistent with the operational resilience condition proposed in the CAA's initial proposals. The CAA noted that GAL was still only committing to have regard to any guidance issued by the CAA rather than to comply with guidance. As neither the licence nor the commitments place any formal caveats with regards to consultation by the CAA before any guidance is issued⁵¹, the CAA accepted the commitments as proposed. However, the CAA noted that, in the event of any enforcement action, it would take into consideration the extent to which GAL has had regard to any guidance issued by the CAA.
- 2.123 Throughout the consultation process, the CAA has stated that

⁵¹ Although as good practice the CAA would normally consult before issuing such guidance.

operational resilience at airports needed strong, centralised leadership to coordinate planning for and response to disruption. It also stated that it was clear this role is best suited to the airport operator with its direct links to all the service providers at the airport. In the proposed licence, the CAA stated that in requiring GAL to take on this responsibility and associated accountability, it recognised that GAL needed to be able to set out reasonable expectations of what it requires from its partners in this area to ensure an effective whole industry response. As far as possible, the CAA considered that these expectations should be developed jointly and be agreed on a voluntary basis but that ultimately it should be up to GAL to understand the requirements of the airport and, as far as possible, its stakeholders during disruption and to take strong leadership decisions.

- 2.124 In the proposed licence, the CAA noted that disruption can be caused by many different factors, including severe weather⁵², industrial action, security incidents, cyber attack, accidents at the airport or even incidents at facilities remote from the airport upon which the airport relies.⁵³ Therefore, the CAA would expect to see that GAL has risk assessments for the infrastructure under its control and for all the services it offers at the airport, with clear management processes and clear communication plans in place for remedying and dealing with the impacts of loss of that infrastructure or service. These processes and plans should also include dissemination of information to passengers and a provision of a 'backstop' level of passenger welfare where the airlines are slow or unable to do so. If these are in place, in the event of any investigation, the CAA would normally expect to concentrate on how well the company had reacted to, and managed the event. However, if the plans are not adequate, the CAA will take proportionate regulatory action, from requiring changes to the plans to taking enforcement action under the Act.
- 2.125 The CAA considered that where services were provided by a third party and GAL only acted as a landlord for the facilities (such as fuel supply or groundhandling services), the CAA would not expect GAL to have contingency plans for ensuring continuity of supply of those services. However, the CAA would only expect GAL to have plans for

⁵² For example, the flooding which caused disruption on Christmas Eve 2013.

⁵³ For example, an accident at a major oil storage depot or disruption to the fuel pipeline could have a significant effect on fuel supply to the airport.

the effect that disruption to those services would have on its own operations.

- 2.126 In particular, the CAA said it would expect GAL to have contingency plans for loss, for whatever reason, of:
- access to key infrastructure at the airport (such as the terminals, runway or airfield);
 - IT systems;
 - key suppliers; and/or
 - key staff (including UK Border Force (UKBF)).
- 2.127 The CAA also made it clear that, in order for resilience plans to work effectively, within the high-pressure environment caused by disruption, they must be underpinned by solid day-to-day working relations, possibly through the development of formal business continuity models. It noted that the government's guidance on resilience⁵⁴ states that "business continuity management must be regarded as an integral part of an organisation's normal on-going management processes." Therefore, the requirement goes wider than times of disruption and the CAA would expect GAL to maintain clear working arrangements with relevant parties. The CAA noted that this will be addressed by GAL's commitments to have a plan setting out how it intends to run an efficient and reliable airport to the levels required by the Core Service Standards or otherwise agreed with other service providers.
- 2.128 GAL has committed to having regard to any guidance issued by the CAA. The CAA considered that the preceding paragraphs constitute guidance on what it expects GAL to include in its resilience plans. The CAA did not propose to issue further guidance at this stage, beyond what is included in this notice⁵⁵, but said it may do so if the need arises, for example following any recommendations from its review of GAL's report on the disruption on Christmas Eve 2013. In addition to issuing guidance, the CAA considered that it should retain a right to require GAL to review and revise the plan if it considered that the plan was likely to fall short of meeting the high level outcome or has been

⁵⁴ <https://www.gov.uk/resilience-in-society-infrastructure-communities-and-businesses>

⁵⁵ The CAA will publish the guidance set out in this notice as a separate notice once the licence is in force.

found wanting following practical experience. The CAA would expect GAL to make the required changes voluntarily in the first instance but, if necessary, may use its powers under the Act to either modify the licence or to take formal enforcement action.

- 2.129 Earlier versions of the commitments required airlines to take the actions allocated to them during disruption. The CAA had concerns that this could allow GAL to exert its SMP over airlines, particularly in a way that was not in the interests of passengers. This was because the airlines were required to take the actions allocated to them in the plans but these did not have the same safeguards that were included in the proposed licence condition. For example, the proposed licence condition made clear that any ‘rules of conduct’ must be proportionate and relate specifically to the purpose of the licence condition to secure the availability and continuity of airport operation services to further the interests of passengers and that GAL must consult on any rules.
- 2.130 GAL’s December 2013 commitments largely follow the principles in the proposed licence condition. GAL will set out within the resilience plans the principles, policies and processes for securing the availability and continuity of airport operation services which it will develop in consultation with all relevant parties. GAL also amended the December 2013 commitments to require the airlines to use best endeavours to cooperate with GAL in implementing the plans, rather than requiring the airlines to comply. The CAA therefore no longer had concerns that GAL could use these provisions to exert its SMP over the airlines. However, the CAA expected GAL to ensure that the actions were applied in a proportionate manner to the various airlines and groundhandlers.⁵⁶ In addition, the CAA reiterated that the actions should not require airlines to do more than is required of them under other legislation, such as their welfare obligations under EU261.⁵⁷
- 2.131 The CAA noted that the requirements on third parties in the commitments to cooperate with GAL in implementing the plans would not be conditions of the licence as the licence cannot put obligations

⁵⁶ By proportionate, the CAA means proportionate to the requirements of an event as well as proportionate to the services offered by each stakeholder.

⁵⁷ Regulation (EC) No 261/2004 of the European Parliament and of the Council of 11 February 2004 establishing common rules on compensation and assistance to passengers in the event of denied boarding and of cancellation or long delay of flights, and repealing Regulation (EEC) No 295/91.

on third parties. It would be up to GAL to decide how to conduct its relations with airlines so as to comply with its commitments and its licence requirements.

- 2.132 The licence requires GAL to comply in a manner designed to further the interests of passengers so the CAA could intervene if GAL exerted its SMP to the detriment of passengers. Furthermore, the CAA has concurrent powers under the Competition Act 1998 to address abuse, particularly where this results in a distortion of competition.

Representations on the proposed licence

- 2.133 There were no further representations on this condition.

CAA's response and final decision

- 2.134 The CAA continues to consider that the licence conditions are appropriate for the reasons set out above and has made no further changes to the condition set out in the proposed licence.

Financial conditions: regulatory accounts and continuity of service plan

The condition as set out in the December 2013 commitments

- 2.135 The December 2013 commitments include a provision to publish detailed statutory accounts consistent with GAL's status as a UK registered company that will provide information for airlines, the CAA and other users of those accounts to undertake an analytical review of GAL's on-going business performance, capital investment and financial returns and to assess whether GAL's charges are reasonable. GAL will not publish separate regulatory accounts but to ensure a consistent approach, GAL will publish the same information in its accounts as was included in the 2011/12 statutory accounts with regards to the operating costs, revenues, fixed asset base, depreciation and capex.
- 2.136 GAL will publish the value of its asset base and the underlying assumptions. The CAA will ask GAL to undertake a shadow RAB calculation to use as part of its ongoing monitoring regime.
- 2.137 GAL will also provide to users of Specified Activities, PRM Services, Check-in & Baggage Storage Facilities,⁵⁸ and to the CAA, an annual

⁵⁸ As defined in the COU.

statement of actual costs and revenues in respect of each of these activities for the previous financial year.

- 2.138 GAL has also committed to preparing and maintaining a continuity of service plan (CSP) describing the legal, regulatory, operational and financial information that an administrator, receiver or new management might reasonably be expected to require, including the aerodrome manual and any other statutory or regulatory documents that GAL is required to maintain. GAL will make such amendments to the form, scope and content of the plan as the CAA may reasonably require.

Reasons for the condition

CAA's proposed licence

- 2.139 The commitments offered in September 2013 included a requirement to publish the value of the asset base and the underlying assumptions and calculations. The CAA considered that this was not sufficient for the calculation of the RAB, which could be different to the statutory asset base for a variety of reasons. The CAA also considered that the continued calculation of the RAB was important should any subsequent RAB-based regulation be required.
- 2.140 The CAA noted that it would be possible for airlines to monitor prices, as the overall revenue from airport and other traffic charges would be available in GAL's statutory accounts. GAL also committed to publish the cumulative revenue difference (including underlying actuals data) for both the blended and published charge basis. The CAA considered that this, together with reporting requirements under the ACRs, would provide airlines with sufficient information to challenge GAL's calculations should they wish to do so. While GAL stated in its response that it would prepare a shadow RAB calculation for the CAA up to 2016, this was not included in the heads of terms of the commitments or the December COU. The CAA considered it was important that GAL continues to undertake a shadow RAB calculation until it considered that GAL no longer meets the MPT. This calculation will be useful in case tighter price control regulation needs to be reintroduced. The CAA said it will therefore continue to ask GAL to undertake a shadow RAB calculation throughout the commitments period, if necessary using its information powers under section 50 of the Act.

- 2.141 The CAA noted that a continuity of service plan (CSP) was included in the commitments and this sufficiently addressed the CAA's concerns regarding continuity of service should GAL find itself in financial distress. The CAA considered that the benefits of including a licence condition in addition to the commitment are unlikely to outweigh the costs. The CAA therefore proposed that the licence did not include a condition in respect of a CSP.

Representations on the proposed licence

- 2.142 There were no further representations on these conditions.

CAA's response and final decision

- 2.143 The CAA continues to consider that the licence conditions are appropriate for the reasons set out above and has made no further changes to the condition set out in the proposed licence.

Part D: Financial Conditions

Financial resilience condition

The licence conditions

- 2.144 The following elements of the standard regulatory financial ring fence are included in GAL's licence:
- a requirement to provide an annual certificate of adequate resources;⁵⁹
 - a restriction on business activity;⁶⁰
 - an ultimate holding company undertaking;⁶¹ and

⁵⁹ GAL's company directors must annually certify to the CAA whether they expect to have (or not to have) adequate resources (including financial, staff and other resources) to continue to operate for the following 24 months. Where circumstances change, the CAA must be informed as soon as possible. The CAA proposed that this requirement can be designed to reduce any administrative burdens.

⁶⁰ The proposed condition sets the restriction quite widely to cover 'the business activities of Gatwick airport'. The proposed condition also includes a de minimis qualification and/or provision for the CAA to grant exemptions, where this would be in passengers' interests.

⁶¹ The proposed condition places an obligation on GAL to obtain a legally binding undertaking from its ultimate holding company not to do anything that would place the Licensee in breach

- an obligation to report changes in the banking ring fence.

Reasons for the licence condition

CAA's proposed licence

2.145 In paragraphs 11.37 to 11.58, the CAA explained why it considered that a full regulatory ringfence condition was not required for the GAL licence and proposed a more tailored condition that did not cut across GAL's existing financial arrangements. The CAA considered it was important to include in this condition the elements listed above.

2.146 GAL included provisions on financial resilience in early versions of the commitments but these did not include all the elements that the CAA considered important. The provisions did include:

- provisions which would require GAL to provide an annual confirmation of adequate resources to operate the airport and to give prior written notice to the CAA if it intends to amend, vary or supplement any of its finance documents in respect of credit rating requirements;
- a requirement to notify the CAA of any variations in the banking ring fence that relate to the credit rating requirement. However if the protection in the banking ring fence changes, in the absence of a licence, there would be nothing the CAA could do to replace that protection. This commitment therefore would only be effective if the commitments were underpinned by a licence; and
- a requirement for the directors to provide an annual certificate of adequate financial resources. However, there was no indication of the time period to be covered. The CAA considered that unless the certificate covered a period of at least two years then there was a risk that there would be insufficient time for remedial action to be taken if issues arose.

2.147 However, the early versions of the commitments did not include:

- a requirement to obtain a holding company undertaking. GAL questioned the benefit of a holding company undertaking given the ownership structure of GAL. The CAA considered that a holding company undertaking is required to prevent the airport operator

of the licence.

from being open to pressure by a holding company to do something which is not consistent with passengers' interests. The CAA did not consider that GAL's current ownership, which could change during Q6, negates the need for this requirement;

- a restriction on business activities as GAL stated that the finance documents include a similar restriction. The CAA was concerned that the finance documents could change, and in the absence of licence protection, remove the protection to passengers.

2.148 The CAA considered that the financial resilience conditions as set out in the final proposals continued to be appropriate in the absence of commitments that could address the CAA's objectives robustly. Therefore, in the proposed licence, the CAA included a separate condition in the licence relating to financial resilience. The CAA considered that these set the right balance between the benefits and costs of facilitating resilience.

Annual certificate of adequacy of resources

2.149 The commitments included an adequacy of resources certificate but it did not state the future period to which this relates. The CAA considered that 24 months was appropriate as it gave the CAA adequate time in which to work with stakeholders and take any action that might be appropriate. The CAA therefore proposed that the licence include a condition requiring a certificate of adequate resources that GAL would have sufficient resources to provide airport operation services at the airport for 24 months. The CAA included a requirement that alongside the certificate GAL should also submit a statement of the factors the directors had taken into account in providing that certificate. This would enable the CAA to assess better the certificate provided.

2.150 GAL considered that requiring a certificate of adequate resources for the next 24 months was not proportionate and suggested this should be 18 months instead. The CAA noted GAL's concerns and said it understood that GAL's banking and bond covenants required it to maintain 12 months' liquidity. However, the CAA noted that its licence condition for adequate resources covers something slightly different - it was not a liquidity requirement but rather that management has the reasonable expectation that it has adequate resources, including financial and operational, for the next 24 months. This does not mean

that it has to have cash in place today, for example, to redeem a bond in 23 months' time, but rather that it has the reasonable expectation that it will have resources in place in time. In effect, management would be confirming that they expect over the next 24 months that the business has sufficient resources to operate.

- 2.151 The annual certificate covering 24 months means that the minimum oversight is approximately 12 months (i.e. the day before the next certificate is produced). If an annual certificate was provided covering only 12 months then towards the end of those 12 months the CAA would have very little forward visibility.
- 2.152 The CAA considered whether an alternative formulation could meet its needs. Alternatives included:
- a certificate covering 12 months but produced quarterly;
 - a 12-month certificate, but a requirement to assess whether the latest certificate still holds true if issued today; and
 - a requirement for a tougher requirement covering the first 12 months and a looser requirement covering the subsequent 12 months.
- 2.153 The CAA considered that none of these provided any material benefit to passengers compared to the CAA's proposals but all were more complex and/or burdensome than the final proposals.
- 2.154 Following representations from airlines that the annual certificate should link to the Core Services rather than airport operation services, the CAA considered that the definition in the Act of airport operation services was wider than that of Core Services in the commitments and, as a new certificate is required annually, this would cover all the Core Services required in the coming year. The CAA therefore did not change this obligation.

Restriction on business activities

- 2.155 The commitments did not include a restriction on the business activities of GAL, as GAL stated that the finance documents include a similar restriction. The CAA was concerned that the finance documents could change, and in the absence of licence protection, remove the protection to passengers. Although it is difficult to tightly define the business activities of an airport operator, the CAA saw merit

in restricting GAL to operating Gatwick and prohibiting it from clearly unrelated activities. Other group companies would remain free to undertake whatever activities they wished. The CAA proposed to set the restriction quite widely to cover “the business activities of Gatwick airport”. The CAA also proposed the inclusion of a de minimis qualification and/or provision for the CAA to grant exemptions, where this would be in the passengers’ interests.

Ultimate holding company undertakings

- 2.156 The commitments did not include an obligation for GAL to obtain legally binding undertakings from holding companies not to do anything that would cause GAL to breach its licence. GAL remained of the view that it was not necessary and was not a useful or proportionate method of addressing the risk of excessive pricing or failure in service standards. The CAA considered that this was an important condition which went wider than just financial resilience. The CAA noted GAL's concerns about the appropriateness because of its corporate structure, but also noted that such an obligation is widespread in other regulated sectors where there is a range of corporate structures. The CAA stated that it would work with GAL to identify those companies in its corporate structure which would be required to give such an undertaking. The CAA proposed that the licence includes an obligation for GAL to obtain legally binding undertakings from holding companies not to do anything that would cause GAL to breach its licence.
- 2.157 The commitments did not include a restriction on the business activities of GAL. GAL questioned the CAA’s proposals to replicate the business restrictions in the licence when there are already debt covenants with similar restrictions. Although it was difficult to tightly define the business activities of an airport operator, the CAA saw merit in restricting GAL to operating Gatwick and prohibiting it from clearly unrelated activities. Other group companies would remain free to undertake whatever activities they wished. The CAA proposed to set the restriction quite widely to cover “the business activities of Gatwick airport”. The CAA also proposed the inclusion of a de minimis qualification and/or provision for the CAA to grant exemptions, where this would be in passengers' interests.
- 2.158 The licence condition also required GAL to bring to the attention of the CAA as soon as possible if it has reasons to believe that the latest

certificate no longer holds true. Combined with the annual certificate this means that the CAA has early sight of any issues and can work with stakeholders to minimise any disruption or deterioration in service and thus act in passengers' interests.

- 2.159 The CAA also considered that the financial resilience licence conditions should be considered as a whole. Other regulated sectors, such as water, energy and NATS (En Route) plc, have more extensive financial resilience licence conditions and special administration regimes. For airports there is no special administration regime and the proposed resilience conditions do not go as far as other sectors (for the reasons explained in the initial and final proposals). As a consequence, the CAA needs to place greater reliance on this licence condition and therefore it is appropriate that it covers a longer period than found in some other sectors.

Obligation to report changes in the banking ringfence

- 2.160 The CAA considered that the commitment given by GAL, that it would notify the CAA of any changes in the banking ringfence relating to the credit rating, was sufficient to meet the CAA's objective in this respect and therefore did not need to be included in the licence.

Representations on the proposed licence

- 2.161 GAL provided a representation on condition D1.2 in relation to the certificate of adequacy of resources. It noted that in each of (a), (b) and (c), the following wording is added at the end of the certificate: "of which the Licensee is aware or could reasonably be expected to make itself aware it is or will be subject for a period of two years from the date of the certificate". GAL noted that these words were taken from the NERL licence and related to the preceding wording "to enable the Licensee to comply with its obligations under the Act and under its licence". GAL considered that this wording did not work in its licence where the preceding wording is "to provide airport operation services at London Gatwick". It suggested that this might be better drafted by deleting the wording and amending the preceding wording to "to provide airport operation services at London Gatwick Airport in accordance with the Commitments".
- 2.162 GAL also proposed that under condition D1.7, Ivy BidCo Limited is the Covenantor, but was happy to discuss this with the CAA.

CAA's response and final decision

- 2.163 The CAA does not consider that the certificate of adequacy of resources should be limited to only those airport operation services that are included in the commitments GAL has made to airlines. Airport operation services in the Act include a number of services that are not explicitly covered by the commitments but which are essential to the efficient running of the airport and the passenger experience, such as the provision of facilities for car parking, shops and other retail businesses, provision of groundhandling services, as well as permitting access or use of land or use of land that forms part of the airport or facilities for the purposes of airport operation services. The certificate of annual resources therefore needs to cover resources GAL needs to have to meet its obligations to all service providers, not just the airlines. The CAA has therefore made no changes to the condition that was included in the proposed licence.
- 2.164 The CAA is content with GAL's suggestion that Ivy BidCo Limited is the Covenantor. This does not require any changes to the licence.
- 2.165 The CAA continues to consider that the licence conditions are appropriate for the reasons set out above and has made no further changes to the condition set out in the proposed licence.

Other issues raised

"Insurer of last resort"

CAA's proposed licence

- 2.166 In their response to the initial proposals, the airlines urged the CAA to remove GAL's unilaterally imposed condition in the COU relating to liability and replace it with a condition which they felt would be present in any normal commercial relationship between a customer and supplier.
- 2.167 The airlines noted in their responses to the final proposals that the commitments still place the burden of "insurer of last resort" on the airlines. They contended this was inconsistent with normal commercial relationships where the supplier would have liability for direct costs incurred by its customers through the supplier's negligence or under performance. They also considered that the clause on waivers was too one-sided now that the commitments also placed obligations on GAL, and should be extended to all parties.

- 2.168 GAL has now removed from the COU the condition requiring airlines to indemnify GAL against all costs etc arising from a breach of the COU or the requirements of any Managing Director's Instructions (MDI) or Gatwick Airport Directives. However, the clause regarding waivers remains pertinent to GAL only, rather than to all parties and the condition absolving GAL from all liability remains unchanged. The CAA noted the airlines' concerns about the clauses on waivers and liability, but notes that these are conditions of the existing COU and not part of the commitments that will also be licence conditions.

Representations on the proposed licence

- 2.169 There were no further representations on this point.

CAA's response and final decision

- 2.170 The CAA considers that no change is necessary to the COU for the reasons given above.

Summary of any changes made to the licence as a result of representations made to the proposed licence

Part A: Scope and Interpretation

- 2.171 The CAA is proposing to include the core area of the airport (as defined in section 5(4) of the Act), but exclude the cargo and aircraft maintenance areas, in the airport area covered by the licence. The CAA is not making any changes to this part of the licence.

Part B: General Conditions

- 2.172 The CAA has not made any changes to the payment of fees condition or to the revocation condition, compared to those set out in the final proposals. The CAA is not making any changes to this part of the licence.

Part C: Commitment Conditions

- 2.173 The CAA is including a licence condition that incorporates the commitments and requires them to be included in the Gatwick Airport COU. GAL must comply with the commitments in a manner designed to further the interests of passengers, so far as reasonably practicable. GAL is restricted with regards to the changes that can be made to the commitments, and is restricted in the level of costs of a future second

runway that it can pass through automatically to the airlines. The CAA has made the following changes to the condition:

- C1.5(b) and C1.8: clarifying that allowed recovery of second runway costs up to £10 million per year is explicitly £10 million per charging year, not a cumulative £70 million over 7 years that can be spent at any time.
- C1.5(b), C1.8, C1.9 and C1.11(d): changing the term “pass through of second runway costs” to “recovery of second runway costs” for clarity.
- C1.11(x): correcting the name of the Annex to the Conditions of use to the agreed “Gatwick Airport Core Service Standards Handbook”.

Part D: Financial Conditions

- 2.174 The CAA has included a financial resilience condition as set out in the initial proposals, and included a requirement to inform the CAA if GAL was to seek advice on insolvency. The CAA is not making any changes to this part of the licence.

Licence for GAL

- 2.175 The licence is set out in Chapter 3 and the December 2013 commitments are set out in Appendix K.

CHAPTER 3
The licence and conditions

Licence granted to

GATWICK AIRPORT LIMITED

by the Civil Aviation Authority

under section 15 of the Civil Aviation Act 2012

on 13 February 2014

Part A: Scope and interpretation of the Licence

A1 Scope

- A1.1 The CAA has made a market power determination under section 7 of the Act on 10 January 2014 that means, for the purposes of section 3 of the Act, Gatwick Airport Limited (the Licensee) is the operator of a dominant airport area at a dominant airport.
- A1.2 The Airport (as defined in sections 66 and 67 of the Act) is London Gatwick Airport.
- A1.3 The Airport Area is those areas of the Airport, that comprise:
- (a) the land, buildings and other structures used for the purposes of the landing, taking off, manoeuvring, parking and servicing of aircraft excluding the aircraft maintenance facilities at hangar 6 maintenance area 1 and hangar 7 maintenance area 2; and
 - (b) the passenger terminals.
- A1.4 The CAA, in exercise of the powers conferred by section 15 of the Act, hereby grants to the Licensee this Licence authorising the Licensee and those persons listed in section 3(3) of the Act, to require a person to pay a relevant charge in respect of airport operation services that it provides at the Airport, subject to the conditions of this Licence.
- A1.5 This Licence shall come into force on 1 April 2014 and shall continue in force until revoked in accordance with Condition B2 of this Licence.

A2 Interpretation

- A2.1 Unless specifically defined within this Licence or in the Act or the context otherwise requires, words and expressions used in the Conditions shall be construed as if they were an Act of Parliament and the Interpretation Act 1978 applied to them. References to an enactment shall include any statutory modification or re-enactment thereof after the date of the coming into effect of this Licence.
- A2.2 Any word or expression defined for the purposes of any provision of Part I of the Act shall, unless the contrary intention appears, have the same meaning when used in the Conditions.
- A2.3 Any reference to a numbered Condition or Schedule is a reference to the Condition or Schedule bearing that number in this Licence, and

any reference to a paragraph is a reference to the paragraph bearing that number in the Condition or Schedule in which the reference occurs.

- A2.4 In construing the provisions of this Licence, the heading or title of any Condition, Schedule or paragraph shall be disregarded.
- A2.5 Where the Licensee is required to perform any obligation by a specified date or within a specified period and has failed to perform, such obligation shall continue to be binding and enforceable after the specified date or after expiry of the specified period, but without prejudice to any rights or remedies available against the Licensee under the Act or this Licence by reason of the Licensee's failure to perform by that date or within the period.
- A2.6 The provisions of sections 74 and 75 of the Act shall apply for the purposes of the publication or sending of any document pursuant to this Licence.

A3 Definitions

- A3.1 In this Licence:
- (a) the Act means the Civil Aviation Act 2012; and
 - (b) the CAA means the Civil Aviation Authority.

Part B: General Conditions

B1 Payment of fees

- B1.1 The Licensee shall pay to the CAA such charges and at such times as are determined under a scheme made under section 11 of the Civil Aviation Act 1982 in respect of the carrying out of the CAA's functions under Chapter I of the Act.

B2 Licence revocation

- B2 The CAA may revoke this Licence in any of the following circumstances and only in accordance with sections 48 and 49 of the Act:
- (a) if the Licensee requests or otherwise agrees in writing with the CAA that the Licence should be revoked;

- (b) if:
- (i) the Licensee ceases to be the operator of all of the Airport Area; or
 - (ii) the Airport Area ceases to be a dominant area; or
 - (iii) the Airport ceases to be a dominant airport;
- (c) if the Licensee fails:
- (i) to comply with:
 - 1. an enforcement order (given under section 33 of the Act); or
 - 2. an urgent enforcement order (given under section 35 which has been confirmed under section 36); or
 - (ii) to pay any penalty (imposed under sections 39, 40, 51 or 52 of the Act) by the due date for any such payment,

where any such a failure is not rectified to the satisfaction of the CAA within three months after the CAA has given notice in writing of such failure to the Licensee, provided that no such notice shall be given by the CAA before:
 - (iii) the proceedings relating to any appeal under section 47 of the Act brought in relation to the validity or terms of an order or the CAA's finding or determination upon which it is based are finally determined; or (as the case may be);
 - (iv) the proceedings relating to any appeal under sections 47 or 55 of the Act brought in relation to the imposition of a penalty, the timing of the payment of the penalty or the amount of the penalty are finally determined.

Part C: The commitment conditions

C1 Commitments

- C1.1 The Commitments are conditions of this Licence and shall be set out in the Conditions of Use.
- C1.2 Obligations placed on third parties in the Commitments shall not be

treated as conditions of this Licence.

- C1.3 In complying with this Condition C1 and the Commitments the Licensee shall, so far as reasonably practicable, do so in a manner designed to further the interests of passengers regarding the range, availability, continuity, cost and quality of airport operation services.

Modification of the Commitments

- C1.4 The Licensee shall not modify the Commitments otherwise than in the circumstances set out in the modification provisions of the Commitments.
- C1.5 The modifications that can be made under Condition C1.4 are modifications set out in the modification provisions of the Commitments at:
- (a) paragraph 6.1 of Schedule 2 to the Conditions of Use (price commitments);
 - (b) paragraph 6.2 of Schedule 2 to the Conditions of Use (recovery of second runway costs in the price commitments) up to a total limit of £10 million in any one charging year;
 - (c) paragraph 5 of Schedule 3 to the Conditions of Use (service commitments); and
 - (d) the final paragraph in Schedule 3 Appendix I to the Conditions of Use (core service standards).
- C1.6 Modifications can be made to the Commitments under Condition C1.4 at any time.
- C1.7 Where the CAA makes any changes to the conditions of this licence under section 22 of the Act, the Licensee shall, as soon as reasonably practicable and subject to the outcome of any appeal to the Competition and Markets Authority under section 25 to 30 of the Act, make any necessary consequential changes to the Conditions of Use.

Recovery of second runway costs

- C1.8 Where a provision in the Commitments at paragraph 6.2 of Schedule 2 to the Conditions of Use allows any amendments to the Indicative Gross Yield Profile to allow for the recovery of second runway costs, any such amendments necessary to recover expenditure by the Licensee above the £10 million in any one charging year allowed

under Condition 1.5(b) shall be subject to the modification provisions under sections 22 to 30 of the Act.

- C1.9 The CAA may, following consultation, issue guidance to the Licensee with regard to the recovery of second runway costs.
- C1.10 Where the Licensee requires a modification to the Indicative Gross Yield Profile in accordance with Condition C1.8, it must inform the CAA in writing, setting out its reasons and justification for the modification in accordance with any guidance issued by the CAA under Condition C1.9.

Definitions

C1.11 In this Condition C1:

- (a) the Commitments means the contractual obligations given by the Licensee to providers of air transport services at Gatwick Airport and in the case of certain obligations also to other service providers of Gatwick Airport as contained in the following provisions of the Conditions of Use as agreed by the CAA and to be effective from the date this Licence comes into force and as amended from time to time under Conditions C1.4 to C1.7 namely:
- (i) Condition 2.1.2 of the Conditions of Use (Applicability and Enforceability of Conditions of Use);
 - (ii) Condition 2.1.3 of the Conditions of Use (Variation);
 - (iii) Conditions 2.1.11-2.1.20 of the Conditions of Use (Dispute Resolution Procedure);
 - (iv) Condition 5 of the Conditions of Use (Price Commitment);
 - (v) Condition 6 of the Conditions of Use (Service Standard Commitment);
 - (vi) Condition 7 of the Conditions of Use (Continuity of Service Plan, Operational and Financial Resilience);
 - (vii) Condition 8 of the Conditions of Use (Investment and Consultation Commitment);
 - (viii) Condition 9 of the Conditions of Use (Financial Information Commitment);

- (ix) Schedules 2, 3 and 4 to the Conditions of Use and associated appendices; and
- (x) Annex to the Conditions of Use (the Gatwick Airport Core Service Standards Handbook);
- (b) the Conditions of Use means the Gatwick Airport Conditions of Use, published by the Licensee;
- (c) the Indicative Gross Yield Profile has the meaning set out in Paragraph 1.11 of Schedule 2 to the Conditions of Use; and
- (d) the recovery of second runway costs means the recovery of reasonable costs (capital, operating and financing) of applying for planning permission for a second runway and the subsequent development of the second runway and associated airport infrastructure.

Part D: Financial Conditions

D1 Financial Resilience

Certificate of adequacy of resources

- D1.1 The Licensee shall at all times act in a manner calculated to secure that it has available to it sufficient resources including (without limitation) financial, management and staff resources, to enable it to provide airport operation services at the Airport.
- D1.2 The Licensee shall submit a certificate addressed to the CAA, approved by a resolution of the board of directors of the Licensee and signed by a director of the Licensee pursuant to that resolution. Such certificate shall be submitted within four months of the end of the Licensee's financial year and shall include a statement of the factors which the directors of the Licensee have taken into account in preparing that certificate. Each certificate shall be in one of the following forms:
- (a) "After making enquiries based on systems and processes established by the Licensee appropriate to the purpose, the directors of the Licensee have a reasonable expectation that the Licensee will have available to it, after taking into account in

particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid, any amounts of principal and interest due under any loan facilities and any actual or contingent risks which could reasonably be material to their consideration, sufficient financial and other resources and financial and operational facilities to enable the Licensee to provide airport operation services at London Gatwick Airport of which the Licensee is aware or could reasonably be expected to make itself aware it is or will be subject for a period of two years from the date of this certificate.”

- (b) “After making enquiries based on systems and processes established by the Licensee appropriate to the purpose, the directors of the Licensee have a reasonable expectation, subject to what is said below, that the Licensee will have available to it, after taking into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid, any amounts of principal and interest due under any loan facilities, and any actual or contingent risks which could reasonably be material to their consideration, sufficient financial and other resources and financial and operational facilities to enable the Licensee to provide airport operation services at London Gatwick Airport of which the Licensee is aware or could reasonably be expected to make itself aware it is or will be subject for a period of two years from the date of this certificate. However, they would like to draw attention to the following factors which may cast doubt on the ability of the Licensee to provide airport operation services at London Gatwick Airport for that period.....”
- (c) “In the opinion of the directors of the Licensee, the Licensee will not have available to it sufficient financial or other resources and financial and operational facilities to provide airport operation services at London Gatwick Airport of which the Licensee is aware or of which it could reasonably be expected to make itself aware or to which it will be subject for a period of two years from the date of this certificate.”

- D1.3 The Licensee shall inform the CAA in writing as soon as practicable if the directors of the Licensee become aware of any circumstance which causes them no longer to have the reasonable expectation

expressed in the then most recent certificate given under Condition D1.2(a) or (b).

D1.4 The Licensee shall obtain and submit to the CAA with each certificate provided under Condition D1.2 a report prepared by its Auditors stating whether or not the Auditors are aware of any inconsistencies between, on the one hand, that certificate and the statement submitted with it and, on the other hand, any information which they obtained during their audit of the relevant year end accounts of the Licensee.

D1.5 If the Licensee or any of its linked companies (or, where applicable the directors and officers of any of those undertakings) seeks, or is advised to seek, advice from an insolvency practitioner or any other person relating to:

- (a) the Licensee's financial position or ability to continue to trade; or
- (b) that linked company's financial position or ability to continue to trade, only to the extent that it would affect the Licensee's financial position or ability to continue to trade, the Licensee must inform the CAA within 3 working days.

Restriction on activities

D1.6 The Licensee shall not, and shall procure that its subsidiary undertakings shall not, conduct any business or carry on any activity other than:

- (a) the Permitted Business; and/or
- (b) any other business or activity for which the CAA has given its written consent for the purposes of this Condition, such consent not to be unreasonably withheld or delayed.

Ultimate holding company undertakings

D1.7 The Licensee shall procure from each Covenantor a legally enforceable undertaking in favour of the Licensee in the form specified by the CAA that that Covenantor will:

- (a) refrain from any action, and procure that every subsidiary of the Covenantor (other than the Licensee and its subsidiaries) will refrain from any action, which would then be likely to cause the Licensee to breach any of its obligations under this Licence;

(b) promptly upon request by the CAA (specifying the information required) provide to the CAA (with a copy to the Licensee) information of which they are aware and which the CAA reasonably considers necessary in order to enable the Licensee to comply with this Licence.

D1.8 Such undertaking shall be obtained within seven days of the company or other person in question becoming a Covenantor and shall remain in force for so long as the Licensee remains the holder of this Licence and the Covenantor remains a Covenantor.

D1.9 The Licensee shall:

- (a) deliver to the CAA, within seven days of obtaining the undertaking required by Condition D1.8, a copy of such undertaking;
- (b) inform the CAA as soon as practicable in writing if the directors of the Licensee become aware that the undertaking has ceased to be legally enforceable or that its terms have been breached; and
- (c) comply with any direction from the CAA to enforce any such undertaking.

Definitions

D1.10 In this Condition D1:

- (a) the Covenantor means a company or other person which is at any time an ultimate holding company of the Licensee;
- (b) a linked company means any company within the Licensee's Group where the financial position of that company or its inability to continue to trade would have an adverse effect on the Licensee's financial position or ability to continue to trade;
- (c) Permitted Business means:
 - (i) any and all business undertaken by the Licensee and its subsidiary undertakings as at 1 April 2014;
 - (ii) to the extent that it falls outside Condition D1.10(c)(i), the business of owning, operating and developing the Airport and associated facilities by the Licensee and its subsidiary undertakings (including, without limitation, any and all airport operation services, provision of facilities for and connected

with aeronautical activities including retail, car parks, advertising and surface access and property development letting and management development thereof); and

- (iii) any other business, provided always that the average over the term of the Commitments of any expenses incurred in connection with such businesses during any one financial year is not more than 2% of the value of the shadow Regulatory Asset Base at the start of the financial year.

CHAPTER 4

A monitoring framework for GAL's commitments

- 4.1 This chapter sets out the monitoring framework that the CAA will introduce with the licence to monitor the effectiveness of the commitments.

CAA's proposed licence

- 4.2 In the proposed licence, the CAA maintained its view that passenger benefits could flow from the flexibility of the commitments, and the scope they offered to develop bilateral contracts that tailored the airport operator's offering to the needs of individual airlines, combined with the licence. The CAA recognised that GAL had addressed many of its and airlines' concerns around the commitments. The CAA also noted that it had gone some way to addressing airlines' concerns around second runway costs through the introduction of a new licence condition.
- 4.3 Part and parcel of the CAA's view was a recognition that significant uncertainty remained about how the commitments framework would evolve - an inevitable outcome from a more flexible framework that could respond to commercial developments. The CAA was, however, resolute that it would step-in to protect passengers' interests should it become necessary. The CAA therefore indicated that it intended to implement a monitoring framework.
- 4.4 Particular areas that the CAA intended to keep under review (and which the CAA had not addressed through licence conditions, although it could if it was in passengers' interests) included:
- the price in the commitments which were above the CAA's fair price benchmark;
 - the service quality scheme, particularly with respect to repeated airport service quality failures;

- the capital plan, which included no commitments to deliver specific outputs beyond a minimum average spend of £100 million per year, so GAL could fail to deliver outputs that were in passengers' interests;
- the commitments did not include a requirement to publish the value of the RAB; and
- the operational resilience commitment only had regard to guidance issued by the CAA.

- 4.5 The CAA therefore considered whether it would be appropriate to introduce licence conditions on these issues. However, it recognised that in some cases this would cut across the flexibilities that were the principal benefit of the commitments, for example in terms of capex. In other areas, the CAA considered that this could add significantly to complexity. For example, if service quality rebate levels were set in the licence but the other price control conditions were outlined in the commitments. Consequently, the CAA saw merit in monitoring performance of the commitments to ensure that they were promoting passengers' interests and that they addressed the particular issues highlighted above.
- 4.6 The CAA did not agree with GAL that the review of the commitments should focus solely on the issues identified by the CAA. Given the flexibilities in the commitments, the CAA highlighted that there may be a number of issues that arise during their operation which it could not predict in advance. Consequently, the CAA considered that monitoring reviews should consider whether the commitments, together with the licensing and monitoring framework, were operating as a whole in passengers' interests.
- 4.7 The CAA also considered that it would be important for the regime and airport operator/airline relationships to bed down and that it would not therefore undertake monitoring in the first year of the new regime, apart from the issues identified below. The CAA therefore indicated that it did not intend to initiate a review until the second half of 2016, when it intended to ask stakeholders for their views and undertake a short and focused assessment of the performance of the commitments, and publish its findings. However, the CAA also noted that should concerns emerge that were of sufficient seriousness, it would consider undertaking a monitoring review before the second

half of 2016.

- 4.8 One area where the CAA considered that annual monitoring was appropriate was around pricing. As the CAA outlined in Appendices H and I of the proposed licence, there was a 1.6% per year difference between the CAA's 5-year fair price benchmark of RPI-1.6% per year (over five years) and GAL's blended price (the most appropriate comparison) of RPI+0% per year. However, the CAA recognised that the prices actually paid by airlines would be determined by a number of factors. Given the importance of price to passenger welfare, the CAA indicated that it would monitor GAL's prices annually.
- 4.9 When monitoring prices, the CAA indicated that it would take into account any material reasons for differences between prices and the fair price benchmark, for example the level of capex. If prices were above the fair price benchmark then the CAA indicated that it would consider action under the licence, which could include introducing additional licence conditions to restrain prices, or placing conditions on GAL's ability to alter the structure of charges (for instance, this could restrict GAL's ability to minimise the overall level of discounts, which are typically on winter charges).
- 4.10 The other area where the CAA indicated it would undertake annual monitoring was on service quality. The CAA noted in the latest version of the commitments that GAL had put forward it had committed to the publication of a report on the achievement of airport wide standards on its website and in the terminals. The CAA indicated that it would expect such publication to include performance against standards and any rebates paid. The CAA also noted that, while in general, it expected service quality monitoring to be carried out by airlines, it would undertake sufficient monitoring to identify whether GAL failed an individual metric for more than six months. If GAL failed an individual metric for more than six months then service quality rebates could reduce to zero and the CAA indicated that it would expect to undertake an investigation into the failure to identify whether any enforcement action was required.
- 4.11 The CAA also indicated that one area where GAL had not yet finalised the commitments in advance of the CAA's decision on the commitments was on the service quality measurement regime and the level of the targets on pier service. The CAA indicated that it expected GAL would reach agreement with airlines (through the ACC)

on these matters. The CAA also noted that if agreement could not be reached it would make a decision on any outstanding issues and may implement that decision using its powers under section 22 of the Act.

- 4.12 The CAA also highlighted that GAL did not believe it was necessary to prepare a shadow RAB calculation for the CAA as part of its ongoing monitoring regime, up to the review scheduled for 2016, but that it would. The CAA considered it was important that GAL continued to undertake a shadow RAB calculation throughout the commitments period unless it was considered that GAL no longer met the MPT. The CAA also considered that this calculation would be useful in case tighter price control regulation needed to be reintroduced. Although it also stated, as per the final proposals, that there should be no presumption that the CAA would use the shadow RAB number as the basis for any future RAB-based price control. To this end, the CAA included the framework for the shadow RAB calculation in Appendix J. The CAA also noted that if it was setting a price control in the future, and if it was considering whether to include capex in the RAB calculation it would continue to use the twin test of: efficient project management and consultation in line with the requirements in the commitments.
- 4.13 The CAA also decided not to include explicit separate monitoring on the prices charged to cargo operators. As there were only 8 dedicated cargo flights at Gatwick in 2012 the CAA found that GAL did not have SMP in this market. The CAA therefore considered monitoring in this area would be unnecessary and disproportionate.
- 4.14 The CAA expected that the monitoring regime and, to some extent, the licensing regime would evolve over time. It noted that, if GAL could develop good relationships with airlines and the flexibilities within the regime were operating in passengers' interests, then this could lead to a scaling back in the CAA's monitoring of the commitments. Contrary to GAL's request, the CAA did not consider that it would be appropriate to commit to undertaking a new market power assessment at that stage. The CAA considered, given the recent completion of the assessments and the scale of resources and time involved, that a new market power assessment should only be undertaken if there was a material change in circumstances.

- 4.15 The CAA noted that if the commitments were not operating in passengers' interests and relationships with airlines were poor then it could, as appropriate, use its enforcement powers and/or impose additional licence requirements through the modification process as set out in the Act. The CAA considered that this would address the risks that the flexibilities within the proposed regime were not working in passengers' interests.

Representations received

- 4.16 In their responses to the proposed licence GAL, easyJet and British Airways did not raise any specific concerns with the proposed monitoring regime. However:
- GAL considered that it did not meet the market power test and that the proposed licence was not required; and
 - easyJet and BA noted that the ACC had provided a response to the CAA consultation, which they supported (see discussion below).
- 4.17 Virgin considered that the CAA needed to be clear that GAL should price to recover a blended rate of RPI-2% (the 7-year RAB price comparison) per annum. Virgin also expressed concern with the assumptions made by the CAA in its calculation of a fair price comparison (an issue examined in Appendix A).
- 4.18 The ACC supported the CAA's decision to implement a monitoring regime alongside the licence but highlighted a number of concerns, including that:
- the arrangement for price monitoring be set out explicitly in the licence, so that expectations were clear for the CAA, GAL and the major airlines;
 - the CAA needed to make clear that it was not going to revisit the accuracy of the assumptions that it had made to calculate the fair price and that the purpose of its price monitoring was to ensure that the CAA's fair price was delivered;
 - while it was appropriate to consider the level of capex when determining the fair price, the reference to 'any material difference' should be removed and that the CAA should make a clear

statement that it will be looking for evidence that prices charged by GAL have declined by 1.6% below RPI, adjusted for capex, save only to the extent that airlines had paid for service enhancements or had failed to meet their contractual arrangements; and

- the CAA make a clearer statement about future intervention as its current wording was too vague and created regulatory uncertainty.

4.19 The ACC also:

- indicated general contentment with the provisions for service quality monitoring and that it was continuing discussions with GAL on the final areas of disagreement;
- welcomed the 2016 review which would consider, more broadly, whether the commitments were, as a whole, operating in passengers' interests;
- supported a shadow RAB being reported, although did not support the twin tests for including projects into the RAB (as it considered that the proposed approach was procedural and bureaucratic); and
- agreed that the CAA should not undertake a new market power assessment unless there was a material change in circumstances.

CAA's response and final decision

4.20 The CAA maintains the view it outlined in the proposed licence that passenger benefits could flow from:

- the flexibility of the commitments; and
- the scope the commitments offer to develop bilateral contracts that tailor the airport operator's offering to the needs of individual airlines, combined with the licence.

4.21 However, the CAA recognises that there is uncertainty with how the commitment framework may evolve – an inevitable outcome given that this is a flexible framework that can respond to commercial developments – and that it will, if necessary, step-in to protect passengers' interests, including through:

- imposing a price control;

- using its enforcement powers; and/or
- imposing additional licence requirements through the modification process as set out in the Act.

4.22 The CAA also continues to propose, in addition to the proposed licence conditions, a monitoring framework to review a number of areas (see discussion below). The CAA considers that this will help ensure that GAL promotes passengers' interests and that any issues associated with the areas outlined below can be more easily addressed.

Operation of the commitments and the 2016 review

- 4.23 The CAA continues to consider that if the commitments are not operating in passengers' interests and relationships with airlines are poor then it will, as appropriate, use its enforcement powers and/or impose additional licence requirements through the modification process as set out in the Act. The CAA considers that this will address the risks that the flexibilities within the proposed regime are not working in passengers' interests.
- 4.24 The CAA also considers that the commitments, together with the licensing and monitoring framework, should be reviewed as a whole, to ensure they are operating in passengers' interests. The CAA has come to this view as it recognises that issues may arise during the operation of the commitments that it cannot predict.
- 4.25 However, recognising that time is required for the regime and airport operator/airline relationships to bed down, the CAA considers it is appropriate that this review is not initiated until the second half of 2016 (unless concerns of sufficient seriousness emerge prior to that date). As part of the review, the CAA will ask stakeholders for their views and undertake a short and focused assessment of the performance of the commitments. It will also publish its findings.
- 4.26 The CAA also recognises that the monitoring regime and, to some extent, the licensing regime may evolve over time. If GAL can develop good relationships with airlines and the flexibilities within the regime are operating in passengers' interests, then the CAA considers that there is scope for a scaling back in the CAA's monitoring of the commitments over time.
- 4.27 A key component of this review will be an assessment of GAL's capital

plan. GAL's capital plan includes no commitments to deliver specific outputs beyond a minimum average spend of £100 million per year – so GAL could fail to deliver outputs that are in passengers' interests.

- 4.28 As outlined earlier, if GAL adopts a different capex plan, the CAA will need to consider if the plans are in passengers' interests, and one factor that it will need to consider will be whether benefits have been realised as a result of the signing of bilateral contracts. Where capital plans are not in passengers' interests, the CAA will take appropriate action.

The price in the commitments

- 4.29 Given the importance of price to passenger welfare, the CAA considers that annual monitoring of GAL's prices remains appropriate.⁶²
- 4.30 In the proposed licence document the CAA stated that it would monitor prices against its 5-year fair price benchmark of RPI -1.6% per year. Virgin has stated that GAL should price to recover a blended rate of RPI-2% per year, based on the CAA's 7-year RAB-based calculation. The CAA does not consider that this is appropriate. The CAA continues to consider the most appropriate comparison is between the blended price in the commitments and the 5-year fair price. The CAA has come to this view as it considers that:⁶³
- a five yearly RAB is the most likely counterfactual; and
 - the CAA's calculations for a 5-year fair price are based on a detailed bottom-up assessment of individual building blocks. The 7-year fair price was developed for comparison with the commitments and took into account changes forecast by GAL in the two years following a traditional 5-year control (2019/20 and 2020/21). There are also some issues that might point to a higher 7-year price that have not been included in the calculations, for example the impact of the greater traffic risk over seven years on the cost of capital. The 7-year price can therefore be regarded as

⁶² This monitoring of prices did not include an explicit reference to prices charged to cargo operators due to the limited number of dedicated cargo flights at Gatwick.

⁶³ Further details on the CAA's reason for the comparison between the fair price and the commitments price are set out in Appendix I.

less certain. The CAA therefore considers that it is relevant to take into account both comparisons, but to place the greatest weight on the 5-year price as this is the effective RAB alternative.

- 4.31 The ACC has also suggested that more details of the arrangement for price monitoring be set out explicitly, so that expectations are clear. The CAA accepts that more information would be useful and has set out below further detail on the approach set out in the proposed licence document.
- 4.32 For the avoidance of doubt, the CAA expects GAL to meet the fair price benchmark of RPI -1.6% per year unless there is a material change in circumstances. The CAA notes that the bar for it to agree to any change over the next 2 years will be very high. That said, the CAA recognises that uncertainty grows over time. The CAA also notes that stability is, in general, in passengers' interests and that it does not expect to carry out a further building block review in 2016 or when it does annual price monitoring.
- 4.33 If the CAA does not consider that prices are fair it will take appropriate action, including, where appropriate, the re-imposition of a price control, or placing conditions on GAL's ability to alter the structure of its charges.
- 4.34 When monitoring prices, the CAA will take into account any material reasons for differences between prices and the fair price benchmark. As the CAA does not wish to disturb incentives to grow volumes, it will not normally regard volumes growing beyond the estimates used to develop the fair price as a basis for prices lower than the fair price. However, if volumes are at least at the forecast level, this underlines the CAA's expectations that prices will fall according to the fair price path. As a result, the main variable that the CAA will take into consideration when assessing the level of prices is capex. If GAL builds the proposed capex plan set out in figures C.1 and C.2, the CAA expects that it will achieve the fair price. However, if GAL adopts a different capex plan, the CAA will need to consider if the plans are in passengers' interest and one factor that it would need to consider would be whether variances flowed from airline bilateral contracts (airlines' and passengers' interests are generally aligned although the CAA recognises that this is not the case in all circumstances).
- 4.35 The CAA also does not consider that it is appropriate to include

explicit, separate monitoring on the prices charged to cargo operators. In 2012, there were only 8 dedicated cargo flights at Gatwick and the CAA has not found that GAL has SMP in this market. The CAA therefore considers that monitoring cargo prices would be unnecessary and disproportionate at this time.

- 4.36 In addition to the annual monitoring of prices, GAL will also be subject to the non-discrimination provisions in the ACRs and the AGRs and the fair, reasonable and non-discriminatory provisions for ancillary services under the commitments.

The service quality scheme

- 4.37 The CAA considers, particularly with respect to the scope for repeated service quality failures, that annual monitoring on service quality is appropriate.
- 4.38 The CAA notes that as part of the report that GAL has committed to publish⁶⁴ on achievement of airport wide standards that it will include information on its performance against standards and any rebates paid. This will provide end users, including airlines greater access to information.
- 4.39 The CAA also considers that notwithstanding airlines not being able to carry out an audit on service quality to the same level as the CAA, they have a commercial relationship with GAL and that there are mechanisms that they could use to try and address any perceived shortfalls in quality. However, the CAA also considers (notwithstanding GAL's commitment to make more information on service quality available), that it should undertake sufficient monitoring to enable it to identify an individual metric failing for more than six months. In the event of such a failure, the CAA would expect to undertake an investigation to determine if any enforcement action was required.
- 4.40 The CAA also considers that that if agreement on the commitments cannot be reached on the airport service quality measurement regime and the level of the standards on pier service, it will make a decision on this and any outstanding issues and may implement its decisions using its powers under section 22 of the Act.

⁶⁴ GAL committed to publish this information on its website and in its terminals.

Other issues

- 4.41 The CAA considers it is important for GAL to undertake a shadow RAB calculation throughout the commitments period, unless it is considered that GAL no longer meets the MPT.⁶⁵ The CAA notes that the commitments do not include a requirement to publish the value of the RAB but that GAL has agreed to do this up to the review scheduled for 2016.
- 4.42 The CAA considers that such a calculation would be useful in case tighter price control regulation needs to be introduced. However, as stated in the final proposals, there should be no presumption that the CAA will use the shadow RAB as the basis for any future RAB-based price control. If the CAA were setting a price control in the future, and were considering whether to include capex in the RAB calculation, it would continue to use the twin tests of: efficient project management and consultation in line with the requirement in the commitments.
- 4.43 While the ACC agrees that a shadow RAB should be reported and monitored (unless or until the market power determination ceases to have effect), it is concerned that the proposed approach to include projects in the RAB is procedural and bureaucratic. The ACC considers that a more appropriate approach would be to only include capex which had been agreed with airlines in the shadow RAB calculation. The CAA notes the ACC's concerns but considers that the ACC's proposed approach of only including capex which has been agreed would represent a tightening of current requirements. The CAA therefore continues to consider that its twin tests for including projects in the RAB (project management and consultation) provide sufficient flexibility and are reasonable. The CAA accepts that there may be scope for further improvement in how projects are included in the RAB but considers that the 2016 review of the commitments, together with the licensing and monitoring framework (discussed above), provide the CAA with an opportunity to assess if improvements in this area (and/or any other area) should be made.
- 4.44 The CAA will also continue to monitor GAL's operational resilience commitment as GAL has only committed to have regard to guidance

⁶⁵ The CAA considered that this calculation would be useful in case tighter price control regulation needed to be reintroduced, although there was no presumption that it would use the shadow RAB number as the basis for any future RAB-based price control.

issued by the CAA. In the event that operational resilience issues are experienced by GAL, and these concerns could have been avoided by GAL following the CAA's guidance, the CAA will take this into account when determining the appropriate enforcement action.

APPENDIX A

A Fair Price

CAA's proposed licence

Approach

- A1 In the proposed licence the CAA calculated a fair price based on the maximum average level of GAL's airport charges, using a single till RAB calculation. The CAA intended that this would act as a counterfactual for the assessment of alternative forms of regulation including GAL's commitments to airlines. In the absence of acceptable commitments, the CAA intended that this calculation could be used as the basis for setting a price cap for Q6.
- A2 The following appendix sets out the CAA's reasons for the approach it has taken to calculating the fair price and addresses the overarching concerns raised by GAL on the use of consultancy studies in the calculation of the fair price. Appendices B to H set out the CAA's detailed consideration of each of the building blocks in the fair price calculation.

The CAA's response to GAL's previous concerns

- A3 In response to the initial proposals GAL raised concerns that the CAA's fair price calculations were flawed, in particular as GAL considered that the CAA had not demonstrated that regulating airport charges at Gatwick would benefit passengers rather than simply airlines, and so would be consistent with CAA's general duty. The CAA's response to GAL's concerns is set out in detail in paragraphs 2.4 to 2.29 of the final proposals⁶⁶ and is summarised as follows.
- The concept of a fair price was consistent with the CAA's general duty to further the interests of passengers by ensuring that, in aggregate, the charges paid by passengers are consistent with the average net costs of those services, while maintaining a suitable

⁶⁶ CAA, October 2013, Economic regulation at Gatwick from April 2014: final proposals, <http://www.caa.co.uk/docs/33/CAP1102.pdf>

level of service quality and an appropriate range of airport operation services.

- In regulating airport charges the CAA would expect that, to some extent, the difference between the regulated price and the market clearing price would be passed on from airlines to passengers through competition in the airline market. If charges were not regulated then airport operators would retain the difference between costs and charges without any discernible benefit to passengers. The CAA noted that its approach was consistent with the CC's final report on the market review into BAA, which for example stated that

"Even under separate ownership, moreover, as a result of capacity constraints, competition in the short term may focus on particular types of traffic, for example in off-peak periods, and therefore be unlikely to be sufficiently effective to substitute for regulation."
(paragraph 6.87)

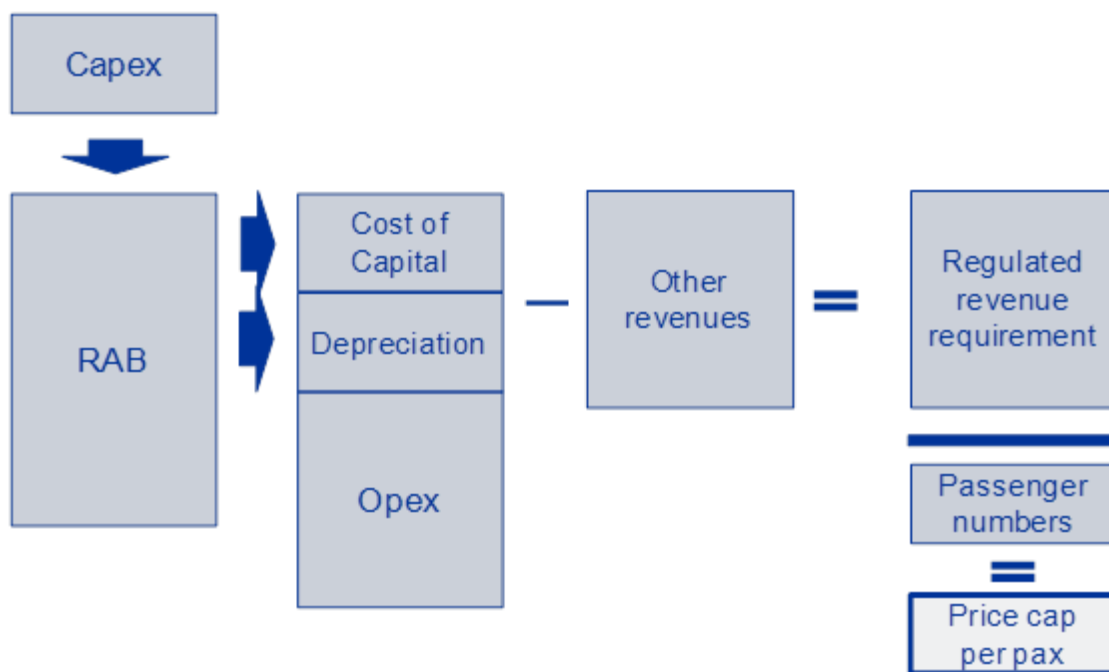
- The use of a single till RAB-based approach for calculating the fair price provided a cost-based price which mimicked what would happen in a fully functioning competitive market and was consistent with the approach commonly used across many regulated sectors. It was also consistent with the approach used by the CC in calculating price caps for Q4 and Q5.
- The concept of a fair price would not be detrimental to future passengers, as the interests of future passengers are likely to emerge as similar to those of current passengers. This was also because most future passengers will be people that already fly. While over time the needs of passengers may change, in a competitive market airlines would need to respond to these changes to maximise their profits.

The concept of the fair price and the impact on passengers

A4 In the proposed licence the CAA considered that the concept of the fair price benefited passengers and was consistent with its statutory duties. The CAA also considered that the fair price based on a single till RAB approach set airport charges in relation to costs and mimicked what would happen in a competitive market. The CAA noted that GAL did not set out how other levels of, presumably higher, prices could serve passengers' interests to an equal or greater extent. This was

particularly so when the fair price was for a minimum level of service quality with airlines able to purchase higher service quality if their passengers demanded it. The CAA noted that, as set out in the final proposals, prices above the fair price (for a minimum level of service quality) were likely to benefit the airport operator rather than passengers. In particular, as new runway capacity was effectively exogenous, any increase in charges above the competitive level was unlikely to lead to additional airport capacity but to increased profits to the airport operator, with no discernible benefits to users. This was likely to be the case for the duration of this price control, with no new runway capacity likely to be available in that time.⁶⁷

Figure A.1: RAB-based building blocks



Source: CAA

A5 The CAA asked SLG economics (SLG) to review the concerns raised by GAL's consultants Compass Lexicon (CL) on whether reductions in

⁶⁷ See Gatwick proposals for a second runway, which state that this could be open by 2025. <http://www.mediacentre.gatwickairport.com/News/A-second-runway-at-London-Gatwick-is-theaffordable-sustainable-and-deliverable-solution-80b.aspx>

Heathrow's proposals for a third runway are forecast to deliver extra capacity between 2025 and 2029, with a statement that a new hub at Stansted or in the Thames estuary would not be delivered until at least 2032. <http://mediacentre.heathrowairport.com/Press-releases/Heathrow-unveils-a-new-approach-to-third-runway-5e2.aspx>

airport charges would be passed on by airlines to passengers in terms of lower air fares. The responses of SLG and BA's consultants RBB Economics (RBB) to the issues raised by CL on the SLG report are set out below.

- CL's view that airlines were capacity constrained and so would not have an incentive to pass through reductions in charges to passengers. SLG stated that average load factors at both Heathrow and Gatwick had scope for further improvement, with increases in load factors seen at both airports over the last five years, and so airlines were not capacity constrained.
- CL's view that a reduction in charges would not impact on the optimal fare if the change in charges was at the aircraft rather than passenger level. Furthermore CL considered that even changes in per passenger charges may not affect fares if airlines were pricing in relation to demand rather than cost. SLG stated that 73% of airport charges at Heathrow and 65% of airport charges at Gatwick were per passenger and so affected the marginal cost and the optimal fare. SLG considered that other elements of airport charges also affected fares as they impacted on per aircraft costs which put upward pressure on the per passenger margins in airline yield management systems. RBB stated that the majority of airport charges at Gatwick were on a per passenger basis accounting for between 55% in the peak and 96% in the winter off-peak of total airport charges, and, as CL had stated, standard economic theory would mean that fares will respond to changes in marginal cost. RBB noted that this was the case even if there was no competition on a route.
- CL's view that if variable airport charges impacted on fares then an airport operator would focus increases in airport charges on the fixed element of charges. SLG stated that airlines will want to ensure that the revenue from passengers on an aircraft will cover the costs of that aircraft and so per aircraft charges will put an upward pressure on the minimum per passenger margins. SLG also stated that it was unlikely that just by restructuring charges from a per passenger to a per aircraft basis airport operators would be able to increase charges indefinitely with no impact on fares as CL seemed to suggest. The CAA noted that between 2005/06 and 2012/13 GAL's real per passenger charges increased by around

30% and Heathrow Airport Limited's (HAL) by over 100%.

- CL's statement that airline aircraft size decisions were a complex commercial decision and it was not clear that reducing aircraft size (as implied by the SLG analysis) would be a rational response to an increase in airport charges as it may have higher variable costs. SLG stated that the decision to alter an aircraft on a route is taken at an aircraft rather than passenger level and is therefore based on the average rather than purely variable costs of the aircraft.
- CLs' view that the empirical evidence does not show airlines have been passing on falls in costs. SLG stated that real per passenger revenues and costs have fallen at both BA and easyJet and for Virgin real fares have risen slower than costs. SLG stated that evidence points to passenger demand growing faster than air fares and costs and so competitive pressures in the airline market have led to cost reductions being passed through to passengers as lower fares.
- CL's statement that easyJet may be more representative of GAL's customer base than BA; and easyJet will have less opportunity to increase aircraft size as it operates a less diverse aircraft fleet. SLG agreed that there may be less opportunity to increase both capacity and load factors at Gatwick than Heathrow due to the lower proportion of full service carriers, however this had not stopped seat and passenger load factors from increasing at both airports. In addition, SLG cited the recent purchase of the Flybe slots by easyJet which will increase average aircraft size.
- CL considered that rising passenger numbers meant that falling air fares reflected a relaxation of capacity constraints. SLG pointed to evidence at Heathrow and Gatwick which showed that passenger numbers have increased faster than the number of flights, which suggested that it is airline behaviour rather than airport investment that has increased capacity. Furthermore SLG stated that the use of price controls is to constrain the SMP of HAL and GAL in the relevant market in which they operate.
- CL's statement that it was unclear whether RBB had considered CL's previous report on how capacity constraints affect the distribution of economic rents between airport operators and airlines. SLG reviewed this report and stated that the empirical

position of the airlines at Gatwick is in between the extreme positions of no capacity constraints and total capacity constraints. SLG stated that where there are firm capacity constraints there are still opportunities to increase aircraft size and load factors. As a result, depending on the degree of competition between airlines, some of the change in airport charges is likely to feed through to passengers.

- CL raised concerns over the efficiency of the secondary slot market. CL claimed that strategic considerations prevented the secondary slot market from operating efficiently and so slots might not be used by the highest value user. SLG did not agree that there was a sub-optimal use of capacity at Heathrow and Gatwick, citing the relatively rare use of slots by smaller aircraft and the fact that slot coordinators take account of the potential use of slots when allocating capacity. Both SLG and RBB cited the European Commission's Impact Assessment on secondary trading of slots which found that secondary trading at London airports had been successful in improving capacity utilisation. RBB further stated that the same study found that, in 2010, 39% of the slots at Gatwick were operated by a different airline to that which operated the slots in 2007, indicating a liquid and active secondary trading market. In response CL stated that the secondary slot market was not fully efficient as airlines may act strategically. SLG agreed that there may be imperfections in the operation of the secondary slot market but optimal efficiency was not required for competition to have an effect.

A6 SLG did not consider in detail CL's and RBB's comments on the potential for airlines to switch. The CAA has considered the potential for airlines to switch in detail in the CAA's MPT in relation to Gatwick (and Heathrow). The CAA found that airline switching is unlikely to constrain a 5 to 10% rise in current airport charges at either Gatwick or Heathrow.⁶⁸

⁶⁸ CAA, January 2012, Market power determination of Heathrow Airport and Market power determination of Gatwick Airport, <http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=12275>

A7 In response to the updated SLG report GAL raised a number of further concerns. The CAA's response to GAL's further concerns was as follows:

- GAL expressed surprise that the SLG report compared the economic regulation of airports with the regulation of railways. The CAA did not consider that its approach to regulating airports, for example the use of a RAB-based approach to setting price controls, was markedly different to the approach used by other economic regulators, including rail. In addition the CAA did not consider that GAL's example of spectrum market regulation was a good comparator to airports not least due to the impact of government policy on privately held runway capacity in the South East (for example as setting airport charges at HAL and GAL at market clearing levels would benefit private airport operators rather than bringing forward additional capacity which would benefit passengers).
- GAL stated that the SLG report did not acknowledge that the CL reports were provided on the basis that the CAA's view of binding capacity constraints was correct. The SLG report explicitly recognised that runway capacity at both Heathrow and Gatwick was severely constrained.⁶⁹ The CAA did not consider that runway capacity constraints were the same as the capacity constraints on airlines which could, to some extent, increase aircraft size and load factor even though there were runway constraints. However increases in airline capacity would not exercise the same constraint on GAL's market power as the relaxation of runway capacity constraints as it would not allow airlines to threaten to move their services to Heathrow (or vice versa).
- GAL did not consider that the updated SLG report substantiated the conclusions reached in the previous SLG report. The CAA rejected this. The updated SLG report reached the same conclusion as the earlier report, that, to some extent, passengers were likely to see the increase (or reduction) in airport charges feed through into higher (or lower) fares. The updated SLG report provided

⁶⁹ SLG, September 2013, Q6 review of the distribution of economic rent between airport, airlines and passengers and cargo users at Heathrow and Gatwick, page 6.
<http://www.caa.co.uk/docs/78/Review%20of%20distribution%20of%20economic%20rent%20-%20final%20report.pdf>

additional empirical evidence to support this statement.

- GAL stated that the SLG report did not explain why airlines operating in a capacity constrained environment would increase fares in the event of an increase in airport charges particularly if such an increase impacted on airlines' fixed costs. The SLG report set out how changes in both fixed and variable airport charges would impact on fares. The CAA noted that competition in the airline market under runway capacity constraints was imperfect and it would expect airlines to consider changes to fixed as well as variable costs in setting fares otherwise airlines would not generate sufficient income to remain in business.
- GAL stated that an increase in charges towards the competitive level would make the most marginal routes no longer profitable, but in a market with excess demand, this would make capacity available for new routes with a higher willingness to pay and hence deliver more optimal use of scarce capacity. The CAA considered that the SLG report had taken account of this point and in particular the efficiency of the secondary slot market.
- GAL stated that the SLG report claimed that low cost carriers would not switch due to sunk costs. The CAA considered that this was incorrect. The SLG report stated that "unless the airport price rise was very significant, it is unlikely that it would prompt the airline to switch to other airports given the sunk costs involved in their existing investments and the one-off costs involved in switching."
- GAL stated that the empirical evidence presented by SLG did not substantiate that fares at Gatwick have fallen, and certainly not in recent years. In addition GAL stated that the data used by SLG was mostly for Heathrow, did not cover all airlines and did not control for changes in journey length. The CAA did not consider that this was correct. The airlines analysed by SLG were BA, Virgin and easyJet. Together these airlines covered over 50% of passengers at both Heathrow and Gatwick.⁷⁰ The SLG analysis took account of journey length by normalising revenues and costs per kilometre. The SLG analysis showed that prices had not fallen as swiftly as costs (for easyJet and BA) although this was not the

⁷⁰ CAA statistics 2012, includes British Midland for Heathrow and flybe for Gatwick given the recent acquisitions.

point being challenged in the original CL report which was whether prices and costs have fallen over the last ten years. The SLG analysis confirmed that both prices and costs fell for both easyJet and BA (whose largest bases are Gatwick and Heathrow respectively) and the reductions in both were similar. For Virgin prices rose slower than costs.

- GAL stated that the SLG report appeared to imply that 17% of flights using small aircraft was a small proportion. GAL considered that this was a significant proportion of flights using smaller aircraft and this demonstrated that there was additional capacity in the South East. The CAA noted that the figures quoted by SLG were the number of passengers rather than the number of flights using smaller aircraft and were for 2012 and included Flybe. In 2012, Flybe made up around 20% of passengers using smaller aircraft and an even greater proportion of the passengers using the smallest type of aircraft for example those under 50 tonnes maximum take-off weight. Consequently, given easyJet's acquisition of the Flybe slots the number of passengers on smaller aircraft at Gatwick was likely to reduce going forwards.

A8 The CAA considered the evidence provided by CL, SLG and RBB. The CAA noted that CL provided little empirical evidence for its arguments and where CL provided theoretical arguments these were either inconsistent with the empirical evidence provided by SLG and RBB, or were not consistent with standard economic theory. The CAA considered that the empirical evidence cited by both SLG and RBB showed that airlines had increased capacity, for example by increasing average aircraft size, and so, would to some extent compete and pass on changes in costs. The CAA noted that GAL itself had accepted that the main increase in capacity going forwards was an increase in aircraft size.⁷¹ The CAA considered that the evidence set out in the MPT in relation to Heathrow and Gatwick demonstrated that airlines were unlikely to switch from an increase in airport charges and so airlines would need to pass these costs onto

⁷¹ GAL, July 2013, Airports Commission: Proposals for providing Additional Runway Capacity in the Longer Term, paragraph 2.24.
http://www.gatwickairport.com/PublicationFiles/business_and_community/all_public_publications/transforming_gatwick/Gatwick_Airport_Proposals_for_additional_longterm_runway_capacity19Jul2013.pdf

passengers or suffer a reduction in profitability. In addition the operation of the secondary slot market did not appear to have prevented significant changes in the airlines operating from Gatwick over the last ten years as shown in figure 2.2 in the final proposals. The CAA further noted that if CL's arguments were correct in that there has been a relaxation of capacity constraints at Gatwick then this was likely to mean that changes in airport charges were more rather than less likely to be passed on. For these reasons the CAA considered that changes in airport charges, would, to some extent, be passed onto users through changes in air fares.

- A9 GAL raised concerns over the CAA's view that an increase in airport charges above the fair price would reduce travel opportunities, lead to higher ticket prices or reduced service quality. Based on the analysis undertaken by SLG and RBB, the CAA continued to consider that an increase in airport charges would, to some extent, lead to higher ticket prices. If an increase in airport charges was not passed on through higher ticket prices, airline profitability in the UK was such that airlines were likely to reduce other costs which could impact on airline service quality⁷², or in extremis reduce routes (although for the reasons set out in the market power assessment the CAA did not consider that this would be sufficient to impact on the profitability of GAL and HAL).
- A10 The CAA considered that the transmission mechanism for such a pass through was clear, where changes in airport charges fed through into changes in the marginal and average costs of airline operations and consequently the fares charged. Furthermore the evidence from UK carriers, set out in the SLG report, showed that airlines tended to pass changes in costs (in particular cost reductions) through to air fares.
- A11 The CAA did not consider that the current RAB based price controls held airport charges below competitive levels, as charges related to costs would be expected in a fully functioning competitive market.
- A12 In summary the CAA continued to consider that it has taken an appropriate approach to the calculation of the fair price and that the consideration of airport charges in relation to this fair price was

⁷² See for example BA's removal of meals on some short-haul flights in response to a decline in profitability, <http://www.theguardian.com/business/2009/jul/29/british-airways-scraps-meals-short-haul-flights>

consistent with the CAA's general duty, in particular as changes in airport charges were to some extent passed on to passengers.

The use of consultancy studies

- A13 In response to the final proposals GAL raised four overarching concerns with the evidence used by the CAA in its calculation of the fair price. In the proposed licence the CAA considered each of the points raised by GAL.
- GAL considered the consultants' reports appeared to lack balance. The CAA rejected this criticism. The CAA stated that it had consulted on the terms of reference of the consultancy studies with GAL and other stakeholders. The consultants had worked to these terms of reference, which were published on the CAA's website. The terms of reference and reports were produced in the context where an appeal against the final licence notice (by GAL or materially affected airlines) was in contemplation and the evidence would be relied on in any appeal. The CAA did not consider that the terms of reference were unbalanced and wholeheartedly rejected any suggestion that the consultants were told to produce unbalanced reports.
 - GAL considered the consultants' reports were based on inadequate evidence or assertion, with GAL in particular querying the evidence provided in the Helios report. The CAA stated that the terms of reference required the consultants to provide evidence of efficiency savings or potential to outperform forecasts. To overcome the potential information asymmetry with GAL, the consultants used a variety of sources of information to reach their findings including benchmarking, national and industry statistics, specific examples from other airports or sectors and local market information or knowledge. The CAA considered that the consultants' reports had adequately addressed the terms of reference and it had taken account of the robustness of the analysis when deciding on the appropriate projections for its fair price calculations.
 - GAL considered the consultants' reports have not sufficiently addressed the feedback provided by GAL. The CAA stated that GAL had had numerous opportunities to comment on the consultants' reports and GAL's concerns had been put to the consultants who had been asked to respond. The CAA did not

expect the consultants to agree with each of the points raised by GAL, nor would it expect GAL to agree with all of the points raised by the consultants.

- GAL complained that the CAA had provided an insufficiently rigorous review of the consultants' reports. The CAA rejected this criticism. The CAA reviewed each of the consultants' reports before they were published and in a number of cases challenged their findings and evidence to ensure that they were robust. The CAA had considered the consultants' reports together with the comments made by GAL and other stakeholders when making judgements on the appropriate projections for its fair price calculations.

A14 The CAA has considered the more detailed points on the specific studies in the building block components.

Representations received

A15 There were no specific representations to the proposed licence on the approach taken to calculate the fair price and the use of consultancy studies. In general, parties reserved their position on the calculation of the fair price, and the individual RAB-based building blocks, and stated that in so far as previous points made had not been taken on board, they remained of concern.

CAA's response

A16 As the CAA has not received any specific additional representations, the CAA maintains its views on the approach taken to calculate the fair price and the use of consultancy studies for the reasons set out above. The CAA therefore continues to consider that the fair price calculation should be based on a single till RAB-based approach and that considering airport charges in relation to this fair price is consistent with the CAA's general duty as changes in airport charges are to some extent passed on to passengers. In addition the CAA continues to consider that its use of consultancy studies is appropriate.

Fair price calculations

- A17 Estimates of a fair price, using a single till RAB-based approach, have been provided over:
- five years, consistent with a typical duration of a regulatory price control used in previous airport reviews, the proposed duration of a RAB-based price control in the initial proposals (given the uncertainties in forecasting for a longer duration⁷³ and is commonly used in other regulated sectors); and
 - seven years, for comparison with GAL's 7-year commitment proposals.
- A18 The following appendices (B to H) do not include proposals for a price control, but provide a basis for assessment of alternative forms of regulation (Appendix I) and also for the CAA's licence conditions.

⁷³ The CAA did not receive responses to the initial proposals that asked the CAA to consider a RAB-based price control of longer than five years.

APPENDIX B

Traffic Forecasts

- B1 This appendix sets out CAA's final traffic forecasts for GAL that has been used to derive the price cap for GAL during Q6. Traffic forecasts are important to a RAB-based price control in a number of ways. They define the denominator in the price cap for Q6, which sets a maximum average revenue yield. They also influence other building blocks dependent on passenger numbers, such as opex, commercial revenues and service quality. This appendix consists of the following sections:
- traffic forecast process to date;
 - the CAA's proposed licence;
 - the representations received; and
 - the CAA's response and final decision.

Traffic forecast process to date

- B2 The approach to traffic forecasting has been subject to extensive discussions between GAL, the airlines and the CAA as part of the formal CE and subsequently.
- B3 In the short term, GAL's forecasting methodology is based on a 'bottom-up' short-term capacity forecast for the first two years (up to 2015/16) and a 'top-down' econometric forecast over the medium and longer term.⁷⁴
- B4 In the longer term, the capacity model explains passenger numbers as a function of supply decisions such as airlines' capacity plans, average aircraft size and passenger load factor, network plans and

⁷⁴ This combined approach, with the first two years based on capacity plans provided by the airlines and econometric modelling for the following years, was thoroughly discussed during the CE process. There was no general disagreement amongst the parties regarding this forecasting approach.

flight frequency based on historical performance and market trends. The model considers long haul and short haul services separately, and therefore requires an assumption about the future proportion of such services at the airport.

- B5 The GAL January 2013 RBP forecasts (which used forecasts by GAL's consultants SH&E⁷⁵ in September 2012) were a refresh of its IBP forecasts taking into account actual outturns for the first five months of 2012/13, submissions from airlines regarding their capacity and route plans at the airport up to 2014/15 and an assessment of the prevailing economic trends at the time by SH&E.
- B6 The ACC expressed concerns about the lack of transparency of the short-term assumptions and the medium-term adjustments made by SH&E in the RBP refreshed forecast. In particular, the ACC considered the use of Economic Intelligent Unit's particular low gross domestic product (GDP) forecast was unjustified. Consequently the ACC asked GAL for the traffic forecast to be recalculated based on the HM Treasury Independent GDP forecast and the same averaging forecasting methodology used by SH&E previously in the IBP.
- B7 The CAA's initial proposals reviewed GAL's RBP forecasts, amongst other things, in terms of its forecasting methodology, GDP and other input assumptions, extent of spilled traffic from Heathrow and the potential for traffic growth at Gatwick by market segment.
- B8 The CAA's forecasts in the initial proposals were also based on the higher than expected passenger outturn in 2012/13 and the short-term capacity plan and traffic forecast data that the CAA received from the major airlines at Gatwick.⁷⁶
- B9 In response to the initial proposals, GAL presented a revised traffic forecast (May 2013) that used the same forecasting methodology but with an adjustment in that forecast traffic up to 2015/16 was based on the short-term capacity model and a wider range of GDP inputs was incorporated for its longer-term econometric forecast. GAL also noted that since the impact of recent developments at the time, such as

⁷⁵ GAL's forecasts were provided by the consultants ICF SH&E.

⁷⁶ The airlines that submitted confidential capacity and traffic information to the CAA constitute around 70% of total passengers carried at the airport, compared with less than 40% that were received by GAL's consultant SH&E.

Flybe's slots deal with easyJet, were not yet known when the forecasting was carried out, they were not reflected in their revised forecast.

- B10 Subsequent to their response, GAL estimated that there would only be a 350,000 to 550,000 per year increase in passengers as a result of switching Flybe's slots to easyJet, based on their consideration that the Flybe slot times were not a perfect fit for the traditional easyJet three wave based business model and taking into account seasonality ratios. This compared with a net increase of 1.6 million passengers per annum suggested by the ACC and easyJet based on the assumption that the average load of 149 passengers per flight would apply to all traffic on these purchased slots throughout the year.
- B11 In its final proposals, the CAA remained of the view that GAL's revised forecast understated the growth potential for the short haul and domestic traffic⁷⁷, particularly in light of the purchase of twenty-five Flybe slots by easyJet which, according to CAA's estimate at the time, would lead to a net increase of around 1 million passengers per annum on average over Q6.
- B12 This estimate of an additional 1 million passengers per annum was based on the CAA's analysis at the time of easyJet's plan to continue to serve some of Flybe's existing domestic and Channel Islands routes out of the airport which have a relatively high proportion of business passengers who tend to value flight frequency more than price alone. Consequently, it was the CAA's view that easyJet might find it difficult, at least in the initial years, to achieve its average load of 149 passengers per flight on these routes.
- B13 The forecast in the CAA's final proposals also included an uplift on GAL's September 2012 base forecast to reflect higher GDP growth, ranging from around 0.7 million in 2015/16 to around 1.7 million in 2018/19. The CAA's final projections represented a total of 186.0 million passengers over the five years of Q6 which were 2.8% or 5.1 million above its initial projections of 180.9 million. This was 3.2% higher than GAL's (May 2013) revised forecast but 2.4% lower than the ACC's (June 2013) forecast.

⁷⁷ This view was also supported by the more updated capacity plan and traffic forecast submitted confidentially to the CAA by airlines that carried around 75% of total passengers at Gatwick.

CAA's proposed licence

B14 Four key issues were raised by stakeholders in response to the CAA's final proposals:

- traffic growth in the base year;
- the more favourable economic outlook and whether expectations of continuous traffic growth over the next seven years are realistic;
- easyJet's use of Flybe's slots and the stability of airline traffic declarations; and
- GAL's recent announcement of 21 new slots from summer 2014.

Base year traffic growth

Issue

B15 Since the initial proposals, traffic at Gatwick has continued to outperform that previously assumed and the rolling 12-month average passenger volume to October 2013 was already running at 35.2 million⁷⁸, that is 0.5 million (or 1.4%) higher than projected in the final proposals (figure B.1).

Figure B.1: Forecast of passengers (in million) for 2013/14 and the rolling year actual

	CAA FP (Sep-13)	GAL (May-13)	ACC (Jun-13)	ACC (Nov-13)	GAL (Dec-13)	Actual (Nov 12-Oct 13)
Passengers	34.7	34.4	34.8	35.2	35.2	35.2

Source: CAA, GAL and ACC.

B16 The airlines considered that the CAA's final proposals forecast did not take proper account of the impact of a higher base year traffic on Q6 passenger volume given the higher traffic outturn so far.

B17 GAL considered that traffic growth in the year to date needed to be tempered by the traffic reductions from airlines ceasing to operate⁷⁹ or delaying commencement of operations at Gatwick. In particular, the higher short-term traffic forecast for 2013/14 and 2014/15 in GAL's latest projection reflected the advancement of the recovery in traffic

⁷⁸ The latest traffic data indicates that Gatwick's passengers reached 35.4m in 2013.

⁷⁹ GAL cited US Airways, Air Berlin, Air One and Hong Kong Airlines as examples.

earlier than previously forecast (by two years against the CAA's final proposals forecast) due to the current optimism in the economy which, in GAL's view, was not expected to lead to permanently higher traffic.

CAA's proposed licence

- B18 The CAA agreed with the airline community that the stronger than expected traffic outturn needed to be reflected in the forecast base year traffic and the following years. However, the extent of upward adjustment would need to be moderated to allow for, amongst other factors, the possibility of some 'one-off' factors due to the summer Olympics in 2012 and the severe winter weather in 2012/13.
- B19 Consequently, the CAA allowed an uplift of around 0.7 million passengers in 2014/15 to reflect the impact of this unexpected strong growth on the overall volume of Q6 traffic. This annual increase was then reduced across the period, down to 0.5 million by the end of Q6.

Representations received

- B20 Virgin and the airline community welcomed the CAA taking account of recent evidence that pointed to higher than previously forecast traffic growth over the Q6 period but noted that the CAA fell short of taking full account of base year growth.

CAA's response

- B21 Respondents raised no new issues or presented new evidence in their representations. Given that passenger traffic at Gatwick reached 35.4 million in the calendar year of 2013, the CAA's decision remains as stated in its proposed licence and summarised above, namely that it is appropriate to allow an initial uplift of around 0.7 million in 2014/15 to reflect the high traffic outturn. This adjustment was gradually reduced down to 0.5 million by the end of Q6. This approach takes account of the inherent uncertainty in traffic forecasting.

Gross Domestic Product outlook

Issue

- B22 UK economic growth accelerated to its fastest pace in more than three years in the third quarter of 2013 as the recovery continued across all main sectors. According to the Bank of England, the recent recovery was likely to be sustained as reduced uncertainty and a continued

easing in credit conditions should help to unlock pent-up demand from households and companies.⁸⁰

- B23 Figure B.2 compares the GDP assumptions used by GAL (June 13) and the ACC (December 12) with the average of a range of latest independent and consensus forecasts. The latest GDP forecasts at the time of the proposed licence represented a significant uplift from GAL's assumptions over most of the Q6 period.

Figure B.2: Comparison of forecast of UK GDP growth

	GAL	ACC	Consensus Forecast	HM Treasury	Bank of England
Year	Jun-13	Dec-12	Oct-13	Nov-13	Nov-13
2013	0.8%	n/a	1.4%	1.4%	1.6%
2014	1.6%	n/a	2.2%	2.3%	2.8%
2015	1.9%	2.0%	2.3%	2.4%	2.3%
2016	2.1%	2.1%	2.2%	2.4%	2.5%
2017	1.8%	2.1%	2.1%	2.3%	
2018	1.7%	2.2%	2.0%		
2019	1.9%	2.3%	2.1%		
2020	2.2%	2.2%	2.1%		
2021	2.3%	2.3%	2.1%		

Source: GAL, ACC, Consensus Forecast, HM Treasury and BoE.

- B24 Given the more favourable economic outlook, the recent announcements on long-haul growth by BA and Norwegian from the airport, and the strong traffic growth in the base year, the airlines considered that there was a significant upside risk to the traffic estimates in the CAA's final proposals.
- B25 GAL considered that economic growth in the current year had been volatile and a return to sustained growth was by no means firmly established. GAL also noted that even during periods of unbroken economic growth, year-on-year traffic growth had not been guaranteed, particularly for a period as long as seven years.

⁸⁰ 'Inflation Report', Bank of England, November 2013.

CAA's proposed licence

- B26 The CAA accepted that traffic growth was by no means guaranteed, however the CAA considered that the GDP elasticities used by GAL in their traffic forecast were based on relationships derived from data over a period of 21 years and so would take this effect into account.
- B27 In light of recent evidence which suggested a more sustained economic recovery, a marked improvement in business and consumer sentiment and the forecast economic outlook, particularly for the immediate term, the CAA considered that there was a need to uplift its short term traffic forecasts for the first three years to 2016/17. The CAA therefore increased its traffic forecast by around 0.2 million in 2014/15, with the increase falling to 0.1 million in 2016/17. However, no additional growth was assumed beyond this.

Representations received

- B28 Respondents raised no specific issues on traffic and the GDP outlook in their representations.

CAA's response

- B29 The latest economic data have continued to suggest a more sustained economic recovery and outlook for the UK over the short term than forecast in October last year (figure B.3). However, sustained economic growth is still by no means certain (particularly for the EU economy) and the short-term traffic forecast is based on airline plans rather than the relationship with economic growth. There has not been an uplift to the Consensus long term forecasts. Consequently the CAA's view on the traffic uplift due to higher GDP growth remains as stated in the proposed licence (0.2 million in 2014/15 and 0.1 million in 2016/17), for the reasons set out above (and in the proposed licence).

Figure B.3: Consensus Forecast of UK GDP growth

Year	Jan- 2014	Oct-2013
2013	1.9%*	1.4%
2014	2.6%	2.2%
2015	2.4%	2.3%

Source: Consensus Forecast. * Figure for 2013 is the latest estimate by the Office for National Statistics.

Use of the acquired Flybe slots by easyJet

Issue

- B30 In its final proposals, the CAA estimated that easyJet's purchase of 25 Flybe slot pairs in May 2013 and the resulting increase in average passenger loads would lead to an additional 1 million passengers per year on average.
- B31 In their response, the ACC continued to consider that the Flybe slots would lead to around 1.9 million additional passengers per year, based on typical easyJet load factors. However, easyJet stated that it now only expected an additional 600,000 passengers per year, as it did not consider that the slots would be fully utilised, particularly in the winter. This was a reduction from easyJet's original estimate of 1.6 million additional passengers per year. The revised estimate of an incremental 0.6 million passengers was based on their planned use of the Flybe slots for summer 2014 and estimates for winter 2015.⁸¹
- B32 Although GAL did not provide an update to their forecast of 350,000 - 550,000 additional passengers per annum due to the sale of the Flybe slots, GAL continued to argue that the ACC and CAA had overstated the impact on traffic growth due to the slot transfer, given that the Flybe slot times were not a perfect fit for the traditional easyJet "three wave" based business model and that the application of the average passenger load of 149 passengers per flight by the ACC did not take into account seasonality ratios or route specific intelligence. GAL also made reference to the easyJet press release on 19 November 2013 which stated that it only expected an additional 300,000 passengers per year from the slots.⁸²

CAA's proposed licence

- B33 Having considered the responses, the CAA decided to reduce its previous estimate of the impact of the transfer of the slots (which assumed an average additional 1 million passengers per year) by 0.55 million passengers in 2014/15 so that the initial increase in

⁸¹ 'Impact on future passenger numbers at Gatwick of the easyJet acquisition of Flybe slots', easyJet, December 2013.

⁸² http://corporate.easyjet.com/media/latest-news/news-year-2013/19-11-2013b-en.aspx?sc_lang=en. easyJet considered that this was simply a cautious statement on its expected passenger numbers.

passengers due to the slot transfer was more in line with the estimates by easyJet and GAL, at 0.45 million.

- B34 Based on an analysis of easyJet's slot portfolio and route network plan for the airport, the CAA considered that the potential long term additional traffic as a result of the slots purchase could be above easyJet's estimate. The CAA therefore assumed that the incremental traffic from easyJet's use of the Flybe slots would grow to 0.6 million per year by 2016/17 and thereafter (i.e. a reduction of 0.4 million per year on the final proposals forecasts).⁸³

Representations received

- B35 Respondents raised no substantive points on this issue in their responses, although Virgin considered that the CAA should have taken full account of the evidence provided by easyJet that suggested a higher impact from the acquired Flybe slots.

CAA's response

- B36 Given that no new evidence of the use of Flybe slots was presented, the CAA continues to consider that the transfer of slots would lead to an initial additional 0.45 million passengers in 2014/15, which would grow to 0.6 million per year by 2016/17 and beyond, for the reasons set out above.

Availability of 21 new slots from summer 2014

Issue

- B37 On 3 October 2013, GAL announced a significant increase to its scheduled capacity limits for summer 2014.⁸⁴ This announcement of 21 new daily slots⁸⁵ - which included 8 morning peak departing slots -

⁸³ The CAA's forecasts for the first two years as presented in the final proposals were based on airlines' latest short-term capacity plan and traffic forecast submitted to the CAA on a confidential basis. However, the CAA's short-term forecasts took into account the likely presence of individual and collective optimism bias in these capacity plans and therefore had taken a conservative approach in deriving its short-term forecast.

⁸⁴ 'Gatwick Airport Scheduling Declaration for Summer 2014', 3 October 2013.

⁸⁵ These were made available through operational improvements on the ground and improved separation control.

constitutes around 2.4% of the total runway movements allocated on a peak summer week during summer 2014.⁸⁶

- B38 The impact of this new peak capacity had not been previously factored into the forecasts by easyJet, the ACC and the CAA.
- B39 BA and the ACC considered that the composition and timing of these slots were such that each peak slot could lend itself to a 3 rotations per day short-haul flight by a based airline. This meant that the 8 new early morning departures slots could facilitate the growth of 24 daily return flights or 48 sectors per day.
- B40 By assuming that half of these slots would be flown year round and the other half would be limited to a 6-month season only, and by applying a similar passenger load per flight as assumed previously in the easyJet's Flybe slot usage, the ACC estimated that the newly created 21 slots would result in an increment of 1.9 million passengers per annum.
- B41 easyJet gave a more conservative estimate of an increase of 900,000 passengers a year which was simply based on the utilisation of the 9 peak departing slots (which includes 1 slot in the evening peak).
- B42 GAL did not consider that the availability of new slots would add to forecast traffic as suggested by the ACC.⁸⁷ In GAL's view, the extra slots were created to fulfil the short term advancement of traffic demand (by about 2 years) that earlier than anticipated economic recovery has generated.

CAA's proposed licence

- B43 The CAA considered that Gatwick, being the busiest single runway airport in the world, had been under runway capacity constraint, especially during the peak periods. It was therefore the CAA's view that the availability of the new peak slots would help alleviate some of the excess demand and lead to increased overall traffic.
- B44 The CAA considered it was difficult to gauge the extent of additional passengers that these newly created peak slots would generate at the

⁸⁶ Total runway movements allocated in a peak week during summer 2014 is 6,021 movements according to the ACL London Gatwick Summer 2014 initial Coordination Report.

⁸⁷ Nevertheless, GAL now expected traffic to increase to 35.2m and 37.3m in 2013/14 and 2014/15 respectively.

airport without knowing how those airlines who acquired the slots would be utilising them (both in the summer season and throughout the year), in conjunction with their existing slot portfolios.⁸⁸

Furthermore, it was plausible that increased services by these airlines could lead to offsetting declines in services and passengers from other operators using the airport.

- B45 The CAA stated that according to the ACL data⁸⁹, total air transport movements (ATMs) and seats initially allocated in summer 2014 were 15.5% and 20.1% higher respectively than in summer 2013, with a corresponding increase of 4.0% in seats per passenger ATM.⁹⁰
- B46 Of the 6,310 weekly slots allocated at the IATA initial coordination conference, 625 of them were acquired by either new entrants (52 slots) or incumbents (573 slots) for new services, including the 147 (=21x7 days) newly created slots per week.⁹¹
- B47 However, the CAA noted that only 2 of the 52 slots acquired by the new entrants were for year-round services, while only 63 of the 573 slots acquired by incumbents were being used to provide year-round services by aligning the summer slots with the schedule in the adjacent season. This seemed to suggest that only a few, if any, of the acquired slots were being used to provide new year-round services. The majority of them were being used by incumbents to either serve a summer season only service or to complement an existing winter service.
- B48 In light of this, the CAA considered that the ACC was likely to have overstated the potential traffic growth by assuming the 8 new peak slots were capable of facilitating 3 aircraft rotations per day throughout

⁸⁸ It should be noted that not all of the slots or seats allocated at the conference will be claimed and/or fully utilised over the whole season as demand for slots at initial coordination for a future season is very likely to be overstated by airlines. It is also plausible that airlines that have acquired the new peak slots may decide to surrender some of their other sub-optimal existing slots as a result.

⁸⁹ London Gatwick Summer 2014 Initial Coordination Report, Airport Coordination Ltd.

⁹⁰ Analysis of ACL's 'Start of Summer Season Report' for Gatwick for the past four years suggests that ATMs at the end of a season were 2.5%-5.5% less than at the start of the season. This is in addition to a likely reduction in slot take up between the initial allocation and the start of the summer season.

⁹¹ These newly created 147 slots per week represent 2.3% of the total weekly slots allocated for a peak week in summer 2014.

much of the year. The CAA considered that it was more appropriate to use a more cautious assumption that each of the peak slots would only facilitate 2 aircraft rotations per day and that half of these slots would be used for a 6-month season only. This was numerically equivalent to an assumption that each peak slot would be used to facilitate 1.5 aircraft rotations per day throughout the year.

- B49 Assuming an average passenger load of 150 on these flights⁹², the CAA estimated that this would lead to an increase of around 1.3 million passengers per annum. These forecasts took into account the potential optimism in, and stability of, airlines' declarations, for example the CAA's forecast growth is lower than the increase in summer slot allocation and the ACC forecast.

Representations received

- B50 Apart from Virgin which stated that the CAA should have taken full account of the impact of the additional slots from summer 2014, respondents raised no specific issues on the use of the 21 additional slots in their representations.

CAA's response

- B51 Given that respondents raised no new substantive points on this issue, the CAA continues to consider that the newly created slots from summer 2014 would result in an increase of around 1.3 million passengers per year over Q6 and 1.1 million per year thereafter, for the reasons set out above.

CAA's decision

- B52 In summary, the CAA's final forecasts take into account the combined impact on traffic due to the better-than-expected growth in the base year, a more upbeat economic outlook particularly in the initial years of the Q6 period, the addition of 21 new peak slots from summer 2014 and the impact of the transfer of Flybe's slots to easyJet.
- B53 The final forecasts shown in figure B.4 are the same as those in the proposed licence and give a total of 193.8 million passengers over

⁹² This is a conservative estimate as the average passenger load on easyJet's A320s at Gatwick was around 160 in 2012 and for other airlines (excluding Flybe) the average load was around 155 according to CAA Airport Statistics. The ACL data presented in the Summer 2014 Initial Coordination Report suggests an increase of 4% in seats per ATM for summer 2014.

Q6, compared to 186.0 million in the CAA's final proposals, an increase of 4.2%. The CAA's forecast is 2.2% lower than ACC's (November 2013) forecast of 198.1 million and 7.5% higher than GAL's (May 2013) forecast of 180.2 million over Q6.

Figure B.4: Forecast of passengers (in million) and annual growth rates

	CAA (Dec 13)	% chg	ACC (Nov 13)	% chg	GAL (Dec 13)	% chg	CAA FP (Sep 13)	% chg	GAL (May 13)	% chg
2012/13	34.2		34.2		34.2		34.2		34.2	
2013/14	35.4	3.4%	35.2	2.9%	35.2	2.9%	34.7	1.5%	34.4	0.6%
2014/15	37.4	5.7%	38.2	8.5%	37.3	6.0%	35.8	3.0%	35.0	1.7%
2015/16	38.2	2.0%	39.0	2.1%	--	--	36.6	2.2%	35.5	1.4%
2016/17	38.8	1.8%	39.6	1.5%	--	--	37.2	1.8%	36.1	1.7%
2017/18	39.4	1.4%	40.3	1.8%	--	--	37.9	1.8%	36.6	1.4%
2018/19	39.9	1.4%	41.0	1.7%	--	--	38.5	1.7%	37.0	1.1%
2019/20	40.5	1.3%	--	--	--	--	39.2	1.7%	37.6	1.6%
2020/21	40.9	1.1%	--	--	--	--	39.8	1.4%	38.2	1.6%
Q6	193.8	1.6%	198.1	1.8%	--	--	186.0	1.9%	180.2	1.4%
Q6+2	275.1	1.5%	--	--	--	--	265.0	1.8%	256.0	1.5%

Source: CAA, ACC and GAL.

APPENDIX C

Capital Expenditure

- C1 This appendix considers the appropriate level of capex to be taken into account in the fair price calculation. It consists of the following:
- capital expenditure process to date;
 - the CAA's proposed licence;
 - the representations received; and
 - the CAA's decision.
- C2 It should be noted that the capex will not be fully paid for during the price control period. Consistent with the RAB methodology, new capex is added to the RAB. Each year, a contribution to prices is made from a capital charge (i.e. the WACC multiplied by the RAB) and a depreciation charge. Therefore, although Q6 capex will have only a limited effect on Q6 prices, it will need to be fully charged to prices over time.

Capital expenditure process to date

- C3 The capital programme has been subject to extensive discussions between GAL and the airlines as part of the formal CE and subsequently. This has led to a number of projects being dropped or refined.
- C4 Following formal CE, GAL's January 2013 RBP set out a capital programme of £0.9 billion for Q6 split between asset stewardship, Q5 carry over and development projects. The ACC supported £0.4 billion of this expenditure but did not support commercial projects which increased prices in Q6 and projects which airlines considered did not provide value for money enhancements to the passenger experience.
- C5 The CAA's initial proposals reviewed GAL's RBP in terms of the inclusion of individual schemes and the efficient cost of those schemes. The review included independent consultancy work

commissioned by the CAA from Davis Langdon (DL) and Steer Davies Gleave (SDG).⁹³ Based on this review the CAA's initial proposals included a capex allowance of £0.8 billion for Q6.

- C6 In response to the initial proposals GAL has updated its capex forecast for the Q6 period from £0.9 billion to £1.1 billion. This difference derived mainly from the inclusion of hold baggage screening (HBS) costs to comply with Department for Transport (DfT) requirements.
- C7 The expenditure on asset stewardship supported by the airlines was reduced by around £6 million due to greater efficiency assumptions. Following GAL's revision of business cases for some projects the ACC expressed support for a number of additional schemes (upgrade check-in (part only), North Terminal (NT) coaching bays, South Terminal (ST) IDL reconfiguration (phase 1), ST public access and Disability Discrimination Act (DDA) compliance, and stand reconfiguration). The ACC did not have a common view on the delivery of 95% pier service in NT (Pier 6 South), NT IDL capacity extension, early bag store and check-in ceilings and floors.
- C8 In its final proposals, the CAA reviewed GAL's updated capex programme. Based on the inclusion of schemes and the assessment of efficient costs the CAA's final proposals included a capex allowance of £0.8 billion for Q6.

CAA's proposed licence

- C9 Following final proposals, which reviewed GAL's updated capex programme of £1.1 billion in terms of the inclusion of individual schemes and the efficient costs of those schemes, in the proposed licence document the CAA reviewed the capex programme mainly in terms of:
- the inclusion of the Pier 6 South project;
 - the inclusion of additional schemes, not previously reviewed under the CAA's final proposals;

⁹³ Consultants' reports are available from:
<http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279>

- construction price inflation; and
- capex in the years 2019/20 and 2020/21.

Inclusion of schemes

- C10 The CAA's review of the inclusion of individual schemes drew on the outputs from CE, the agreements reached between the airport operator and airlines, independent consultancy work commissioned by the CAA from DL⁹⁴ and SDG⁹⁵, and research into whether schemes were in passengers' interests. The CAA's proposals used DL's proposals on scheme costs for enhancement schemes, adjusted, where appropriate, for the proposed reduction in scope. The CAA's proposals on asset stewardship were based on core efficiencies identified by SDG.
- C11 The CAA considered that airlines have an important but not an exclusive role in helping it define how it furthers passengers' interests for the purpose of development proposals for Q6. While airlines do not represent passengers, their interests are often broadly aligned. However, this may not always be the case, for example in situations of airline market power, or where passengers' ability to act in the market is hampered (e.g. information issues). Additionally, future passengers may have interests which are not well articulated by airlines currently operating at the airport.
- C12 The CAA undertook independent validation and assurance to ensure that a settlement is in passengers' interests, drawing on various sources including passenger research, complaints data and the views of the CAA Consumer Panel as set out in the final proposals.
- C13 The CAA found that the majority of schemes proposed by GAL were in passengers' interests. The CAA's view in the proposed licence was based on the CAA's earlier findings that the scope of some schemes was not fully justified and should be reduced, in particular NT border zone, NT arrivals, NT early bag store schemes and NT/ST check-in and bag drop. The CAA also removed the costs of three schemes:

⁹⁴ Davis Langdon, September 2013, Gatwick Airport: Q6 Capex review for the CAA: Phase three report - final, <http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279>

⁹⁵ Steer Davies Gleave, September 2013, Review of Maintenance, Renewals and Other Operating Expenditure at Gatwick Airport: Phase 3 Final Report, <http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279>

runway 2 costs, where the inclusion of the scheme did not appear to be consistent with previous regulatory treatment of these costs; business systems transformation and hangar facilities, where there was not sufficient evidence to include the costs of the scheme. Having received updated business cases from GAL for the revised schemes, the CAA included the costs of the following projects that were not included in the CAA's initial proposals: NT coaching bays and NT baggage reclaim.⁹⁶

- C14 In its proposed licence the CAA continued to consider the inclusion of the NT Pier Service scheme (**Pier 6 South** extension) would provide passenger benefit and therefore should be included in the core capex. The CAA placed weight on DL's statement that the scheme was the only viable long-term solution to maintaining 95% pier service in the NT. The CAA considered that in Q6 alone, given the relatively small increase in pier service forecast by GAL (from 93.4% to 96.6% in 2018 based on the average busy day), it appeared that increased towing could provide a means of maintaining 95% annual average pier service, in particular as GAL forecast similar levels of towing in 2013. However, by the end of Q7 the reduction in pier service without Pier 6 South could be substantial at around 5% and GAL has stated that increased coaching at this level would not be operationally feasible. Consequently, the CAA considered that Pier 6 South is required to meet airport operational requirements in Q7. If the Pier 6 South extension was delayed until Q7 then this could increase the total costs of the project as the Q5 design work could need to be repeated and there would be additional costs of renewals during Q6. GAL estimated the delay costs at around £44 million based on an independent assessment of pavement (stand, pier and taxiway) conditions undertaken in 2012. The CAA considered that any costs in this respect would not be in passengers' interests. Consequently, the CAA maintained its view that the costs of the Pier 6 South scheme should be included in the capital plan for Q6.
- C15 On 2 December 2013, GAL requested that if the CAA was to recalculate the RAB, then it should include the following additional capex:

⁹⁶ Review of individual schemes was set out in paragraphs 4.33 to 4.59 CAA's final proposals.

- runway 2 additional costs of £20 million for the purpose of the Airports Commission (above the costs previously forecast);
- re-development of the Gatwick train station cost at a cost to GAL of up to ₤ (with a scenario that the government would be contributing £180 million)⁹⁷; and
- noise insulation scheme costs.

C16 For reasons stated in its initial and final proposals, the CAA maintained its view not to allow **runway 2** costs to be added to the RAB.⁹⁸

C17 The CAA did not consider it appropriate to add the **station re-development** project to the Q6 capex because:

- on 4 December 2013, the government published the National Infrastructure Plan 2013⁹⁹ which announced that the government was taking forward measures proposed by the Airports Commission¹⁰⁰ by introducing a package of improvements to airport-surface access. Although these measures mentioned a full re-development of the railway station at Gatwick, it was mentioned that a sum of £50 million (not £180 million as initially implied by GAL) would be made available subject to satisfactory commercial negotiations with the airport operator;
- discussions with DfT relating to this project were at an early stage, as pointed out by GAL and as confirmed by the government's statement of 4 December 2013;

⁹⁷ GAL, Gatwick's counter-response to the ACC's response to the CAA's final proposals, 2 December 2013.

⁹⁸ Chapter 5 of CAA's initial proposals, in particular paragraph 5.50 and Chapter 4 of CAA's final proposals, in particular paragraph 4.43.

⁹⁹ Available from: <http://www.parliament.uk/documents/commons-vote-office/December%202013/3%20December/4th-December-2013/1.CHANCELLOR-National-Infrastructure-Plan.pdf>

¹⁰⁰ Letter from the Airports Commission with recommendations on short-term surface transport measures, paragraph 26 November 2013, available from: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263208/surface-access-letter.pdf

- GAL has not provided the CAA with any details or breakdown of this costs other than an overall estimate of around £ over the commitments period;
- the project has not been consulted with airlines;
- a £53 million scheme (with GAL's contribution of around £8 million) for the station's upgrade was agreed in 2010 and planned to complete in 2013; and lastly
- the Office of Rail Regulation (ORR) published its final determination setting out funding, required outputs and the regulatory framework for Control Period 5 (CP5: April 2014 - March 2019) in October 2013¹⁰¹ and this project was not considered.

C18 In relation to the **noise insulation** scheme the CAA pointed out that GAL has not provided an estimate of the overall cost of the scheme apart from stating £. The CAA therefore considered it did not have sufficient evidence to include this scheme.

Efficient cost of individual schemes

- C19 The CAA's review of the efficient scheme costs drew on the two above mentioned independent consultancy studies commissioned by the CAA: the SDG study that reviewed GAL's capex on asset stewardship and the DL study that reviewed GAL's enhancement/development capex projects. SDG identified efficiencies to asset stewardship costs from the removal of double-counting in project risk allowances and a reduction of on-costs to be in line with benchmarks. DL identified efficiencies to project costs from a reduction in unit costs, a reduction in on-costs in line with benchmarks and the removal of double-counting in risk allowances.
- C20 It should be noted that both SDG and DL undertook their analysis based on the 2013/14 price base used by GAL. The CAA converted these costs to 2011/12 prices.
- C21 To be consistent with the price in the commitments and a RAB-based comparator the CAA has only included the costs of the core capex

¹⁰¹ ORR, Periodic Review 2013: Final determination of Network Rail's outputs and funding for 2014-19, October 2013, available from: <http://www.rail-reg.gov.uk/pr13/PDF/pr13-final-determination.pdf>

plan. The CAA noted that under both the commitments and a RAB-based alternative, GAL has proposed that the costs of HBS were held outside the proposed price cap/path. The CAA has not included the costs of hangar facilities and business systems transformation in the core capex plan as the business cases for these projects did not appear to be strong.¹⁰² The CAA also excluded the costs related to the development of the second runway from the capital plan.

C22 In the proposed licence the CAA reviewed more recent trends of the **construction price inflation**. In its final proposals the CAA examined forecasts of the construction output price index (COPI).¹⁰³ The airlines considered that the CAA should adjust the capex allowance by the forecast difference between COPI and RPI. This would reduce prices as COPI was forecast to be below RPI. The CAA noted that COPI was only forecast to be below inflation in the first few years of Q6 and was forecast to return above inflation in the second half of Q6. The CAA pointed out that the COPI forecasts were based on All New Construction forecasts which included categories that would not apply to GAL's capex, such as Housing. The CAA also noted that the Infrastructure component of All New Construction had been increasing at a higher rate than the overall All New Construction index in the past few years and considered this trend was likely to continue into Q6. The CAA therefore continued to consider it inappropriate to make a separate additional allowance for COPI given:

- recent trends: with Infrastructure COPI above All New Construction COPI, and All New Construction COPI marginally below RPI forecasts; and
- the uncertainty involved in the COPI forecasts and its volatile nature, which were also noted by the CC in its Q5 review.¹⁰⁴

¹⁰² The CAA notes that GAL does not consider itself to be the operator of the maintenance facilities as part of the operator determination.

¹⁰³ See paragraph 4.62 of the CAA's final proposals.

¹⁰⁴ CC, Heathrow Airport Ltd and Gatwick Airport Ltd Q5 price control review, 2007, Appendix D: Capital investment and construction inflation, available from: <http://www.competition-commission.org.uk/our-work/directory-of-all-inquiries/heathrow-and-gatwick-quinquennial-review/final-report-and-appendices-glossary>. In this review the CC also stated that in the past construction price inflation has been more pronounced for housing projects than infrastructure projects and therefore considered that inflationary pressures would be more appropriately measured by analysing trends in the infrastructure COPI and the commercial

Overall Q6 capex allowance

- C23 In the proposed licence based on the inclusion of schemes and the assessment of efficient costs the CAA included a capex allowance of £0.8 billion over a 5-year control period.
- C24 Figure C.1 sets out the CAA's forecast Q6 capex programme based on its stretch targets for renewals and proposals on scheme costs adjusted where appropriate for proposed reductions in scope as set out in its final proposals. The total core capex programme was forecast at £790.8 million which represented a 13% reduction in GAL's core plan in its response to the CAA's initial proposals.

Figure C.1: CAA's forecast on the core and development capex plan for Q6 in the proposed licence (£ million)

	2014/15	2015/16	2016/17	2017/18	2018/19	Total
Total asset stewardship	55.1	74.3	63.5	64.3	63.1	320.3
ST Baggage & Pier 1	61.9	21.7	0.0	0.0	0.0	83.6
Pier 5	2.7	0.0	0.0	0.0	0.0	2.7
Other carry over projects	1.6	0.0	0.0	0.0	0.0	1.6
Total carry over	66.3	21.7	0.0	0.0	0.0	88.0
Delivery of 95% Pier Service in NT	4.5	43.6	70.5	32.8	0.6	152.0
NT Security Reconfiguration	4.4	6.0	5.3	2.3	0.0	17.9
Early Bag Store	0.5	0.6	5.2	5.0	0.5	11.8
Upgrade Check-in & Bag Drop	0.9	2.7	4.4	4.0	22.6	34.6
NT Border Zone	0.0	0.4	0.8	4.2	1.7	7.1
NT IDL Capacity Expansion	18.2	25.0	22.2	8.2	0.0	73.6
Stand Reconfigurations	0.7	7.1	1.4	0.2	0.0	9.4
Long Stay Car Products	0.0	0.0	0.0	0.6	4.1	4.7
Digital Media	0.1	2.4	0.8	0.1	1.6	5.0
Commercially Important Persons Departures	0.1	1.8	0.0	0.0	0.0	1.9
NT Baggage Reclaim	0.0	0.0	0.2	1.3	1.2	2.6

building COPI. The CAA notes, however, that although Infrastructure COPI may be a more accurate measure of future construction price inflation for airport operator capex, forecasts for Infrastructure COPI were not available.

	2014/15	2015/16	2016/17	2017/18	2018/19	Total
NT Arrivals Transformation	0.4	1.3	4.0	0.0	0.0	5.7
ST IDL Capacity	0.0	0.4	1.0	9.2	13.9	24.5
CIP Arrivals	0.1	1.8	0.0	0.0	0.0	1.9
Additional NT Coaching Bay	0.1	0.2	0.6	0.9	0.0	1.9
ST Public Transport and DDA Access	0.4	0.3	2.7	4.1	0.0	7.6
Consolidated Car rental and Motor Transport facility	0.3	0.9	3.5	0.0	0.0	4.7
Stands 551 and 552	0.8	5.3	0.0	0.0	0.0	6.1
Minor Projects	1.9	1.9	1.9	1.9	1.9	9.4
Total core enhancement capex	33.3	101.8	124.5	74.9	48.0	382.5
Total core capex plan	154.7	197.8	188.0	139.2	111.0	790.8
Business Systems Transformation	3.1	3.1	3.1	2.8	2.8	14.9
Hangar Facilities	3.7	0.0	0.0	0.0	0.0	3.7
HBS replacement	5.9	4.3	49.8	42.7	6.6	109.4
Liquid Explosives Detection	0.0	0.4	1.2	0.0	0.0	1.6
Total development projects	12.7	7.8	54.1	45.5	9.4	129.6
Total capex plan	167.5	205.6	242.1	184.8	120.5	920.4

Source: CAA calculations

Q7 capex

C25 For the first two years of Q7, 2019/20 and 2020/21, the CAA's forecast capex was £168.6 million and £216.6 million respectively based on GAL's RBP. The CAA considered it appropriate to base the capex allowance in the first two years of Q7 on GAL's forecast (after removing HBS costs which were moved to Q6) for the purpose of calculating a 7-year comparison fair price. The CAA noted that GAL's commitment of £100 million spend per year was the minimum requirement for investments and did not mean that the capex in the first two years of Q7 would be £200 million.

C26 In the proposed licence the CAA's forecast for the first two years of Q7 also included the costs of the ST IDL capacity project which were not included in its final proposals for those two years. As discussed in its

final proposals, the CAA considered that this project would provide net financial benefits to passengers during Q7 and therefore considered the project to be in passengers' interests.¹⁰⁵ Following GAL's explanation that there was an error in the project sheet previously sent to the CAA and that the project would not finish in Q6, the CAA considered it appropriate to amend its previous forecasts for the first two years of Q7 to include the additional costs of the project.

C27 The CAA pointed out that given the early stage of development of many projects it has not been possible for the CAA to undertake a detailed bottom-up review of the expenditure on individual projects. The CAA also noted that given the early stage of development, costs were likely to change before the projects are delivered. Figure C.2 sets out the CAA's forecast capex plan for the first two years of Q7.

Figure C.2: CAA's forecast capex for the first two years of Q7 in the proposed licence (£ million)

	2019/20	2020/21
Asset stewardship	78.4	99.2
Long stay capacity (Decking) post 2019	1.9	4.7
CIP Building replacement (NT)	9.4	9.4
NT Avenue reconfiguration	1.9	4.7
NT Baggage Reclaim reconfiguration	0.0	2.8
NT Short Stay Car Park	1.7	8.6
ST Baggage Reclaim	0.9	0.9
Additional staff car park capacity	2.4	2.7
NT IDL Phase 2 (Post 2019)	18.9	18.9
Baggage capacity expansion (Post 2019)	0.0	1.9
Railway contribution	9.4	9.4
Bridge over railway	0.0	0.9
ST Short Stay Multi Storey Car Park	0.0	1.9
Product development - Car Parking, Post 2019	1.9	1.9
Terminals works Post 2019	4.7	8.0
Piers works (Post 2019)	11.3	16.0

¹⁰⁵ See paragraph 4.55 of the CAA's final proposals.

	2019/20	2020/21
Commercial products (£25m holding figure, scope to be determined)	4.7	4.7
Industrial bays (assume 3 warehouses and associated bays works)	3.8	3.8
Landside restaurant	0.0	0.9
ST IDL Capacity	17.2	14.9
Total	168.6	216.6

Source: CAA analysis of GAL's RBP

Representations received

- C28 The CAA received only one representation in response to its proposed licence commenting specifically on the capex allowance.
- C29 Virgin stated it was disappointed in the CAA's decision to include Pier 6 South in the capital plan. Virgin stated that generally the airlines believed the project was unnecessary and poor value for money and that the scheme's inclusion inflated the fair price comparison.

CAA's response

- C30 As part of its final proposals and the proposed licence, the CAA reviewed the cost and inclusion of individual schemes. On making a decision on which schemes to include in its fair price calculation the CAA has considered how best to further its statutory duties in particular to further the interests of existing and future passengers, and to do so, where appropriate, by promoting competition. The CAA reviewed the inclusion of the Pier 6 South project in paragraphs 4.44 - 4.52 of its final proposals and paragraphs C25 to C30 of the proposed licence document (as summarised above).
- C31 The CAA notes Virgin's comment on the inclusion of Pier 6 South. The CAA however maintains its decision to include this scheme in its capex allowance for reasons summarised above, namely:
- the scheme would provide passenger benefit;
 - Pier 6 South is required to meet airport operational requirements in Q7; and

- if the Pier 6 South extension was delayed until Q7 then this could increase the total cost of the project (additional renewals) and the delay costs would not be in passengers' interests.
- C32 The CAA also notes that one of Gatwick's airlines supported the inclusion of the Pier 6 South scheme.
- C33 The comparison between the fair price and the commitments price is discussed in more detail in Appendix I.

Subsequent development

- C34 On 29 January 2014, GAL began consulting its airlines on the possibility of consolidating easyJet into one terminal.¹⁰⁶
- C35 easyJet currently remains split between the North and the South terminals. Although GAL's RBP was based on the continuation of split terminal operation for easyJet through to 2020, GAL presented some business cases for a scenario of easyJet consolidating in the ST.¹⁰⁷ GAL, and subsequently the CAA, focused on the scenario of easyJet remaining split as this was the most likely scenario at the time. The CAA's capex forecasts have therefore been based on this option.
- C36 The consultation document provided by GAL considers three possible scenarios.
- easyJet consolidating into ST: GAL estimated that this would increase its £1.1 billion capex plan by £79 million.
 - easyJet consolidating into NT: GAL assessed this would have a medium to high impact on capex, capital cost, opex, revenue and timing/disruption.
 - continued split terminal operation for easyJet.
- C37 GAL stated that consolidating easyJet would have benefits from reducing confusion and inconvenience for passengers and inefficiency for crew and groundhandling operations.

¹⁰⁶ E-mail from GAL dated 30 January 2014 which included a consultation document sent out to airlines.

¹⁰⁷ Consolidation into the ST was the consolidation option preferred by easyJet and GAL at the time.

- C38 Based on its analysis, GAL's preferred scenario is the consolidation of easyJet into NT as soon as feasibly possible; ideally by November 2015.
- C39 As the possible scenario of easyJet consolidating is still at an early phase and subject to further consultation, the CAA does not consider it appropriate to amend its capex forecast at this stage. The CAA would only expect significant changes to the capex plan if there were clear passenger benefits.

CAA's decision

- C40 As discussed above, the CAA's decision on inclusion of individual schemes proposed by GAL is based on its proposed licence which incorporated the following:
- outputs from CE;
 - the agreements reached between the airport operator and airlines, especially following GAL's revision of several schemes post-RBP;
 - independent consultancy work by DL on GAL's enhancement/development projects;
 - independent consultancy work by SDG on asset stewardship; and
 - research into whether schemes were in passengers' interests.
- C41 Based on the above analysis and reasons, the CAA maintains its decision on GAL's capex allowance and efficiency over Q6 and the first two years of Q7 as discussed in the proposed licence (see figure C.3 below).

Figure C.3: CAA's decision on capex (£ million)

	2014/15	2015/16	2016/17	2017/18	2018/19	Total	2019/20	2020/21
Asset stewardship	55.1	74.3	63.5	64.3	63.1	320.3	78.4	99.2
Carry over	66.3	21.7	0.0	0.0	0.0	88.0	0.0	0.0
Core enhancement capex	33.3	101.8	124.5	74.9	48.0	382.5	90.1	117.4
Total core capex plan	154.7	197.8	188.0	139.2	111.0	790.8	168.6	216.6
Development enhancement capex	12.7	7.8	54.1	45.5	9.4	129.6	0.0	0.0
Total capex plan	167.5	205.6	242.1	184.8	120.5	920.4	168.6	216.6

Source: CAA calculations

APPENDIX D

Operating Expenditure

- D1 This appendix considers the appropriate opex allowance for the Q6 price control calculation and contains the following sections:
- a summary of the CAA's opex process to date;
 - a description of the opex allowance contained in GAL's RBP for Q6;
 - a summary of the CAA's final view for the Q6 opex allowance as set out in the proposed licence document;
 - a summary of stakeholders' views on key issues affecting the opex forecasts; and
 - the CAA's final decision for the opex allowance over Q6.

Opex process to date

- D2 To date, the Q6 opex process has consisted of the following stages.
- GAL published its IBP in April 2012 providing its initial opex estimate of £1,528 million over Q6.
 - Between July and December 2012, GAL and the airlines engaged in a process of CE over the forecasts in the IBP, providing a report to the CAA highlighting areas of agreement and disagreement for investigation and assessment.
 - In January 2013 GAL updated its opex estimate in the RBP. This estimate reduced total opex by 3% to £1,481 million over Q6. This estimate was summarised in Chapter 5 of the CAA's initial proposals.
 - The CAA commissioned several consultancy studies to assess the forecasts contained in the IBP and RBP based on benchmarking, analysis of historical trends and testing the assumptions underlying the business plan.

- The CAA used this evidence to develop the opex estimate described in the initial proposals published in April 2013. The forecast was for £1,385 million over Q6, equivalent to a 1.1% reduction per year. This estimate was based on GAL achieving an efficient cost base by the end of Q6.
- Stakeholders responded to the initial proposals and the CAA published its final proposals in October 2013. This included a lower opex forecast of £1,378 million, equivalent to a 1.3% reduction per year over Q6.
- Stakeholders responded to the final proposals in November 2013.
- In January 2014 the CAA published its proposed licence which set out its final view for the opex allowance taking account of stakeholders' views.

D3 Figure D1 provides a summary of the opex forecasts in GAL's business plans and the CAA's initial and final proposals and the proposed licence for comparison.

Figure D.1: GAL opex forecasts

£ million 2011/12	2014/15	2015/16	2016/17	2017/18	2018/19	Total
IBP	296	299	304	312	317	1,528
RBP	288	294	297	300	301	1,481
CAA - IP	283	280	277	274	271	1,385
CAA - FP	283	279	276	272	269	1,378
CAA - PL	284	281	279	276	274	1,393

Issues

D4 GAL and the airlines hold different views over the appropriate opex allowance for Q6 based on differing assumptions about the scope for efficiency. There is also some uncertainty and informational asymmetry between GAL and the CAA over opex, which requires the CAA to apply judgement to several issues. The CAA considers that the main areas of disagreement between GAL and the airlines concerning GAL's opex projections and the CAA's proposals have been:

- the analysis and conclusions of the top-down benchmarking;
- the analysis and conclusions of the employee pay benchmarking studies and achievability of efficiency savings;
- the analysis and conclusions of the pensions benchmarking, studies and achievability of efficiency savings;
- the scope for greater security process efficiency including flow rates, roster efficiency and the potential for outsourcing;
- the scope for greater efficiency through savings in other areas including maintenance, utilities, rent, rates, police, Air Navigation Services (ANS), cleaning and other costs;
- the scope for greater efficiency from frontier shift; and
- the CAA's judgement over these issues and the overall scope for efficiency at Gatwick.

D5 Each of these issues, stakeholders' views and the CAA's final views as set out in the proposed licence are described below.

Top-down benchmarking

Issue

D6 The CAA reviewed the available benchmarking evidence and undertook its own analysis as part of the initial proposals. The CAA concluded that this analysis tended to suggest that GAL had scope for efficiency catch-up based on direct comparisons of adjusted unit costs with other airport operators. The analysis also indicated that opex per passenger had grown rapidly in comparison with other airport operators and airlines.

D7 In the final proposals the CAA updated the benchmarking analysis and concluded that overall the available benchmarking evidence indicated that Gatwick is operating at around the average level of airports of its size and characteristics. However, there were several airports with similar characteristics, which outperform Gatwick. This suggested that there may be scope for further catch-up efficiency.

- D8 In response to the final proposals, GAL welcomed the updated benchmarking analysis which showed that Gatwick was slightly below the average of the sample. However GAL disagreed with the CAA's conclusions that the analysis indicated that there could be scope for efficiency. GAL also made several criticisms of the analysis, including that adjustments based on national GDP per capita concealed regional wage differentials, which put GAL at a disadvantage. GAL stated that it drew labour from the south east of England, where GDP per capita is 26% higher than the EU average, compared with 12% higher for the UK as a whole.
- D9 GAL undertook further analysis applying regional GDP data to the CAA's benchmark dataset and found that Copenhagen had reduced opex per passenger by 18% rather than 38%. GAL estimated that Copenhagen had reduced its opex per passenger from £10.23 in 2005 to £8.43 in 2010, meaning that its costs were actually higher than Gatwick. GAL estimated that Gatwick had lower costs than all of the airports in the sample except Luton, Glasgow and Stansted.
- D10 GAL stated that it had recently \times and had achieved significant improvements in efficiency represented by a 32% reduction in opex per passenger since 2009/10, compared to a 4% increase at Heathrow. GAL also stated that these findings meant that it was unlikely to have further scope for catch-up efficiency.
- D11 GAL commented on the CAA's statement that operators of airports with a high proportion of low cost carrier passengers tend to have lower operating costs, stating that the varied and evolving nature of its traffic, competition with other London airports and high rates of utilisation meant that it had to provide a wider service proposition, which increased its costs.
- D12 GAL made several points regarding comparisons between Gatwick and Copenhagen airport, stating that there were several differences which meant that the airports were not perfectly comparable. These differences included that: terminal 1 at Copenhagen handled only domestic traffic, terminal 2 and 3 share a common security search area, IDL, baggage, border and arrival facilities; unlike Gatwick Copenhagen has no segregation between arriving and departing passengers and Copenhagen's three runways meant that it was less congested than Gatwick. GAL also stated that comparisons between airlines and airports were not relevant.

- D13 GAL did not agree with the CAA's comments on the AT Kearney analysis and stated that it should be given more significance than the other top-down studies. GAL stated that the study had applied a more detailed methodology and the comparisons were more appropriate. GAL also stated that the study showed that GAL's opex per passenger was £8.22 in comparison with an average of £9.89.

CAA's proposed licence

- D14 GAL's adjustments to the top-down benchmarking analysis were based on amalgamating the GDP and population of several regions including inner London and others to represent labour costs at Gatwick. On this basis GAL estimated that GAL's wage costs were 26% higher than the EU average. The CAA considered that Inner London has the highest GDP per capita in Europe and its inclusion in a sample to represent Gatwick was not appropriate. The CAA also considered that Eurostat data for the South East better represented GAL's labour market meaning that average wages in Gatwick's labour market area are around 16% higher than the EU average.
- D15 The CAA updated its benchmarking analysis to account for differences in regional wage levels based on Eurostat Purchasing Power Parity (PPP) adjusted data¹⁰⁸ (taking the South East as a proxy for Gatwick). Relative to the previous analysis in the final proposals, this showed that the adjusted operating costs per passenger at Gatwick were closer to those at Stansted but higher than Aberdeen (reflecting very high wages in north eastern Scotland), and remained higher than several comparators including Copenhagen, Dublin, Edinburgh and Glasgow. The CAA considered that this updated analysis did not alter its previous conclusions.
- D16 The CAA noted GAL's comments regarding the relevance of comparisons of operating costs between airlines and airport operators but considered that such comparisons can be useful. It is common practise for regulators to compare the performance of a company over time with comparable industry benchmarks; this includes companies in different industries.

¹⁰⁸ http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/1-21032013-AP/EN/1-21032013-AP-EN.PDF

- D17 The airlines made several comments about the savings that have been made in the airline industry and contrasted this with the rise in GAL's prices. Virgin provided some evidence which indicated that it has been able to reduce costs in real terms in several areas including ✂, which suggests that GAL should have been, or be able to, make similar reductions in areas of its business.
- D18 The AT Kearney study was focused on benchmarking central support costs, which only account for around 13% of opex. The CAA considered that this study was less relevant to the assessment of total opex from a top-down perspective. The CAA noted that the AT Kearney study undertook a detailed bottom-up analysis of central support costs and took account of this in the assessment of central support costs. However, this method was not applied to other parts of GAL's cost base in the study. Gatwick had the highest level of low cost carrier passengers in the AT Kearney sample, and this was likely to mean that the sample airports would have higher costs all else equal. AT Kearney were not able to disclose the airports in the sample due to confidentiality and the CAA noted that it could not be sure of the comparability of the sample.
- D19 The CAA considered that its benchmarking analysis was robust, and consistent with the available independent evidence and that it has drawn appropriate conclusions, confirmed by the findings of the various bottom up efficiency studies.

Employee pay

Issue

- D20 GAL's RBP assumed that staff wages would rise by RPI+0.75% per year. The IDS employee reward benchmarking study examined GAL's staff costs against comparators finding that total staff reward was between 9% and 13% higher than benchmarks based on comparisons with general and aviation market rates. The analysis took account of variations in regional pay differentials, organisation size and other factors to compare staff costs. IDS also found that basic salaries at GAL had increased by 33% between 2006 and 2012, nearly twice the average rate of increase in the South East and that

GAL had relatively high levels of absenteeism; 10 days per person per year compared with benchmarks of 6-8 days in the wider economy.

- D21 Taking account of the points described above, in the final proposals the CAA considered that GAL could reduce staff costs by between £19.4 million and £25.1 million per year by 2018/19.
- D22 In response to the CAA's final proposals, GAL stated that the CAA had overestimated the potential for reductions to staff costs. It stated that staff costs were the only controllable element of opex and that the CAA's frontier shift savings would also largely fall in this area. GAL stated that in combination the CAA had effectively assumed that it could reduce staff costs by £26.8 million per year.
- D23 GAL was concerned that the CAA had not taken account of its feedback on the IDS staff cost benchmarking study. GAL restated that the IDS study was not consistent with the methodology applied to the CAA's NATS (En Route) plc (NERL) review, in which IDS made a statement that the examination of individual job roles should allow for $\pm 10\%$ variation from the benchmark in individual staff roles to account for statistical noise in the variations in pay rates.
- D24 GAL stated that the CAA had overstated the potential for staff cost efficiency because it had applied the benchmark efficiency to GAL's gross staff costs in 2011/12 of £141 million. This overstated the potential saving as the figure included costs attributable to the capital programme.¹⁰⁹ These costs had been evaluated separately through the capex efficiency review and this created a risk of double-counting the scope for efficiency savings.
- D25 GAL stated that the CAA had overestimated the feasibility of making changes to staff and pension policies, stating that it had inherited legacy wage arrangements from the previous owners, and had worked hard to bring wages into line with benchmarks. GAL considered that the CAA had not sufficiently considered the pace at which changes could be made to wages and pension arrangements and had not permitted any allowance for transitional or redundancy costs required by the implied changes.

¹⁰⁹ GAL's 2011/12 regulatory accounts state that £16.9 million worth of staff costs were capitalised.

- D26 GAL did not accept that it could reduce staff costs by 20% with a nominal pay freeze. GAL stated that a proposed pay agreement at 2% nominal for 2013/14 and 2014/15 had not yet been agreed between GAL and its unions and this award was going to dispute resolution through Advisory, Conciliation and Arbitration Service (ACAS). GAL highlighted that this provided an indication of the difficulties it would face in reducing wage costs and that reducing staff pay by 20% over 5 years would 'undoubtedly' lead to industrial action. GAL stated that a wage freeze would restrict its ability to recruit in key support areas and that the CAA had made overly optimistic assessments of economic growth in passenger and commercial revenue forecasts.
- D27 GAL provided analysis of two potential changes to staff costs; increasing the proportion of security officers on new starter rates, and sub inflation pay settlements, which it estimated could save a total of £9.8 million per year in total.
- D28 GAL did not agree with the CAA's estimate that it could achieve an efficiency of around £1 million per year through reducing rates of absenteeism. It stated that its rates of short-term absenteeism were around 5 days per annum comparable to benchmark rates of 4.4 to 5.6 days per annum. It stated that the reason for its higher rates of long-term absenteeism was the greater stress and physical strain involved in manual security jobs.
- D29 Virgin stated that it was concerned that the CAA had been inconsistent in its analysis of macroeconomic factors. It stated that there was no data to support the modification of the original staff cost efficiency proposal, and that if wages are expected to increase more rapidly this would have a positive effect on commercial revenues that should also be taken into account. A stronger economy could also increase rates of turnover, which would allow GAL to employ staff on lower rates.
- D30 BA stated that there was evidence to suggest that the UK labour market has behaved differently in the recent recession. The fall in employment has been much lower than expected based on historical experience with firms 'hoarding' labour. This was likely to mean that wage growth is likely to be suppressed in any recovery over the next few years.

CAA's proposed licence

- D31 The CAA considered that GAL's comments on the interpretation of the IDS study of NERL wage costs were not relevant to the airport study. IDS's advice on the NERL study was provided in reference to the assessment of individual job roles and not overall staff costs at a company level. The CAA considered that disregarding individual job roles with low variation to benchmarks would skew the analysis towards only relatively high and low paid jobs and distort the assessment of overall staff cost efficiency. The IDS analysis was also based on two separate benchmarks; general and aviation markets, which were used to estimate an upper and lower bound for the differences in total staff costs. Each benchmark had different levels of divergence across job roles and modifying or excluding roles within 10% of the benchmark would adversely affect the analysis.
- D32 The CAA noted that GAL's own benchmarking evidence indicated that total staff costs were \approx higher than benchmarks, which suggested that the IDS study could provide a conservative estimate of the potential for efficiency.
- D33 The CAA did not accept GAL's assumption that staff costs are the only controllable element of opex or that frontier shift savings would need to be made wholly in staff costs. Frontier shift savings were based on the observed performance of companies across a range of sectors, which have been able to increase their total factor productivity (TFP) by around 1% per year on average. GAL was likely to have scope to make similar savings through a range of measures such as technological progress, greater energy efficiency, new security equipment, reducing outsourced costs or restructuring for example.
- D34 The IDS study was based on 2011/12 data which took account of the changes to GAL's staff costs since the sale, this was reflected in the relative benchmarks between Heathrow, Gatwick and Stansted, which indicated that GAL's staff costs were closer to benchmarks.
- D35 The CAA's proposals were based on GAL reducing staff costs by 9% to 13% gradually by 2018/19 in line with the IDS benchmarks. The CAA considered that this was an appropriate length of time for GAL to make required changes to its cost base and is consistent with the "glide path" approach applied to HAL.

- D36 The CAA accepted GAL's comments on the capitalisation of staff costs and the potential risk for double-counting efficiency through the capex efficiency studies. GAL's total staff costs in 2011/12 were £141 million. This included £20.9 million capitalisation meaning that net staff costs (included in opex as opposed to capex) were around £120 million. Staff costs increased to £144 million in 2012/13 including £22.1 million capitalisation, meaning net staff costs increased to £122 million. The CAA estimated that the potential wage cost efficiency could therefore be lower than assumed in the final proposals - between £16.5 million and £21.4 million by 2018/19.
- D37 In the final proposals the CAA stated that the recent improvement in the economic outlook could mean that wages in the general economy could rise faster than inflation, reducing the scope for wage efficiency savings. In the proposed licence the CAA noted that new forecasts from the OBR¹¹⁰ indicated that real wage growth was unlikely and average earnings were forecast to remain below inflation over Q6 on a cumulative basis. Figure D.2 shows that average wages were expected to be around 2% lower in real terms by the end of Q6 compared with a 2012 base. The CAA considered that this meant that GAL was likely to have greater scope for efficiency.

¹¹⁰ Office for Budget Responsibility, Economic Outlook December 2013.

Figure D.2: OBR real average earnings growth assumptions

Year	March 2013 forecast		December 2013 forecast	
	Average Earnings	2012=100	Average Earnings	2012=100
2012	-1.1%	100	-1.2%	100
2013	-1.8%	98.2	-1.6%	98.4
2014	-0.1%	98.1	-0.3%	98.1
2015	0.4%	98.5	0.0%	98.1
2016	0.4%	98.9	-0.1%	98.0
2017	0.1%	99.0	0.0%	98.0
2018	0.1%	99.1	-0.2%	97.8

Source: OBR March and December Economic Forecasts

Note: Real average earnings calculated by subtracting RPI from nominal average earnings.

- D38 The CAA considered that lower average wage growth over Q6 meant that GAL was likely to be able to reduce costs by more than assumed in the IDS study, which was based on wage levels in 2012. Accounting for the reduction in average earnings over Q6 meant that GAL could reduce wages by between 11% and 15%. This would result in a saving of between £13.4 million and £18.2 million per year by the end of Q6 (based on lower staff costs and accounting for capitalisation).
- D39 The CAA noted GAL's comments about the difficulties of achieving the proposed wage cost efficiencies and GAL's sensitivity analysis. The CAA considered that the proposed savings could be exceeded through a nominal wage freeze, and that similar measures are being applied throughout the public sector. This indicated that the savings are achievable. The CAA noted that GAL has other methods of reducing staff costs, which could include reducing rates of absenteeism, increasing the proportion of staff on lower rates of pay and, if necessary restructuring functions to reduce headcount.
- D40 GAL's analysis of the impact of below inflation pay rises is based on an assumption that pay growth should be 2% less than inflation in 2014/15, followed by 1% below inflation for the rest of the period. The CAA considered that this was overly generous given the existing level of staff cost inefficiency.

- D41 The CAA noted that GAL's levels of absenteeism were higher than benchmarks (including at Heathrow) and could be reduced. The CAA did not accept that GAL's employees were under higher levels of stress or physical strain than the average UK company employee.
- D42 The CAA estimated that the cost efficiency assumption could be exceeded with a nominal wage freeze over Q6 which would reduce costs by around 21%, assuming average inflation of 3.5%. The CAA noted this was significantly above the CAA's proposed reduction of 11% to 15% and indicated that the savings were achievable. The CAA based the wage costs efficiency on GAL's own staff costs and headcount proposals and had not assumed that any changes in headcount are required.

Pensions - future service costs

Issue

- D43 In the CAA's Q5 November 2007 proposals for Heathrow and Gatwick, the CAA stated that BAA's pension costs should be capped "on the basis of cash contributions to the pension fund each year" but that these should be capped at an appropriate level, to ensure airport users are not disadvantaged by the relative generosity of the scheme. Previous analysis by the CC indicated that an allowance of 20% of pensionable pay was appropriate. The CAA decided to allow a cap of 25%, partially to enable BAA to make changes efficiently.
- D44 A study conducted by IDS estimated that pension costs would be equivalent to 24% of pensionable pay in 2013 on average (31% for the defined benefit (DB) and 10% for the defined contribution (DC) scheme).
- D45 Whilst below the Q5 cap, this was estimated to be higher than comparative benchmarks of 20% for DB schemes and 7% for DC schemes. Based on this evidence, the CAA considered that GAL could reduce pension costs by up to £5 million by 2018/19.
- D46 Following stakeholders comments on the initial proposals, the CAA commissioned Government Actuary's Department (GAD) to review the pension benchmarking analysis and stakeholders' responses. The study reviewed the initial proposals, and the benchmarking

undertaken by IDS. GAD concluded that DB costs are based on a number of factors including the type of benefits provided, funding assumptions and other factors affecting investment returns such as asset allocations. GAD considered that this created some uncertainty over the comparability of individual DB pension scheme contribution rates and that there is a range of possible contribution rates associated with an efficient level of pension benefit provision due to legitimate differences in funding assumptions.

- D47 GAD considered that it was appropriate for the CAA to assume further efficiencies in GAL's pension scheme, as savings were being proposed by HAL, and analysed two changes based on comparisons with other typical DB schemes; increasing the normal retirement age from 60 to 65, and reducing the scheme's accrual rates from 1/54th to 1/60th. These were the same changes considered by the CC in the Q5 review.
- D48 Based on this analysis and GAL's own valuation assumptions GAD estimated that an appropriate allowance for DB pension costs would be 20% to 22% of pay. The CAA took account of GAD's advice and assumed a contribution rate of 21% through Q6. This resulted in an efficiency of £3 million per year by 2018/19.
- D49 The CAA also stated that GAL has relatively high average DC contribution rates of 11% in comparison to average rates of 7%.¹¹¹ Reducing the contribution rate to 7% would result in an efficiency of £2 million per year by the end of Q6. However, the benchmark comparisons may be affected by the organisation of pension payments. In particular, GAL has implemented a salary sacrifice scheme which would tend to increase its pension costs relative to benchmarks. Overall, the CAA considered that GAL had scope to reduce total pension costs by between £3.4 million to £5.0 million by the end of Q6.
- D50 GAL had significant concern with the CAA's analysis of pension costs. It stated that the CAA had not taken account of the closure of the DB pension scheme, which would effectively 'sunset' over the longer term. GAL also stated that this was critical to the analysis of the airport operator's overall long-term cost base and demonstrated that GAL was actively managing pension costs to an appropriate level.

¹¹¹ Occupational Pension Schemes Annual Report 2010 (ONS), page 31.

- D51 GAL also considered that the GAD benchmarking analysis was not appropriate because it relied on comparisons with pension schemes from other businesses and sectors, not comparable to GAL. GAL stated that the benchmark data was out of date and that negative movements in funding costs associated with falling bond yields reduced the reliability of the benchmarking evidence.
- D52 GAL also stated that the pace of change implied by the pension efficiency was unrealistic as the CAA's final proposals represent a 35.5% cut to the pension contribution rate from April 2014. GAL stated that the CAA had given no consideration to the commercial and HR realities in determining an appropriate contribution rate or suitable time period over which to implement any pension scheme changes.
- D53 GAL highlighted that the CAA had granted it a pension allowance of 20% of pay, compared to 23% to 24% of pay for HAL. GAL stated that it did not understand the reason for this difference and as the pension schemes both originate from the former BAA DB scheme, it would expect the allowance for HAL and GAL to be the same.
- D54 GAL stated that GAD had based its estimate on the provision of typical pension benefits, but had not accounted for GAL's atypical funding assumptions. GAL provided four scenarios which suggested that if GAL used typical funding assumptions, its pension cost allowance should be between 22% and 25%.
- D55 The ACC stated that the CAA should make further changes to its pension allowance including reducing the employer contribution rate for the DB scheme to 14% in line with benchmarks; contribution rates for the DC scheme should be set at around 7% reflecting benchmark rates.
- D56 The ACC stated that the 2011 ONS Occupational Pension Schemes Annual Report estimated that the average employer contribution rate to a closed private sector DB scheme was 14.4% in 2011, excluding any deficit reduction payments. The ACC concluded this was a more appropriate contribution rate for GAL.
- D57 The ACC also stated that the average employer contribution rate for a DC scheme was 6.5%, and there was no reason why GAL could not bring its own DC scheme into line with market averages.

- D58 The ACC stated that pension policy had long-term implications for the company and its users and highlighted the CAA's Q5 policy statement that the CAA would seek to move towards a comprehensive treatment of wage and pension costs. The ACC stated that this policy had not been adhered to in the CAA's final proposals.
- D59 The ACC highlighted that the GAD report had stated that there could be scope for further benefit reductions based on more recent changes made by other schemes, which it stated could result in contribution rates falling to around 12%. The ACC believed that the CAA had not considered this option seriously.

CAA's proposed licence

- D60 The CAA considered that GAL's comments about the benchmarking of its pension costs were not relevant to GAD's assessment of efficiency. GAD's analysis was based on GAL achieving benchmark levels of benefit provision, including reducing the retirement age and accrual rate of the pension scheme and was based on GAL's own funding assumptions. The analysis was consistent with the analysis undertaken for the Q5 review and assumed the same changes.
- D61 The impact of the changes was calculated using GAL's own funding assumptions and was not affected by changes to bond yields.
- D62 The CAA assumed that GAL could achieve an efficient opex cost base gradually by the end of Q6 and has made no explicit assumptions about the implementation of changes in the first year of Q6. The efficiencies were based on GAL bringing its pension scheme into line with benchmarks by 2018/19, which should be achievable. GAD also stated that there may be scope for further reductions based on the latest trends in DB pension provision, which may not be reflected in the latest data on typical scheme provision.
- D63 The CAA modelled its efficiency savings on GAL's pension membership data; taking account of GAL's closure of the DB scheme and the resultant reductions in DB scheme membership and cost.
- D64 The CAA noted GAL's comments about the difference in the pension allowance between HAL and GAL and its scenario analysis suggesting that it should have a higher rate of allowance. The different allowance between HAL and GAL was caused by the different funding assumptions applied by each scheme. HAL had

made more conservative assumptions about its pension liabilities, which, all else equal, meant that the short-term cash contribution required for a given level of pension benefit would be higher. For this reason the CAA provided a higher allowance based on GAD's advice. The CAA noted that different funding assumptions affected the timing of pension costs, but had a negligible impact on overall long-term cost. This was because more conservative pension funding assumptions were more likely to result in a funding surplus, which would reduce the need for future contributions.

- D65 GAD's high level review of GAL's pension funding assumptions indicated that GAL's assumptions were not out of line with standard practice and the CAA saw no reason to make different assumptions. GAL, in agreement with its pension trustees, had chosen to apply less conservative assumptions than HAL and the CAA evaluated its pension costs in line with those assumptions.
- D66 In line with the Q5 policy statement which stated that: 'there is advantage in moving progressively towards a regulatory approach in which labour costs are evaluated holistically, and discretion afforded to the regulated companies... to decide how best to remunerate staff.', the CAA undertook a combined analysis of staff costs through the IDS benchmarking analysis which provided an analysis of costs with and without pension payments. However, in this case, the CAA considered that a separate analysis of staff costs identifying the differences between staff on DB and DC pension schemes was necessary to account for the different pension funding assumptions applied by each airport operator which made direct comparisons of total staff costs difficult.
- D67 The CAA noted the ACC proposal that pension costs should be capped at a benchmark rate of 14% based on ONS data of average company contribution rates. Similar analysis was used in the IDS study. The CAA noted that there were two issues with this benchmark analysis.
- Different schemes with the same level of benefit provision have different contribution rates based on different funding assumptions.
 - The ONS dataset was based on data from 2011. Since then, pension asset returns have been negatively affected by changing macroeconomic factors including declining bond yields, which have

increased average contribution rates.

- D68 These two factors meant that the ONS benchmark data was not perfectly comparable with GAL's pension cost forecasts. The CAA considered that it was therefore more appropriate to analyse future service costs based on GAL's funding assumptions and the level of benefits provided as described in the GAD report.
- D69 The CAA considered that the analysis of DC pension costs was not affected by these issues and there was an argument that GAL could reduce its costs from 11% to 7% in line with the benchmark. However, the CAA noted that GAL had implemented a salary sacrifice scheme, which would tend to increase its DC costs relative to benchmarks.
- D70 Overall, the CAA considered that GAL had scope to reduce pension costs by between £3.4 million to £5.0 million by the end of Q6.

Pensions - deficit

Issue

- D71 In November 2011 a report by the GAL scheme actuary estimated that a deficit of £12 million was likely to arise at the next scheme valuation in September 2013. Based on a recovery period of 10 years, GAL included deficit recovery costs amounting to £5.7 million over Q6 in its RBP.
- D72 The CAA commissioned GAD to consider the treatment of the pension deficit. GAD concluded that there are two possible regulatory approaches to the treatment of pension deficits.
- Users meet the expected costs of benefit accruals, but the management of the scheme's liabilities is a matter for the company.
 - Or users meet total pension costs including deficit contributions (and therefore also benefit from any surplus) subject to those costs being efficiently incurred.
- D73 Based on the treatment of BAA's pension deficit costs in Q5, and the lack of a signalled change in policy, GAD concluded that the latter

approach was appropriate and that in principle, deficit costs should be included in the Q6 allowance.

- D74 GAD also found that GAL's latest interim funding update in September 2012 showed a total deficit of £1 million, which would be immaterial to the opex allowance once spread over a typical deficit recovery period of 5-15 years.
- D75 The CAA accepted GAD's conclusion that, in principle, deficit costs should be included in the opex allowance based on the latest available full or interim pension funding valuation. The CAA stated that GAL's RBP estimate was not based on a full or interim valuation and excluded these costs, equivalent to £1.4 million by the end of Q6.
- D76 In response, GAL welcomed the CAA's decision to accept the principle that pension deficit costs should be included in the "fair price calculation" but did not agree with the CAA's decision to disregard its pension deficit estimate based on the insignificance of the £1 million deficit estimate recorded in the September 2012 actuarial funding assessment. GAL stated that an estimate by the scheme actuary showed that, based on existing scheme funding principles and allowing for changes to market conditions, GAL's pension deficit would be between £15 million and £20 million in September 2013. GAL considered the estimate included in its RBP was a reasonable assumption as it was based on more prudent assumptions than applied by HAL to estimate its deficit.
- D77 GAL stated that its estimate did not allow for any potential changes in the valuation methodology that may be agreed as part of the 2013 valuation and a more prudent approach to the valuation methodology could have a material adverse impact on the scheme deficit. GAL pointed out that the assumptions used to calculate the deficit were less prudent than those applied in the analysis of HAL, and that adopting HAL's assumptions would increase its deficit estimate.
- D78 GAL also stated that the next full actuarial valuation of GAL's pension scheme would be conducted in September 2013 and that, in principle, the deficit estimated in that valuation should be included in the opex allowance. GAL also stated that in practice the valuation would not be available in time to inform the CAA's final decision, but the CAA must make a reasonable allowance for the likely deficit costs. GAL stated that this would be consistent with the CAA taking account of future

events with reference to the treatment of expected commutation payments to HAL associated with the sale of Edinburgh and Stansted.

- D79 The ACC disagreed with the decision to allow GAL's deficit costs and stated that as a matter of principle, GAL's shareholders should bear the risk of deficit payments, given that: any deficit is likely to reflect GAL's inefficiency; and the Q5 regulatory policy statement states that pensions should not be considered a cost pass through, but should be considered as part of a reasonable allowance for staff remuneration.
- D80 The ACC considered that risks should in principle rest with those best able to manage them, so that GAL has a proper incentive to manage its pension costs effectively.
- D81 The ACC noted that GAD's analysis was based on GAL's own 2010 valuation report including the rate of future pay increases. The ACC stated that GAL's annual report stated that it had assumed that wage growth would be RPI+0.5% and noted that this was not consistent with the CAA's wage efficiency proposal. The ACC stated that GAD had not taken account of this in its estimate of deficit costs.
- D82 The ACC also stated that pension policy had long-term implications for the company and its users and highlighted the Q5 policy statement that the CAA would seek to move towards a comprehensive treatment of wage and pension costs. The ACC stated that this policy had not been adhered to in the CAA's final proposals.
- D83 The ACC stated that the CAA should set out its pension policy for the future, building on the Q5 policy statement and stating clearly that no deficit payments will be made in future, unless the scheme benefits are consistent with benchmarks.

CAA's proposed licence

- D84 The CAA accepted that in principle deficit costs should be included in the opex allowance. GAD's recommendation was that the deficit allowance be based on the latest available full or interim actuarial valuation. The latest valuation showed that GAL's deficit was expected to be around £1 million in total. The CAA considered that recovery payments were therefore immaterial to the opex allowance over Q6 once spread over a typical recovery period of 5-15 years.
- D85 GAL's estimate that the deficit would increase to £12 million was based on declines in corporate bond yields in 2012 and an

amendment to its funding assumptions; that salaries will grow by 0.5% per annum. The CAA considered that these changes were not consistent with the CAA's wage proposals, or GAL's own valuation assumptions.

- D86 The CAA did not consider it appropriate to make adjustments to the deficit costs based on recent changes in market conditions, which could be reversed over Q6. The CAA considered that the latest actuarial review provides the best estimate of GAL's future deficit costs. There was considerable uncertainty about GAL's estimate and possible changes to the deficit during Q6. In contrast, there was high certainty over the commutation payments to be made in respect of the sale of Edinburgh and Stansted.
- D87 The CAA noted GAL's concerns that the pension deficit may turn out to be higher than forecast in the latest valuation, and the ACC's comments that GAL was best placed to manage the pension deficit. This issue is discussed further in the future pension policy section below.
- D88 The CAA noted the ACC's comments about adherence to the Q5 regulatory policy statement, which is quoted in an earlier section. The CAA interpreted the policy statement as applying only to future service pension costs which are an integral part of staff cost remuneration. The CAA did not consider that deficit costs were intended to be covered by this policy statement. The CAA stated that deficits were attributable to a shortfall on the bulk of pension assets accrued over generations of employees. Including deficit costs as part of total staff cost benchmarking analysis could force GAL to reduce staff costs to below market rates to account for unrelated and largely uncontrollable shortfall on historic pension assets, conversely any future surplus would imply that GAL could raise staff wages well above benchmark rates.

Future Pension Policy

Issue

- D89 GAD stated that the CAA should consider setting out its policy for the future treatment of pension costs highlighting two issues; potential

changes in the estimate of the scheme deficit at the next valuation and future policy for deficit recovery. This policy would only apply to GAL in the event that RAB-based regulation was applied.

- D90 GAD also stated that funding positions fluctuate over time due to changes in market conditions and other factors. The scheme's funding position could change significantly during the Q6 period and it would be a reasonable aim for the CAA to ensure that the choice of baseline valuation date does not affect the balance of pension costs met by shareholders and airport users in the long term. GAD stated that this could be achieved by adjusting for any differences between reasonably incurred pension deficit contributions and the price control allowance at future price controls (through an adjustment to the RAB for example).
- D91 In addition GAD stated that there were advantages in using the latest full actuarial valuation for the purpose of setting the deficit allowance, as it was consistent with the actual setting of future contribution rates and represents a more robust assessment of the scheme following a process set out in legislation.
- D92 GAD also suggested that the CAA could consider options to strengthen incentives for the airport operator to manage pension costs such as only taking into account a certain percentage of the pension scheme deficit at future price control reviews, or signalling that the funding risk in respect of benefit accruals after a certain cut off date is entirely a matter for the company and its shareholders.

CAA's proposed licence

- D93 With regard to the treatment of any deficit recovery costs at the next price control, the CAA considered that there were three main policy options:
- a continuation of the current policy, whereby passengers pay for deficits, and benefit from surpluses;
 - a policy whereby shareholders pay for deficits, and benefit from surpluses; or
 - a hybrid approach whereby deficit and surplus payments are shared between passengers and shareholders.

- D94 An example of the latter approach is the 'incremental deficit' method developed by Ofgem whereby pension liabilities are split between those accrued before and after a cut off point. Any scheme deficit is then split between these portions with passengers paying for the former, and the company for the latter.¹¹²
- D95 The CAA stated that it intended to consult stakeholders on potential changes to the treatment of deficit costs at the next price control review based on the options described above. Stakeholders should not assume that this would result in any changes to the current policy.

Pensions - commutation payment

Issue

- D96 In 2010, GAL made a commutation payment of £104.7 million to BAA related to the sale of the airport. This payment removed GAL's liabilities associated with former employees in the BAA pension scheme. GAL stated that this payment should be included in the RAB as it was an investment by GAL which reduced ongoing opex costs, which would otherwise have been included in the opex allowance.
- D97 The CAA commissioned GAD to provide advice on the treatment of the commutation payment. GAD concluded that the commutation payment had reduced GAL's pension liabilities, and potential deficit contributions associated with its former employees in the BAA pension scheme. GAD stated that, in principle, the commutation payment should be recovered by GAL because:
- the payment relates to liabilities for employees at Gatwick;
 - had the payment not been made, GAL (not Heathrow Airport Holdings Limited) would have been liable for additional pension contributions;
 - information provided by HAL indicates that the funds to meet the commutation payment were provided by the purchaser of GAL; and

¹¹² Ofgem, 2013, Energy Network Operators' Price Control Pension Costs - Regulatory Instructions and Guidance: Triennial Pension Reporting Pack supplement including pension deficit allocation methodology.

- HAL has not sought to recover the amount of the commutation payment through its pension allowance, whereas GAL is seeking to do so.

D98 GAD also stated that:

- the payment was likely to be higher than the expected costs of the liabilities avoided overall; but
- the commutation payment was around 45% of the section 75 estimate of the liabilities avoided, meaning that the risk associated with those liabilities has been removed at a relatively low cost.¹¹³

D99 Based on the second point GAD concluded that it would be reasonable to include the full amount within the Q6 opex allowance spreading the cost over a long time period. GAD also stated that excluding part of the commutation payment would create inconsistencies with HAL's pension cost allowance, where the full amount of the commutation payment has been taken into account in the scheme deficit.

D100 In the final proposals the CAA accepted GAD's recommendation that the commutation payment should be included in GAL's Q6 allowance in full. The CAA included the full payment of £104.7 million in GAL's opening RAB with a depreciation period of 15 years to spread the recovery of the payment over time - reflecting typical deficit recovery periods of 5 to 15 years.

D101 GAL responded that it welcomed the CAA's decision that the commutation payment should be included in GAL's Q6 allowance in full. However, GAL stated that the amount included in the RAB should be adjusted to account for inflation and estimated that the payment should increase from £104.7 million to £112.5 million to account for inflation.

D102 GAL also stated that it did not agree with the CAA's decision to set the depreciation of the payment at 15 years, stating that the length of the depreciation period should be independent of the amount of the payment. GAL argued that it should be allowed to recover the

¹¹³ 'Section 75' is a method of valuing pension liabilities as specified under section 75 of the Pensions Act 1995. The valuation methodology is considered to provide a benchmark of the cost of fully insuring against the risk of future pension deficits.

payment over a 10-year period in line with the normal period over which a company would fund a pension deficit. GAL also stated that there should be an interest adjustment based on GAL's cost of capital to account for amounts unrecovered since the payment date.

- D103 The ACC did not support the inclusion of the pension commutation payment within the GAL fair price estimate. The ACC stated that it did not understand the reason for the CAA's change of view on the commutation payment since the initial proposals and could not see any justification in GAD's report. The ACC argued that airlines were not consulted on the payment by GAL, and had not had a chance to comment on its value for money. The ACC considered that as GAL was going to make a rate of return on the payment, this was vitally important.

CAA's proposed licence

- D104 The CAA considered that it was appropriate to uplift GAL's commutation payment to account for inflation. The RPI index was 226.5 in 2010/11 and 237.3 in 2011/12. This meant that the payment should be increased by 4.7% to £109.7 million. The CAA included this amount in GAL's RAB.
- D105 The CAA considered that it was appropriate to assume that the payment is recovered over a 15-year period. This was in line with typical deficit recovery plans and reflected the large size of the payment. GAL had effectively paid a lump sum to remove pension costs which otherwise would have occurred over many years. Therefore, the CAA considered it was appropriate that the recovery of this cost was spread over a long time period.
- D106 The CAA did not consider that it was appropriate to include an interest adjustment based on GAL's cost of capital for amounts unrecovered since the payment date as GAL undertook the commutation payment without consultation with users and at its own risk.
- D107 The CAA noted the ACC's concerns about a lack of consultation on the payment and its concerns about value for money. The CAA also noted that the GAD study had found that the payment had effectively removed GAL's pension cost liability risk associated with former employees for 45% of the section 75 cost. Therefore the CAA considered the cost to be efficient and sought to avoid overburdening passengers in Q6 by spreading its recovery over a 15-year period.

The CAA considered that it had taken account of the airlines' views on the commutation payment through responses to the initial and final proposals and publication of the GAD study.

Other opex

Issue

- D108 The CAA commissioned SDG to examine the 'other opex' costs in GAL's business plan, including costs related to; rent and rates, utilities, police, NATS, PRM, cleaning and other items. The study proposed 'core' and 'stretch' efficiencies in several areas based on a combination of benchmarking evidence and challenges to the assumptions underlying the business plan. The original report concluded that GAL could achieve savings of between £4.6 million and £6.0 million relative to its business plan.
- D109 The CAA commissioned SDG to update its report to take account of stakeholder feedback on the initial proposals. SDG reviewed the evidence provided by stakeholders and provided an update to its report, reiterating most of its original conclusions.
- D110 The CAA considered GAL's points and did not agree with its criticisms of the SDG report. Many of the efficiency proposals were based on the application of less conservative assumptions in the business plan including the use of official forecasts or policy for utility and police costs for example. The CAA considered that GAL had not provided an adequate explanation for different assumptions used in its business plan. In the final proposals the CAA included savings of between £4.6 million and £6.0 million per year in its efficiency proposals based on the SDG Other Opex report.
- D111 In response, GAL stated that it was disappointed that SDG had not altered its original conclusions on the study in response to GAL's evidence. GAL considered that it had provided evidence to support its cost projections for utility and police costs whilst the consultant's proposals lacked evidence. GAL made specific comments criticising the NATS, police and cleaning cost efficiency proposals stating that the CAA's approach was consistently unbalanced.

- D112 GAL highlighted that the CAA had frequently acknowledged the risks of reliance on benchmarking evidence, but had not taken account of this risk in its interpretation of SDG's proposals.
- D113 GAL stated that NATS's costs would experience upward pressure due to scope and capability risk including from GAL's approach to improving runway utilisation, increasing air traffic control officer (ATCO) wages and that there is a lack of suitable substitutes. GAL stated that SDG's assumption that GAL could reduce costs through improvements to procurement strategy were overly optimistic.
- D114 GAL stated that the Winsor review of police pay indicated re-distribution of pay calibrated on levels of specialism as opposed to length of service. As the police deployed at Gatwick had one of the highest degrees of specialist skills this would increase pay at Gatwick faster than the average.
- D115 GAL stated that SDG's benchmarking made no attempt to normalise for service cleaning standards. GAL stated that it had very high expectations of cleaning standards which meant that costs would increase more rapidly than the average trend for minimum wages.
- D116 GAL stated that it was disappointed that the study had not offered substantive fact-based evidence to support its conclusions or how the proposed efficiencies could be achieved.

CAA's proposed licence

- D117 The CAA stated that most of GAL's points were considered at earlier phases of the study and that SDG had therefore not changed its conclusions in the final update of the report.
- D118 GAL's RBP assumed 1.9% real terms growth in police costs over Q6. SDG's efficiency proposal was based on a lower rate of growth in line with official policy. The CAA noted that police wage growth had been capped at 1% nominal for the past two years in line with government policy and real terms growth in pay at an aggregate level is unlikely over Q6. This was confirmed in the assumptions stated in the Sussex Police accounts.
- D119 The CAA stated that the Winsor review contained a variety of measures reforming police pay. While some specialist skills would be rewarded with higher pay, the overall reforms were intended to reduce police costs. Measures included lower rates of pay for new officers,

pension reform and ending automatic promotion based on time served, overall these reforms mean that GAL's police costs were unlikely to rise in real terms over Q6.

- D120 The CAA stated that no benchmarking dataset can be considered perfectly comparable to GAL, but several steps were taken to improve the comparability of the data with that provided by GAL, including adjusting terminal areas and costs and seeking a wide range of benchmarks. All the airports were UK based and SDG did not consider that there were significant differences in service quality between the airports considered. SDG had also sought to take account of changes to employers' compulsory contributions to staff pensions, which had been omitted by GAL's analysis.
- D121 In relation to cleaning, the CAA stated that SDG took account of differences in front of house and back of house terminal areas and accounted for the growth of minimum wage costs. GAL's wage growth assumptions had been systematically higher than benchmarks.
- D122 The CAA considered that it had taken account of GAL's comments on the SDG Other Opex study and that it had provided a clear rationale for the basis of its efficiency proposals. Many of the savings (police, utilities and cleaning) were based on a lower estimate of outturn costs based on official data or policy. This reflected the conservative assumptions in GAL's RBP, (which included high wage growth assumptions for example). The CAA assumed that GAL could achieve savings of between £4.6 million and £6.0 million per year relative to its business plan, based on the conclusions of the SDG Other Opex report.

Maintenance costs

Issue

- D123 The CAA commissioned SDG to assess GAL's maintenance cost forecasts. SDG benchmarked GAL's costs against eight other airports and concluded that some efficiency was likely to be possible through either maintaining costs per square metre at 2012/13 levels over Q6 or a reduction in maintenance costs in line with more efficient external benchmarks. SDG concluded that GAL could reduce maintenance

costs by between £0.8 million and £4.2 million per year by the end of Q6. The higher savings were based on GAL closing 50% of the gap with external benchmarks.

- D124 In the final proposals, the CAA commissioned SDG to update its report to take account of stakeholder feedback on the initial proposals. SDG did not accept most of GAL's criticisms of the study; that the report contained factual inaccuracies or that the assessment of efficiency was unbalanced.
- D125 In response to comments from the airlines that GAL should close 100% of the gap with external benchmarks, SDG stated that this would not be appropriate due to Gatwick's characteristics as a multi-terminal airport, which could increase its costs relative to other airports.
- D126 Overall, SDG concluded that the responses to the initial proposals did not raise any new evidence or arguments that had not been considered in the earlier phases of the study and maintained its efficiency estimates. In the final proposals, the CAA adopted efficiency savings of between £0.8 million and £4.2 million per year by 2018/19 relative to GAL's RBP.

CAA's proposed licence

- D127 The CAA considered that it had taken account of stakeholders' responses to SDG's report. SDG's efficiency proposals were based on holding costs constant in real terms per metre square or reducing the gap with more efficient benchmarks by 50%. These proposals were supported by benchmarking comparisons with eight other airports which showed that GAL's maintenance costs were 49% higher than the average of other UK airports. GAL's RBP also assumed that total maintenance costs per square metre would rise by 10% over Q6 (including staff costs) reflecting GAL's conservative RBP assumptions for staff costs to increase by RPI+0.75%. This indicated that there was likely to be scope for efficiency over Q6.
- D128 The CAA adopted efficiency savings of between £0.8 million and £4.2 million per year by 2018/19 relative to the RBP within its efficiency range.

Central support costs

Issue

- D129 The CAA commissioned Helios to examine GAL's central support cost forecasts. The study examined historic and forecast central support costs at Gatwick and collected a range of benchmarks based on costs at other airports, airlines and bespoke Hackett and Gartner data tailored to GAL's characteristics as a business. GAL's costs were compared against these benchmarks to estimate the potential for greater efficiency in the business plan.
- D130 The study concluded that GAL could potentially reduce central support costs in several areas including finance, HR, IT and airport management. Overall, the study concluded that GAL could reduce central support costs by between £2.9 million and £5.4 million per year by the end of Q6.
- D131 The lower target was based on GAL maintaining current levels of cost over Q6, matching conservative benchmarks and removing unjustified increases in the RBP including in insurance and consultancy costs. The higher 'stretch' target was based on closing the gap with the most efficient external benchmarks.
- D132 In considering how to interpret this evidence the CAA considered several factors including:
- the late delivery of the report and lower level of stakeholder engagement, which had limited the airlines' opportunity to comment on the evidence;
 - the wide range of benchmarks used in the report which sometimes provide conflicting assessments of efficiency and indicate that there is a wide range of cost levels in central support activities;
 - the lack of detailed understanding of the drivers of central support costs provided by the report, and a lack of detailed cost saving proposals to support the potential efficiency savings suggested by the benchmarking evidence;
 - the AT Kearney report provided by GAL which indicates that GAL is at or below average levels of cost in most areas of central support (in comparison to an undefined sample of European airports);

- the impact of proposed staff cost efficiency on central support costs; and
 - responses from the airlines and GAL to the CAA's initial interpretation of the evidence.
- D133 Both the AT Kearney and Helios studies indicated that GAL's performance in central support activities was generally close to comparable benchmarks of average performance. The CAA considered that this suggested that GAL was not particularly inefficient in this area. However, the Helios study did indicate that; there was scope for improvement relative to more efficient benchmarks; that staff costs are relatively high (supporting the conclusions of the IDS study) and that in some areas GAL's business plan implied deterioration in performance over Q6.
- D134 On balance, the CAA considered that it was appropriate to incorporate the 'core' efficiency proposals of the Helios study, after taking account of the reduction in central support costs linked to the wage cost efficiency described above.
- D135 Central support staff account for around 10% of total staff costs and this proportion of the staff cost efficiency can therefore be attributed to central support activities (£2.2 million by 2018/19). Accounting for this, the CAA incorporated savings of £0.7 million by 2018/19 into its efficiency range.
- D136 GAL responded that the Helios benchmarking did not feature any benchmarks that were tailored to a company of GAL's size, location, and industry despite such benchmark's being available. GAL highlighted the LECG Corporation (LECG) study undertaken for NERL as an example and suggested that the Hackett and Gartner benchmark of IT costs used by Helios was inappropriate.
- D137 The ACC noted that the Helios study found that GAL could reduce central support costs in several areas including finance, insurance, legal and communications costs and proposed that savings could be made through reducing wages, outsourcing, restructuring and reducing the seniority of departments. The ACC was critical of the CAA's interpretation of the study results and questioned why the CAA had paid for the report if it did not find the results satisfactory.

D138 The ACC stated that the CAA should adopt the mid-point of the consultant's recommendations (equal to £4.2 million per year in 2018/19). Similar points were made by easyJet.

CAA's proposed licence

- D139 The CAA did not agree with GAL's criticism of the study. The CAA considered that central support functions were generally comparable across industries and the Helios study has taken account of a wide range of benchmarks including finance and HR benchmarks developed with guidance from the Hackett Group and specifically tailored to GAL's characteristics. The study had also used airport operator and airline cost benchmarks and other public information to develop an estimate of an appropriate range of cost in each central support activity based on key drivers including passenger numbers, employees and revenue.
- D140 The CAA stated that the uncertainty associated with the benchmarking and comparability with GAL had been taken into account through the analysis, the range of benchmarks examined and the interpretation of the study conclusions.
- D141 The CAA adopted Helios's core efficiency proposals, which included savings in insurance, finance, HR and legal costs where GAL had assumed costs would increase without justification. The Helios study efficiency proposals were partially based on staff cost reductions, which interacted with the CAA's overall wage cost efficiency proposal. The CAA took account of this interaction and reduced the efficiency to a net £0.6 million per year.
- D142 The CAA noted the ACC's comments on the interpretation of the study. The CAA considered the stretch efficiency proposed by Helios, but did not have sufficient confidence in the benchmarking analysis to apply this efficiency. The CAA stated that the benchmarking analysis indicated that there was a wide range of costs in central support activities, meaning that a conservative approach to efficiency should be taken. Furthermore, the study did not indicate that GAL was particularly inefficient compared to benchmarks. This finding was further supported by the AT Kearney study submitted by GAL.

Efficiency frontier

Issue

- D143 In calculating the level of efficient operating costs over Q6, the CAA has to make an assumption as to how the "efficiency frontier" (the level of costs that a hypothetically efficient operator might incur) might change over time. The CAA commissioned Cambridge Economics Policy Associates (CEPA) to examine this question.
- D144 CEPA estimated that, based on an estimate of adjusted TFP growth across a range of industries, an efficient organisation with a cost structure similar to GAL should expect to see ongoing net frontier efficiency gains of between 0.9% and 1.0% per year.
- D145 The CAA commissioned CEPA to update their study in response to GAL's submission to the initial proposals including a report commissioned from Oxera critiquing CEPA's analysis.
- D146 CEPA considered that the points raised by Oxera on behalf of GAL had already been accounted for in its study. It did not agree with Oxera that it was inappropriate to compare Heathrow, Gatwick and Stansted to other regulated utilities and considered that it had adopted standard practice for the estimation of frontier shift, consistent with regulatory precedent.
- D147 CEPA stated that its report had undertaken the sensitivities suggested by Oxera and that some of Oxera's comments appeared to be based on an earlier draft version of the report, which was no longer relevant.
- D148 CEPA stated that the examples cited by Oxera were not relevant to Gatwick. The Water Industry Commission for Scotland (WICS) decision was based on the recognition that there would be significant upward pressure on opex resulting from the requirements for Scottish Water to improve its performance. The Postcomm decision was contingent on the level of investment undertaken by Royal Mail. CEPA concluded that its recommended frontier shift range of between 0.9% and 1% remained valid.
- D149 In the final proposals, the CAA adopted CEPA's recommendation for a frontier shift target of between 0.9 and 1% and used this to estimate an efficiency saving for GAL accounting for the stretch savings included in the RBP. The CAA included a saving of between £6.0

million and £7.4 million by 2018/19 in the range of potential opex savings.

- D150 GAL responded that staff costs were the only part of its cost base that it could control and that therefore the frontier shift efficiency proposal would have to be achieved through further reductions in staff costs. GAL stated that the achievability of these reductions in staff costs was questionable.
- D151 GAL reiterated its previous criticisms of the CEPA analysis stating that CEPA had not taken account of the breakup of BAA and security costs arising from changes to the security regime. GAL did not consider the CEPA report to be useful evidence.
- D152 GAL noted that CEPA acknowledged that it should have made explicit adjustments for quality and changes to security costs and service quality. GAL also noted that CEPA suggested that its estimates were likely to be biased upwards.
- D153 GAL stated that it was concerned that the CAA had applied efficiencies based on overlaying both top-down and bottom-up benchmarking and that this risked double-counting the potential for efficiency. GAL also stated that the CAA had not provided evidence to respond to this point.
- D154 GAL stated that Oxera suggested that an adjustment for catch-up efficiency should be applied to the estimation of frontier shift. GAL stated that whilst the approach recommended by CEPA had been adopted by Ofgem, it was considered flawed by some energy companies. GAL stated that a recently completed academic study showed that productivity growth estimates based on EU KLEMS data include catch-up efficiency with an estimate of around 25%.¹¹⁴ Therefore the frontier shift target could effectively double-count the catch-up efficiency analysis.
- D155 The ACC considered that the frontier shift target should be applied to the latest available actual data, rather than GAL's forecast, as this would ensure that GAL's outperformance would be shared with users.

¹¹⁴ Timmer, M., O'Mahony, M. and Van Ark, B. (2007), 'EU KLEMS Growth and Productivity Accounts: Overview'.

D156 Virgin stated that the frontier shift target should be applied from the baseline point "when the airport is already efficient" and estimated that the total frontier shift savings for Q6 was £43.5 million. Virgin questioned the CAA's interpretation of GAL's security cost efficiency stating that the total security staff costs in the RBP did not support GAL's claim of an annual £3.9 million stretch efficiency. Virgin stated that total staff costs are forecast to grow by 3.8% over Q6 despite the efficiency initiative.

CAA's proposed licence

D157 The CAA noted GAL's comments on the potential for overlaps in catch-up and frontier shift efficiency and the research by Oxera and others suggesting that a 25% adjustment to the frontier shift target is appropriate to account for this issue. The Oxera study stated that 'after applying the 75%/25% frontier shift/catch-up split, the range for the potential frontier shift becomes 0.4% to 1% per year with a mid-point of 0.7%'. The CAA noted that this range was broadly consistent with CEPA's analysis which indicated a range of 0.9% to 1%.

D158 The Oxera study was prepared for Northern Ireland Electricity Limited (NIE). The CC has recently published its provisional determination for NIE's price determination. In this determination, the CC found that recent regulatory decisions indicate a range of between 0.5% and 1% for opex frontier shift and state that 'a productivity assumption of 1 per cent a year should be applied to NIE's costs (i.e. to each of opex and capex).' This was based on evidence from the business plans submitted by the GB Distribution Network Operators (DNOs), most of which have included an assumption that costs can be reduced by 1% per year.

D159 CEPA also addressed this issue in their response to Oxera's note and did not consider that an adjustment to remove catch-up efficiency was necessary. CEPA acknowledged that the EU KLEMS data could suffer from a degree of measurement error associated with structural inefficiencies within firms but that "there should not be any long term systematic structural inefficiencies among the firms operating within our comparator sectors". CEPA also stated that it had placed a lower weight on sectors which include regulated companies, where catch-up efficiency would be more likely to be an issue within the KLEMS database. CEPA also pointed out that Ofgem had questioned the estimation of the 75%/25% split which was based on a comparison of

UK industry catch-up with the world frontier for the period 1979-1988.¹¹⁵

- D160 The CAA considered that the break-up of BAA and improvements in opex efficiency were an issue for the assessment of catch-up efficiency, not frontier shift. This had been taken account of separately in the bottom-up analysis.
- D161 For these reasons, the CAA considered that a frontier shift target of between 0.9% and 1% was appropriate and consistent with regulatory precedent.
- D162 The ACC argued that the CAA should base the efficiency savings on actual costs from 2012/13, arguing that this would ensure that GAL's cost savings were passed through to passengers. The CAA considered that basing the frontier shift estimate on the latest year of actual data would slightly reduce the frontier shift efficiency applied to GAL (1% per year from a lower number). The CAA stated that the ACC's argument was related to the scope for catch-up efficiency, which has been assessed separately.
- D163 The CAA included efficiency savings of between £6.0 million and £7.4 million by 2018/19 in the range of potential opex savings.

Security process efficiency

Issue

- D164 The CAA has considered three issues regarding security process efficiency at GAL:
- the scope for improvements in GAL's security flow rates;
 - the scope for improvements in GAL's security roster efficiency; and
 - the scope for efficiency gains from outsourcing.
- D165 In the final proposals the CAA noted that peak hour security processing flow rates at Gatwick are around 250 passengers per hour per lane in the ST and 200 in the NT (fluctuating higher and lower

¹¹⁵ Ofgem (2012), RIIO-T1/GD1: Real price effects and ongoing efficiency appendix, Final decision, pages 18-19.

between summer and winter). This is relatively high compared with other airports with a benchmark sample average of around 170, and significantly higher than at Heathrow, which has flow rates around 150.¹¹⁶

- D166 Overall, the CAA considered that GAL's flow rates appear to be high in comparison to benchmarks and the business plan incorporates further improvements. Based on the RBP, passengers per security FTE are expected to rise by 10% overall by 2018/19 and security headcount is expected to fall by around 8%. Based on benchmark comparisons, this suggested that GAL has limited scope to reduce security costs through improving flow rates. The CAA did not therefore propose further efficiencies related to improving security flow rates.
- D167 The CAA stated that the IDS study indicated that GAL's roster system was relatively efficient and that rates of overtime were not high. GAL had also made several improvements to this area of its operations since the sale of the airport. The CAA did not propose to include further savings related to roster efficiency.
- D168 The CAA noted that security outsourcing has been introduced at several European airports, including Birmingham and Oslo and has been proposed as an option for GAL by the airlines. Outsourced security staff are used by the AOC to operate baggage security at Heathrow. This was considered by the airlines to be an activity analogous to passenger security in terms of scale, complexity and staff skill.
- D169 The ACC provided evidence of potential savings based on benchmarking GAL against bids from outsourced security companies. The CAA considered that GAL's security processes were relatively efficient and therefore, any differences in cost were likely to be caused primarily by GAL's relatively high staff wage and pension costs. This had been taken into account through the employment benchmarking analysis and proposed wage and pension cost efficiencies described above, which will bring GAL's staff costs into line with efficient benchmarks by the end of Q6. Lower costs from an outsourced provider would be likely to be achieved through the same savings.

¹¹⁶ Confidential information supplied by HAL and GAL including Benchmark Analysis of 10 European Airports.

Therefore applying further savings based on this evidence was likely to double-count the potential for reductions in security costs.

- D170 Overall, based on these points, the CAA considered that there was limited scope for further efficiency in GAL's security processing.
- D171 In response to the final proposals, noting the CAA's comparison of flow rates at Heathrow and Gatwick, GAL stated that the CAA's analysis was flawed. GAL stated that HAL was not likely to have greater pressure on its security processes as there are airlines at Gatwick which also apply a two bag policy, including BA and Norwegian. GAL stated that easyJet had also recently introduced a new hand baggage sizing rule.
- D172 GAL stated that as business passengers tended to travel more frequently they were used to security arrangements and were therefore quicker and easier to process, which this would tend to benefit HAL's flow rates.
- D173 The ACC stated that the CAA had failed to take account of many of the arguments and evidence provided by airlines, including security cost benchmarking and the proposal to increase the utilisation of Archway Metal Detectors (AMD).
- D174 Virgin re-submitted its security cost benchmarking analysis, which showed that GAL's security costs per man year were 72% above benchmarks and estimated that GAL could reduce its costs by £69.1 million over Q6.

CAA's proposed licence

- D175 The CAA considered that, in addition to the core efficiency of the security function, there were several largely uncontrollable factors which affected security flow rates including passenger profile, baggage quantity and content. These factors influenced flow rates in several ways including:
- the time taken for passengers to divest their luggage onto and from security conveyors and to pass through security arches;
 - the number of x-ray scans per passenger; and
 - the time it takes for a security officer to scan an individual bag and make an assessment of any security threat.

- D176 The CAA noted that HAL's largest carrier BA operated a policy of allowing two items of hand baggage through security as standard. GAL's largest carrier easyJet allowed only one item of luggage as standard. This meant that the average number of bags per passenger would be higher at Heathrow, and as a consequence hand bag density may be higher at GAL.
- D177 The CAA considered that it was likely to take longer to process a passenger with two bags, than with one bag. Two bags required at least two x-ray images to be taken and increased the time required for the passenger to divest and collect their belongings. The density of the bag was likely to be a less significant factor to overall processing times.
- D178 GAL stated that HAL had a greater proportion of business passengers, who were likely to be more familiar with security procedures, which would tend to increase flow rates. The CAA considered that this may be true, but such passengers were also likely to carry more electronic items, such as laptops and tablet computers, which need to be removed from hand luggage and scanned separately. Such passengers were likely to take longer to divest and may therefore reduce flow rates. HAL also had a higher proportion of travellers from outside the EU who were less likely to be familiar with security processes.
- D179 Overall, noting the uncertainty associated with each of these factors, the CAA considered that, on balance, HAL was likely to face slightly greater pressures on security processes. This was also reflected in the airport benchmarking provided by GAL, which showed that larger hub airports such as Amsterdam had lower flow rates than smaller airports with higher proportions of low cost carriers. For example, Amsterdam has a flow rate of \times passengers per hour compared to around 150 at Heathrow and up to 250 at Gatwick.
- D180 The CAA noted the airline benchmarking which showed that GAL's security staff costs were around 70% higher than benchmarks. To some extent this finding was supported by the IDS study, which found that security staff costs were between 22% and 39% higher than benchmarks.
- D181 GAL's high staff costs were taken into account by the CAA's wage and pension cost efficiency proposals described above. The CAA

considered that applying further savings based on the above evidence was likely to double-count the potential for reductions in security costs.

Passenger forecasts

Issue

- D182 The CAA considered the differences between GAL's passenger forecasts and the CAA's higher passenger forecast assumptions, and considers that it is appropriate to take account of this factor explicitly.
- D183 The CAA assumed that traffic growth would be around 6% higher than GAL's RBP assumptions over Q6. This would increase opex in some areas of the business including security costs for example. To account for this, the CAA increased the opex allowance by £6.6 million by the end of Q6 based on an elasticity of 0.3.

CAA's proposed licence

- D184 The CAA's latest forecasts showed that traffic numbers were expected to be higher than assumed in the final proposals and 10% higher than assumed in the RBP. Based on an elasticity of 0.3, this would increase the traffic allowance from £6.6 million to £10.2 million by the end of Q6.

Other issues

CAA Security Charge

- D185 The CAA will assume responsibility for aviation security regulation and compliance monitoring in 2014 and will levy a charge on airport operators (and other parties) to fund this activity. This charge is expected to be around 4.9p per departing passenger. On this basis GAL is likely to be charged around £1 million per year by 2018/19. The CAA included an allowance to account for this.

Additional Evidence from Airlines

- D186 The CAA considered that most of the evidence provided by airlines had been considered either directly by the CAA or through one of the

consultancy studies. Many of the proposals made by the airlines were likely to be implemented by the airport operator to achieve the efficiencies proposed by the CAA, for example reductions in wage rates, pensions, absenteeism and security costs.

Other Changes

- D187 GAL updated the business case of several of its capital projects in Q6 after the publication of the final proposals. This changed the opex associated with those projects. Overall, the business case updates suggested that GAL's opex would be £0.8 million higher than assumed in the RBP by 2018/19. The CAA incorporated this into its opex allowance.

Overall level of opex

Issue

- D188 The CAA identified several areas where GAL was likely to be able to reduce its operating costs. The evidence indicated a range of potential savings and the CAA has had to apply some judgement to its choice within the range.
- D189 In the final proposals, the CAA proposed an overall efficiency target of £32.5 million per year by 2018/19, which was equivalent to a reduction of 1.2% per year and resulted in a total allowance of £1,378.3 million over Q6. This was equivalent to a 7% reduction relative to GAL's RBP.
- D190 In response, the ACC stated that the CAA had adopted the lowest point in the range of efficiency savings, highlighting the conservative interpretation of the Helios evidence equivalent to 25% of the total savings proposed by its consultants.
- D191 The ACC also stated that the CAA's reasoning that GAL needed to have a realistic chance of outperformance and other areas such as WACC and passenger forecasts indicated that the CAA placed more weight on the interests of GAL's shareholders than the interests of passengers.

- D192 The ACC stated that its own proposed efficiency target of 2.8% per year was a challenging but more realistic level of saving considering the large amount of inefficiency embedded in the GAL business plan.
- D193 GAL stated that it considered that the CAA's treatment of opex was poorly evidenced, and the judgements were unbalanced. It stated that some of the CAA's conclusions were based on errors and it had double-counted the scope for efficiency in some areas.
- D194 Virgin did not agree that the CAA should "ensure that GAL has a realistic chance of outperformance" and should base its projections on the efficient costs of running the airport. Virgin was critical that the CAA had failed to find any new efficiency between the initial and final proposals.
- D195 Virgin stated that the CAA had not taken account of its evidence. It re-submitted its response to the initial proposals which showed that its suppliers (3) had been able to reduce costs by between 3% and 3% between 2008/09 and 2013/14 in real terms highlighting the contrast with the increase in airport charges.

CAA's proposed licence

- D196 The CAA considered each of the points raised by stakeholders in developing its efficiency proposals. The CAA rejected GAL's statement that its assessment of opex efficiency was poorly evidenced and judgements were unbalanced for the reasons set out in paragraph A11. The detailed justification for the efficiency proposals is set out throughout this appendix. The CAA also rejected Virgin's statement that the CAA had not taken account of its evidence. The CAA and its consultants took account of the evidence provided by both GAL and airlines in developing the efficiency proposals.
- D197 A breakdown of the efficiency saving associated with each piece of evidence in the high and low stretch scenario is shown below in figure D.3. The analysis indicated that GAL could achieve efficiencies of between £23.8 million and £36.4 million per year by 2018/19. This was equivalent to an annual reduction of between 0.62% and 1.54% per year.

Figure D.3: Breakdown of Low and High Stretch Scenario

2011/12 prices	Low Stretch	High Stretch
£million	2018/19	2018/19
RBP	301.2	301.2
Other Opex	-4.6	-6.0
Maintenance	0.8	-4.2
Central Services	-0.6	-0.6
Wage efficiency	-13.4	-18.2
Wage growth	-5.6	-5.6
Pension Efficiency	-3.4	-5.0
Pension Deficit	-1.4	-1.4
Frontier shift	-6.0	-7.4
Traffic	+10.2	+10.2
Other	+1.8	+1.8
Total	-23.8	-36.4
CAA	277.4	264.8

- D198 In coming to a judgement over the appropriate point within the efficiency range the CAA considered stakeholders' views and took account of several factors including:
- evidence that opex per passenger at Gatwick was close to the average of European comparators;
 - some of the higher efficiency targets identified in the consultancy studies were based on comparing GAL with the most efficient benchmarks, which may not reflect the typical efficiency of a business operating in a competitive environment;
 - evidence of good performance in some areas of GAL's business including security processing;
 - the inherent risk associated with efficiency proposals based on benchmarking evidence, which cannot perfectly account for specific factors at Gatwick;
 - evidence that airlines had been able to control costs in some areas more effectively than GAL;

- the need to ensure that GAL has a realistic chance of outperformance as a regulatory incentive, balanced against the interests of passengers not to pay for inefficiency in GAL's operations; and
- the achievability of the opex allowance and the risk for service quality impacts from reductions in opex including the significant pension and pay efficiencies proposed by the CAA.

D199 On balance taking account of the points listed above, the CAA proposed an overall efficiency target of £27.7 million per year by 2018/19. This is slightly below the mid-point of the range, equivalent to a reduction of 0.90% per year and results in a total opex allowance of £1,393 million over Q6.

Representations received

D200 The CAA received no specific additional representations in relation to opex forecasts, although Virgin stated that it continued to consider that GAL could deliver more significant operating cost savings than proposed by the CAA and that it was not value for money for passengers to subsidise GAL's pension scheme and the commutation payment. GAL stated that in so far as previous points had not been taken on board, they remained of concern.

CAA's response

D201 As the CAA has not received additional new representations on opex, for the reasons set out above, the CAA continues to consider that its analysis of opex issues is robust and consistent with the available evidence. The CAA therefore considers that the opex allowance set out in the proposed licence is appropriate.

CAA's decision

D202 Based on the assessment described above, the CAA's decision on the projections for GAL's opex allowance over Q6 are set out in figure D.4 below.

Figure D.4: CAA's final projections for opex (2011/12 prices)

£ millions	2014/15	2015/16	2016/17	2017/18	2018/19	Total
RBP	288	294	297	300	301	1,481
CAA - IP	283	280	277	274	271	1,385
CAA - FP	283	279	276	272	269	1,378
CAA – proposed licence	284	281	279	276	274	1,393
CAA - decision	284	281	279	276	274	1,393

APPENDIX E

Commercial Revenues

- E1 This appendix discusses GAL's commercial revenues for the purpose of calculating the fair price and includes the forecasts set out in the CAA's proposed licence, a summary of representations received and the CAA's decision.
- E2 The forecasts for GAL's commercial revenues (revenues from retail, car parking and property) are significant as they are deducted from the revenue required from airport charges under the single till approach.

Commercial revenues process to date

- E3 To date, the Q6 commercial revenues process has consisted of the following stages.
- In April 2012 GAL published its IBP providing its initial forecast of commercial revenues.
 - Between April and December 2012, during the CE process, the airlines' consultants, Javelin and Airport Commerce and Talent Management (ACTM) considered that there should be more ambition in GAL's commercial revenue projections. There was, however, little discussion on commercial revenues during CE.
 - In January 2013, GAL's final commercial revenue forecasts were published in the RBP.
 - The CAA's initial forecast was discussed in Chapter 7 of the CAA's initial proposals published in April 2013. The initial proposals were based on a phase 2 report from the CAA's independent consultants SDG.¹¹⁷

¹¹⁷ SDG, Assessment of Commercial Revenues at Gatwick Airport, Final report (phase 2), April 2013, available from:
[http://www.caa.co.uk/docs/78/Gatwick%20Final%20Report%20\(sent\)%2009Apr13%20redact](http://www.caa.co.uk/docs/78/Gatwick%20Final%20Report%20(sent)%2009Apr13%20redact)

- The CAA's revised forecast was discussed in Chapter 6 of the CAA's final proposals published in October 2013. The final proposals were based on a phase 3 report from SDG¹¹⁸ updated to incorporate, where appropriate, issues raised by stakeholders in their responses to the CAA's initial proposals and the CAA's revised traffic forecast. This resulted in Q6 commercial revenues that were around 6% lower than forecast by ACC and 12% higher than forecast by GAL.
- The CAA's final view on commercial revenues was set out in Appendix E of the CAA's proposed licence published in January 2014. This updated the forecasts for the CAA's latest traffic forecasts and also include an uplift to reflect revenue improvements from changes to GAL's capex programme.

CAA's proposed licence

- E4 In the proposed licence the CAA forecast total commercial revenues at £1,076.6 million over a five-year Q6 period. The CAA used SDG's commercial revenue per passenger forecasts¹¹⁹ together with the CAA's traffic projections. The CAA also identified additional efficiencies from improvements to GAL's capex schemes. Once converted to 2011/12 prices the changes in these schemes provided an additional £19 million of revenue over the five years of Q6 or £29 million over seven years.
- E5 Figure E.1 below presents the GAL, ACC and CAA's forecasts for Q6 commercial revenues.

[ed%20finalv2.pdf](#)

¹¹⁸ SDG, Assessment of Commercial Revenues – Gatwick Airport, Final report (phase 3), September 2013, available from:

<http://www.caa.co.uk/docs/78/SDG%20-%20LGW%20Commercial%20Revenues%20REDACTED.pdf>

¹¹⁹ The proposed licence used SDG's phase 3 report forecasts.

Figure E.1: Forecasts for commercial revenues in Q6

£m 2011/12 prices	2014/15	2015/16	2016/17	2017/18	2018/19	Total
GAL RBP	183.4	173.4	179.0	181.1	188.0	904.9
ACC*	217.3	217.7	219.3	230.7	240.4	1,125.3
CAA IPs	190.5	185.8	195.2	199.9	209.5	981.0
CAA FPs	196.4	193.4	202.3	207.2	216.1	1,015.3
CAA proposed licence	201.3	209.3	214.8	222.8	228.3	1,076.6

*Based on Javelin/ACTM's retail and car parking forecasts, SDG property forecast and ACC's November 2013 traffic forecast

Source: GAL, ACC and CAA

E6 The CAA's proposed licence document examined the commercial revenues projections under the following key issues:

- use of SDG's consultancy studies;
- retail;
- car parking;
- property; and
- overall commercial revenues.

Use of consultancy studies

E7 The CAA based its proposed licence forecast of commercial revenues on SDG's projections per passenger uplifted with its own traffic forecasts and adjusted for the improvements in capex schemes.

E8 SDG's work consisted of three reports - interim, phase 2 and phase 3 reports. In the initial proposals the CAA used SDG's projections per passenger from the phase 2 report from April 2013. In its phase 3 report, SDG considered additional evidence put forward by the stakeholders in response to the CAA's initial proposals. The CAA's final proposals used SDG's projections per passenger from the phase 3 report from September 2013. In the proposed licence, the CAA continued to base its car parking and property revenues per passenger on SDG's September 2013 report. For retail revenues, the CAA used SDG's retail revenues per passenger adjusted to account for revenue increases from improvements in capex schemes.

- E9 The CAA noted that in developing the consultancy studies SDG considered the data available and the evidence provided by all parties (including reports by Javelin provided by the airlines). The CAA considered that SDG took a balanced view between the evidence provided by stakeholders as well as its own analysis.
- E10 The CAA noted that SDG increased its commercial revenue forecasts in the phase 3 report to reflect changes in the 2012/13 outturn versus GAL's projections, particularly in relation to car parking. This was slightly offset by downgrading certain forecasts (e.g. bookshop revenues) following additional information provided by GAL. The CAA also noted that SDG's revised forecasts also took into account specific adjustments advised by GAL. The CAA considered that the SDG study provided a balanced argument on the key issues concerning GAL's commercial revenue forecasts.

Retail

- E11 The CAA based its retail revenues forecasts on SDG's forecasts, which encompassed:
- a 12% fall in tobacco sales from the Tobacco Display Act (TDA) and no tobacco ban during Q6;
 - an increase in retail margins from striking a different contractual arrangement ✕;
 - a reallocation of retail space from catering to retail but with the potential revenue increase reduced by 50% since the initial proposals;
 - a reduction in the fall in bookshop revenues with a minor adjustment to the forecasts based on the 2012/13 performance;
 - an increase in advertising revenues from additional sponsorship; and
 - growth in telecoms income in line with passenger volumes.
- E12 The CAA noted that no new evidence was presented by stakeholders in relation to the potential impact of tobacco legislation on tobacco sales. The CAA also clarified that SDG's assumptions were based on a wide range of benchmarks as set out within their April 2013 (phase 2) and September 2013 (phase 3) reports. The assumption that a reduction in tobacco sales could be mitigated by allocating tobacco

space to other product categories was one made by the airlines' consultants and was not included in SDG's financial assumptions. The CAA however considered this point when choosing to incorporate the 12% impact of TDA on tobacco sales rather than the 20% impact also proposed by SDG.

- E13 The CAA maintained its view that the target bookshop revenues were achievable and pointed towards WH Smith's more recent announcement of preliminary results for the year ending 31 August 2013¹²⁰, which presented a positive outlook on the future of Travel performance. The CAA also noted that if all benefits from improved margins went to WH Smith (as mentioned by GAL) and not shared in any way with GAL, it suggested room for renegotiation of the contract with WH Smith to redress the balance.
- E14 Having received no additional evidence to amend its earlier margin target of 3% over the whole Q6, the CAA continued to consider this target achievable.
- E15 In relation to the airlines' comments that the CAA's forecasts did not account for a more positive macroeconomic outlook, the CAA noted that SDG did acknowledge the strengthening of the economy in its September 2013 report.¹²¹ SDG had since confirmed that the increase between its phase 2 and phase 3 reports was somewhat driven by improved macroeconomic assumptions. The CAA noted the potential upsides in the macroeconomic environment. However, the CAA considered that the impact of economic growth on retail revenues per passenger was hard to quantify. The CAA had assumed a direct relationship between commercial revenues and passenger growth which was in part driven by economic growth. However, there seemed to be little correlation between various macroeconomic factors such as GDP or real household consumption and historic retail revenues per passenger. The CAA also noted that the airlines did not appear to have a methodology to quantify this relationship. The CAA therefore did not assume a further uplift to its per passenger forecasts for stronger economic growth. The CAA

¹²⁰ WH Smith PLC, Preliminary results announcement for the year ended 31 August 2013, available from:

http://www.whsmithplc.co.uk/docs/Prelims_Press_Release_2013_Combined_FINAL.pdf

¹²¹ Paragraph 2.11.

noted that individual measures such as new retail offerings were likely to make a bigger impact on the per passenger forecasts.

- E16 The CAA noted that no new evidence was put forward to address e-commerce revenue proposals or the switch between catering and retail space. For the reasons discussed in the CAA's final proposals, the CAA considered it appropriate to maintain its previous forecasts.¹²²
- E17 The CAA adjusted SDG's retail revenue forecast to account for additional revenue from GAL's updated business cases for some capex projects. The CAA identified improvements in terms of commercial revenues in the following schemes:¹²³
- ST IDL Capacity;
 - NT IDL Reconfiguration and Expansion; and
 - NT Arrivals Transformation.
- E18 As GAL did provide a detailed breakdown of the additional revenues, the CAA based its forecast on the information from the revised business cases. Once converted to 2011/12 prices, the changes in these schemes provide an additional £19 million of revenue over the five years of Q6 or £29 million over seven years.

Car parking

- E19 Car parking revenue forecasts were based on SDG's phase 3 report forecasts. SDG suggested that there was the potential to outperform GAL's RBP revenue forecast for car parking due to:
- increases in long stay pricing for pre-booked products in the peak season;
 - above inflation increases in long stay roll-up parking;

¹²² See paragraphs 6.18-6.20 of final proposals.

¹²³ The slight additional non-aeronautical revenue from the revised business case of additional NT coaching bays was considered to be related to other revenues rather than commercial revenues. As discussed in Appendix F of the proposed licence, the CAA based its forecast of other revenues on GAL's forecast (along with own opex efficiency assumptions). As the latest forecast of other revenues was received from GAL on 22 August 2013 (that is after the revised business cases were provided in June 2013) the CAA assumed the additional revenue from the improvement of this scheme was already accounted for in GAL's forecasts.

- additional revenues from the licensing scheme with impact slightly reduced since SDG's phase 2 report which the CAA based its initial proposals on; and
 - enforcement of forecourt pick-up activity into short stay car parks with impact slightly reduced since SDG's earlier report which the CAA based its initial proposals on.
- E20 The increase of forecast revenues between the CAA's initial proposals and final proposals was mainly a result of an improvement in car parking revenue performance at Gatwick which increased the forecasts for 2013/14 (before the start of Q6) by 3%. The CAA noted that the increase due to improved outturns in the base year was further supported by GAL's interim financial statement for the six months ended 30 September 2013¹²⁴ which pointed towards a 16% period-on-period increase in net car parking revenue per passenger due to increased valet capacity, better yield management at peak times and increased transactions from third party consolidators and third party operators.
- E21 The CAA considered that GAL had not provided new evidence against SDG's identified opportunity to increase long stay roll-up prices. The CAA considered that the benchmarks from other airport operators quoted in the SDG report continued to provide evidence of higher roll-up prices than those in place at Gatwick.
- E22 The CAA pointed to SDG's statement that at peak times GAL's car parking products were priced close to or sometimes cheaper than off-airport facilities. The CAA considered it was incorrect for GAL to assume that SDG's findings were based on a comparison for one booking date and one entry date. The CAA explained that SDG ran several tests on different dates and for different entry dates and the additional findings were mentioned in their September 2013 report.¹²⁵ The additional findings supported the previous claims that GAL's prices were cheaper than those of some other operators.

¹²⁴ GAL, Report and Unaudited Interim Financial Statements for the six months ended 30 September 2013, available from:
http://www.gatwickairport.com/Documents/business_and_community/investor_relations/Gatwick_Airport_Limited_Interim_Financial_Statements_30September2013.pdf

¹²⁵ Paragraph 2.98.

- E23 In relation to SDG's statement that that the off-airport licence scheme would generate from £0.7 million to £1.2 million per year the CAA pointed out that SDG had already reviewed their forecasts and adjusted it by some 4%, reducing revenue by £0.2 million. GAL did not provide additional evidence to further amend this assumption.
- E24 The CAA continued to agree with SDG's identified opportunity in enforcement of forecourt activity into short stay car parks, which have already been reduced by 1% following some further explanations from GAL. The CAA also queried GAL's statement that enforcement activity would not bring a net benefit as it would make the undertaking questionable given the cost of introducing enforcement and the potential negative impact on passengers.
- E25 The CAA noted that the car parking e-commerce initiatives proposed by SDG and accepted by the CAA in its final proposals applied only to car parking, hence making the provision of Wi-fi service irrelevant.
- E26 The CAA also stated that, for reasons set out in the final proposals and in light of lack of further new evidence from stakeholders to amend previous assumptions, it continued to consider it was appropriate to base its car parking revenue projections on the work by its consultants.

Property

- E27 In the proposed licence the CAA's property revenue forecast was based on SDG's phase 3 report forecasts. SDG maintained its increased forecasts of property revenues compared to GAL's RBP but included a minor downwards adjustment from SDG's phase 2 report following consideration of stakeholders' comments in response to the CAA's initial proposals.
- E28 SDG forecast additional property revenues based on a combination of:
- further income from re-letting of office and ramp voids;
 - ad hoc contractors' accommodation; and
 - additional turnover-related income from hotels.
- E29 The CAA noted that following a discussion between SDG and GAL in July 2013 SDG reduced their revenue forecasts for Concorde House. The CAA agreed with SDG's view that there was opportunity for the

asset to be re-let during Q6 and therefore proposed no change to the final proposals forecast.

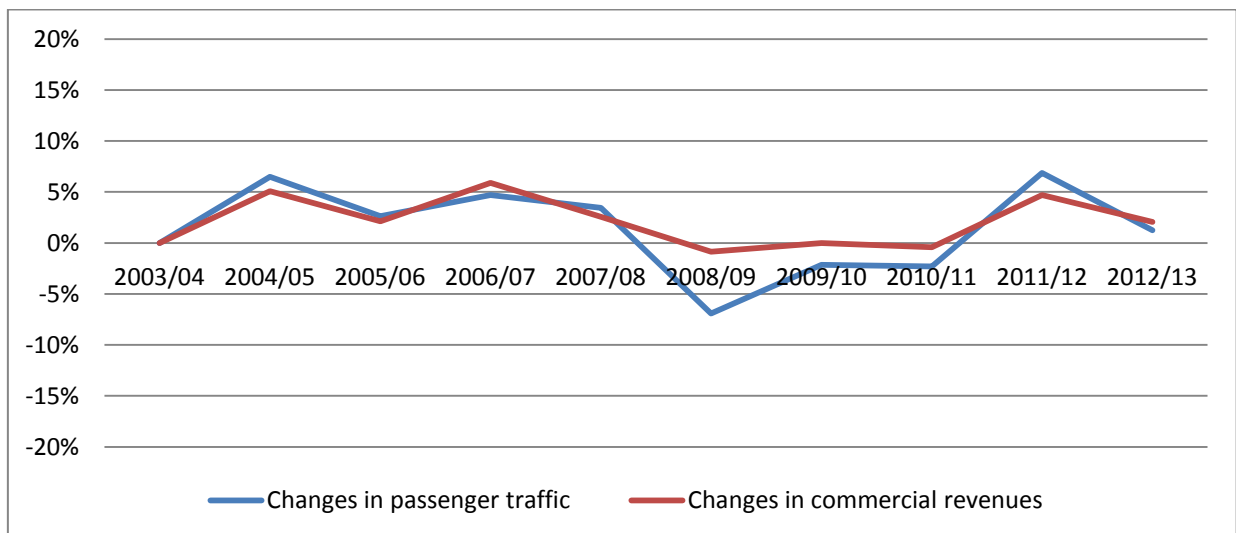
- E30 The CAA continued to consider that the reintroduction of the Pier 5 accommodation would bring an incremental revenue benefit.
- E31 The CAA agreed with SDG that there were opportunities to increase revenues from ad-hoc contractors' accommodation. The CAA welcomed that GAL has already made some allowance for revenue from contractors' accommodation to improve but considered SDG's forecasts reasonable.
- E32 Having received no additional evidence to amend its earlier forecasts, the CAA maintained the property revenue per passenger assumptions set out in its final proposals.

Overall commercial revenues

- E33 GAL had previously disagreed with the CAA's methodology of uplifting the forecasts for commercial revenues per passenger by traffic forecasts noting that not all categories of commercial revenues were directly affected by traffic.
- E34 The CAA continued to consider its methodology of uplifting the forecasts for commercial revenues per passenger by traffic forecasts appropriate. The CAA acknowledged that the link between property revenues and traffic forecasts was not as direct as that between traffic and retail and car parking revenues. However, the CAA noted that property revenues consisted of elements which were linked to passenger numbers. For example, the CAA considered it reasonable to assume that as passenger numbers at the airport increased, there would be room to increase revenues from hotels and airline accommodation. The CAA pointed out that SDG provided its forecasts on a per passenger basis. The CAA noted that over the last ten regulatory years changes in commercial revenues have been generally aligned with changes in traffic numbers, see figure E.2. The CAA also noted that its methodology of uplifting total commercial revenues per passenger with traffic forecasts was consistent with that used previously by the CC in its Q5 price control review for Gatwick

and Heathrow¹²⁶ and Stansted¹²⁷ as well as the CAA in its Q5 decision.

Figure E.2: Alignment of changes in passenger traffic and commercial revenues



Source: GAL's regulatory accounts, CAA analysis

Representations received

E35 The CAA received only one representation on commercial revenues in response to its proposed licence commenting specifically on the level of commercial revenues. Virgin welcomed the increase in the forecast revenue between the final proposals and the proposed licence, however, it considered this should have been more significant. Virgin also stated that the CAA should have placed more weight on the reports by Javelin.

¹²⁶ CC, Heathrow Airport Ltd and Gatwick Airport Ltd Q5 price control review, 2007, available from: <http://www.competition-commission.org.uk/our-work/directory-of-all-inquiries/heathrow-and-gatwick-quinquennial-review/final-report-and-appendices-glossary>

¹²⁷ CC, Stansted Airport Ltd Q5 price control review, 2007, available from: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2008/fulltext/539.pdf

CAA's response and decision

- E36 The CAA notes that Virgin did not elaborate on the general comment which had been raised previously and addressed by the CAA in the proposed licence document. The CAA maintains its view that SDG took a balanced view between the evidence provided by stakeholders, which included the Javelin reports, as well as its own expert analysis. The CAA notes that the inclusion of additional revenue from improved capex schemes provides a further stretch to the SDG retail revenues forecasts.
- E37 The CAA continues to consider its forecast of commercial revenues is appropriate. The CAA also notes that the CAA's overall commercial revenues forecast over five years is only 4% lower in comparison to the ACC's updated forecast (or 1% lower in comparison to the ACC's initial forecast).¹²⁸ At the same time, the CAA's forecast is 19% higher in comparison to GAL's RBP.¹²⁹
- E38 For the reasons set out of above the CAA maintains its forecast of commercial revenues as expressed in the proposed licence document and discussed above. The CAA's decision on its commercial revenue forecasts is therefore based on:
- core targets identified in an independent consultancy by SDG which assessed GAL's proposed commercial revenue forecasts;
 - the CAA's analysis of potential upside to retail forecasts from the improvement of capex schemes; and
 - the CAA's traffic forecasts, discussed in Appendix B.
- E39 The CAA has based its commercial revenue forecasts on the revenue per passenger forecasts provided by SDG, adjusted to reflect the increased revenues from capex schemes and CAA's traffic forecasts, as set out in figure E.3 below. For the two years following Q6 where SDG did not provide projections, the CAA has assumed that the difference between the SDG and GAL per passenger commercial

¹²⁸ ACC's overall forecast is based on ACC's retail and car parking forecasts, CAA's property forecasts and ACC's traffic projections.

¹²⁹ The CAA notes that GAL's figure does not include revised traffic forecasts or additional revenue from GAL's improved capex schemes.

revenue forecasts remains constant. The years 2019/20 and 2020/21 also include additional revenue from the improved capex schemes.

Figure E.3: CAA's decision on commercial revenues per passenger

2011/12 prices	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
£ per pax							
Retail	3.57	3.71	3.78	3.86	3.92	n/a	n/a
Car parking	1.13	1.10	1.07	1.04	1.04	n/a	n/a
Property	0.68	0.67	0.69	0.75	0.75	n/a	n/a
Total	5.38	5.48	5.53	5.66	5.72	5.67	5.61
CAA final passenger forecast	37.4	38.2	38.8	39.4	39.9	40.5	40.9
£ million							
Retail	133.6	141.7	146.7	152.1	156.7	n/a	n/a
Car parking	42.3	42.0	41.5	41.0	41.5	n/a	n/a
Property	25.4	25.6	26.7	29.7	30.1	n/a	n/a
Total	201.3	209.3	214.8	222.8	228.3	229.2	229.5

Note: numbers may not add up due to rounding

Source: SDG and CAA

E40 The CAA's decision maintains the total commercial revenues of £1,076.6 million over the five year Q6 period. The breakdown of total commercial revenues for Q6 is as follows:

- Retail: £730.8 million;
- Car parking: £208.3 million; and
- Property: £137.5 million.

APPENDIX F

Other Charges

- F1 This appendix considers the appropriate level of other charges to be taken into account in the fair price calculation. Under a single till approach, this revenue would be included in the calculation of a RAB-based price control. The revenue is from charges on airlines and other companies operating at the airport for facilities and services that are essential for their operations.¹³⁰

Other charges process to date

- F2 CE did not discuss revenues from other charges. GAL included forecasts of revenue from other charges in its January 2013 RBP. As much of the revenue is a recharge of GAL's costs, GAL mentioned that the level of revenue was directly related to its cost forecasts.
- F3 The CAA did not take a view on GAL's forecasts in its initial proposals. However, as it needed a forecast to calculate a fair price at Gatwick, it used GAL's January 2013 RBP forecast revenue of £392 million (in 2011/12 prices) over the seven years. In its final proposals and proposed licence the CAA adjusted GAL's forecasts for the CAA's efficiency assumptions.

CAA's proposed licence

- F4 In its initial proposals, the CAA said its other regulated charges (ORCs) forecasts would be based on GAL's forecasts adjusted by the CAA's operating cost forecasts. The CAA used this approach in its final proposals. As the ORCs are based on cost recovery, with the

¹³⁰ Other charges in GAL's forecasts include revenue from: check-in and baggage, staff car parking, fixed electrical ground power, staff identity cards, bus and coach, airside licences, electricity, gas, water and sewerage, heating, PRM, vehicle fuel and oil, and other non-specified revenue.

majority of the costs being operating costs, in its proposed licence the CAA continued to hold the view that the correct way of forecasting revenues during Q6 is to adjust them by its operating cost forecasts. The CAA did not consider that it would have been reasonable to use a different approach to forecast the proportion of GAL's operating costs that are recovered through ORCs to the approach it used to forecast GAL's other operating costs. The CAA further noted that, with the information provided under the Transparency Condition, the agreement on the principles on which ORCs had been set in Q5 (including that charges were based on cost recovery) and the annual consultation with users on each of the charges through the Gatwick Charges Group, airlines had greater transparency over ORCs than GAL's other charges during Q5. The CAA, therefore, based its forecasts of ORC revenue on GAL's forecasts with the operating costs element (which makes up 78% of GAL's forecast revenue) adjusted downwards to reflect the lower operating costs that the CAA considered GAL would be able to achieve during Q6.

Representations received

F5 There were no specific representations on other charges.

CAA's response and decision

F6 As there were no representations on other charges the CAA has maintained its forecasts for other charges for the reasons set out in paragraph F4 above. The CAA's forecast revenue is shown below in figure F.1 and figure F.2.

Figure F.1: Forecast revenue from other charges in Q6 (£m in 2011/12 prices)

	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Check-in/baggage	18.26	20.21	20.40	21.13	20.95	20.97	20.94
Staff car park	6.80	6.87	6.94	7.01	7.08	7.15	7.22
Fixed electrical ground power (FEGP)	2.43	2.45	2.53	2.52	2.51	2.52	2.53
Identity cards	1.04	1.05	1.05	1.06	1.06	1.07	1.07
Bus & coach	0.64	0.64	0.64	0.64	0.64	0.64	0.64
Airside licences	0.08	0.08	0.08	0.08	0.08	0.08	0.08
Electricity	6.66	6.88	7.30	7.38	7.49	7.63	7.78
Water & sewerage	0.78	0.78	0.77	0.77	0.76	0.76	0.76
Heating	0.23	0.23	0.23	0.25	0.25	0.24	0.24
Gas	0.16	0.17	0.19	0.20	0.21	0.22	0.23
PRM	6.16	5.95	6.27	6.61	6.98	7.37	7.78
Vehicle fuel and oil	2.65	2.66	2.66	2.65	2.66	2.66	2.67
Other non-specified revenue	3.14	3.31	3.49	3.68	3.68	3.68	3.68

Source: GAL revised forecasts adjusted to reflect the CAA's opex efficiency assumptions

Figure F.2: CAA's final projections from other charges (£m in 2011/12 prices)

2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
49.05	51.27	52.56	53.98	54.36	54.99	55.61

Source: GAL revised forecasts adjusted to reflect the CAA's opex efficiency assumptions

APPENDIX G

Q6 RAB

- G1 This appendix:
- summarises the CAA's analysis and its final view as set out in the proposed licence with respect to GAL's RAB; and
 - concludes with the CAA's final decision for the RAB, which is incorporated in its financial modelling of its final decision for the fair price.

CAA's proposed licence

Deriving the opening RAB for Q6

RAB roll forward in the year 2013/14

- G2 The opening RAB of £2,399.9 million as at 31 March 2013 in GAL's January RBP was a forecast opening RAB. GAL's 2012/13 regulatory accounts updated it by an actual opening RAB as at 31 March 2013, which is £2,391.6 million.
- G3 In the proposed licence the CAA reduced the opening RAB for 31 March 2013 by £8.3 million to reflect the difference between the forecast and actual capex spend in the year 2012/13. The reduction in the opening RAB also decreased the revaluation of the opening RAB by £0.2 million.
- G4 In the absence of an updated view from GAL on capex spend in the year 2013/14, the CAA assumed the spend was in line with the forecast capex in GAL's January RBP, which was £200.4 million.
- G5 Figure G.1 sets out the CAA's final view as set out in the proposed licence for GAL's RAB roll forward in the year 2013/14 including the adjustment to the opening RAB as at 31 March 2013.

Figure G.1: GAL's RAB roll forward in the year 2013/14

£ million nominal	CAA's PL	GAL's Jan BP	Difference
Opening RAB as at 31 March 2013	2,399.9	2,399.9	-
Opening RAB Adjustment	-8.3	0.0	-8.3
Opening RAB Revaluation	62.2	62.4	-0.2
Capital additions	200.4	200.4	-
Regulatory Depreciation	-153.2	-153.2	-
Indexation	0.6	0.6	-
Closing RAB as at 31 March 2014	2,501.7	2,510.2	-8.5

Source: GAL's regulatory accounts year ended 31 March 2013 and GAL's January business plan

Inclusion of pension commutation payment

- G6 GAL proposed that the CAA include the commutation payment of £104.7 million made by GAL to the BAA pension scheme in 2009 upon the sale of the airport to the opening RAB as at 1 April 2014 and uplift the amount to 2011/12 prices.
- G7 In the proposed licence the CAA considered responses from both GAL and the airlines. These issues were discussed in Appendix D: operating expenditure. The CAA's final view was to include the pension commutation payment in the RAB and uplift the amount by inflation of 4.8% to 2011/12 prices, which resulted in a total amount of £109.7 million to be included in the RAB. Figure G.2 summarises the change in the opening RAB for Q6 between the CAA's final proposals and proposed licence.

Figure G.2: Opening RAB for Q6 - comparison between CAA's final proposals and the CAA's final view as set out in the proposed licence

£ million	Price base	CAA's PL	CAA's FPs
Closing RAB as at 31 March 2014	2013/14	2501.7	2510.2
Price base adjustment of closing RAB		140.0	140.5
Closing RAB as at 31 March 2014	2011/12	2361.7	2369.7
Pension commutation payment	2010/11	104.7	104.7
Indexation of commutation payment		5.0	-
Adjusted pension commutation payment	2011/12	109.7	104.7
Opening RAB as at 1 April 2014	2011/12	2471.4	2474.4

Source: CAA

Deriving the depreciation charges and the RAB for Q6

- G8 The CAA's final view in the proposed licence for the RAB during Q6 was based on GAL's forecast net capex, depreciation of the existing assets and depreciation of forecast capex in Q6. GAL's depreciation of existing assets was in line with GAL's regulatory accounts, and GAL's asset lives and depreciation policy were consistent with those in the Q5 decision.
- G9 The depreciation of new capex for Q6 was calculated on a straight-line depreciation basis. The CAA:
- validated the depreciation charges for the existing assets and GAL's projections for the value of capex spent in Q5 - the depreciation charge deducted from the RAB during Q5 is the same as that included in the Q5 decision;
 - increased depreciation by £7.3 million each year to adjust for the pensions commutation payment, which was based on a depreciation period of 10 years;
 - reduced depreciation in line with the reduction in capex in the CAA's final projections compared to GAL's revised capex plan; and
 - removed the depreciation profiling between Q6 and Q7, as it does not see merit, in this case, of moving value from one period to another.

G10 The CAA's forecast for GAL's RAB throughout Q6 is set out in figure G.3.

Figure G.3: CAA's forecast for the depreciation charge

£m (2011/12 prices)	2014/15	2015/16	2016/17	2017/18	2018/19	5 yr total	2019/20	2020/21	7 yr total
Depreciation - existing assets and Q5 additions	141	134	124	107	104	610	98	90	798
Depreciation - new additions	1	16	22	27	40	106	48	57	211
Depreciation-pensions commutation payment	7	7	7	7	7	37	7	7	51
Regulatory depreciation profiling	0	0	0	0	0	0	0	0	0
Total depreciation	150	156	154	142	151	753	154	154	1,061

Source: CAA

Rolling forward the RAB for Q6

G11 The CAA's forecast for the Q6 RAB is set out in figure G.4 below.

Figure G.4: CAA forecast of the Q6 RAB for GAL

£m (2011/12 prices)	2014 /15	2015 /16	2016 /17	2017 /18	2018 /19	5 yr total	2019 /20	2020 /21	7 yr total
Opening RAB	2,471	2,476	2,518	2,552	2,549	2,471	2,509	2,524	2,471
Net capex	155	198	188	139	111	791	169	217	1,176
Depreciat ion	(150)	(156)	(154)	(142)	(151)	(753)	(154)	(154)	(1,061)
Closing RAB	2,476	2,518	2,552	2,549	2,509	2,509	2,524	2,587	2,587
Average RAB	2,474	2,497	2,535	2,551	2,529	n/a	2,517	2,555	n/a

Source: CAA

Representations received

G12 The CAA received no specific representations on the RAB for Q6 in response to its proposed licence.

CAA's response and decision

G13 As the CAA has not received additional representations, the CAA's views on the level of GAL's RAB over Q6 remain as set out in figure G.4 for the reasons set out above.

APPENDIX H

Calculation of the Fair Price and Financeability

- H1 This appendix:
- sets out the CAA's final view for GAL's WACC as set out in the proposed licence;
 - sets out the CAA's final view of the fair price for GAL for Q6 as set out in the proposed licence;
 - assesses the extent to which price at this level would enable GAL to finance its projected investment in Q6; and
 - sets out the CAA's response to any representations to the proposed licence on the fair price and financeability for GAL for Q6.
- H2 The CAA's analysis of the components of WACC, a summary of the responses to its consultation and its calculation of the total WACC from those components is set out in full in 'Estimating the Cost of Capital: a Technical Appendix to the economic regulation of Heathrow and Gatwick from April 2014: Notices granting the licences'¹³¹]

WACC

CAA's proposed licence

- H3 The CAA's final proposal for GAL's WACC was 5.95% on a pre-tax real basis. This equated to a vanilla¹³² WACC of 5.10%.
- H4 Based on the analysis contained in the CAA's Technical Appendix on WACC to the proposed licence, the CAA's final view for GAL's WACC was 5.70% on a pre-tax real basis. This equated to a vanilla WACC of 4.90%. The main reason for the change from the final proposals as set out in the WACC Technical Appendix was a reduction in the cost

¹³¹ The Technical Appendix can be found at: <http://www.caa.co.uk/docs/33/CAP%201140.pdf>.

¹³² The vanilla WACC is the pre-tax cost of debt and the post-tax cost of equity weighted by gearing. It therefore excludes any adjustments for tax.

of equity from lower assumed total market return. This took into account the additional new evidence set out in the CC's provisional findings on NIE. Combined with the forecast RAB derived in Appendix G of this document, the forecast WACC charge (or cost of capital) for GAL over Q6 is shown in figure H.1 below.

Figure H.1: WACC charge included in the GAL Q6 fair price calculation

£m (2011/12 prices)	2014/15	2015/16	2016/17	2017/18	2018/19	5 yr total	2019/20	2020/21	7 yr total
Average RAB	2,474	2,497	2,535	2,551	2,529	n/a	2,517	2,555	n/a
Cost of capital	141	142	144	145	144	717	143	146	1,006

Source: CAA

Representations received

H5 The CAA received a number of representations on the calculation of the cost of capital, including a detailed joint response from Professor Sudarsanam on behalf of BA and Virgin.

CAA's response and decision

H6 The responses on the cost of capital and the CAA's response are set out in the Technical Appendix on the WACC for the granting of the licence. For the reasons set out in this document, the CAA continues to consider that a WACC of 5.70% (pre-tax real) is appropriate for GAL. The WACC charge therefore remains as set out in figure H.1.

Fair price calculation

CAA's proposed licence

H7 The CAA's proposed licence for GAL was to set a fair price equivalent to a maximum increase in average airport charges of RPI-1.6% per year over a 5-year Q6 period, and RPI-2.0% per year, if the final projections are extended to 7 years. Figure H.2 shows each building block component which contributed to the CAA's final fair price calculation.

Figure H.2: CAA's fair price calculation in the proposed licence

£m (2011/12 prices)	2013/ 14	2014 /15	2015 /16	2016 /17	2017 /18	2018 /19	5 yr total	2019 /20	2020 /21	7 yr Total
Opex		284	281	279	276	274	1393	273	272	1,939
Depreciation		150	156	154	142	151	753	154	154	1,061
Cost of capital		141	142	144	145	144	717	143	146	1,006
Total revenue requirement		574	580	577	564	569	2864	570	572	4,006
Other revenues		(250)	(261)	(267)	(277)	(283)	(1,338)	(284)	(285)	(1,907)
Net revenue requirement		324	319	309	287	286	1,526	286	286	2,098
Passengers (no. millions)		37.4	38.2	38.8	39.4	39.9	193.8	40.5	40.9	275.1
Unprofiled yield per pax (£)	8.31	8.66	8.37	7.96	7.28	7.17	n/a	7.08	7.00	n/a
Year-on-year change	n/a	4.3%	-3.3%	-4.8%	-8.6%	-1.5%	n/a	-1.3%	-1.0%	n/a
5-year smoothed price cap (RPI-1.6%)										
Profiled yield per pax (£)	8.31	8.19	8.06	7.93	7.75	7.62	n/a	n/a	n/a	n/a
Year-on-year change	n/a	-1.4%	-1.6%	-1.6%	-2.3%	-1.6%	n/a	n/a	n/a	n/a
7-year smoothed price cap (RPI-2.0 %)										
Profiled yield per pax (£)	8.31	8.16	7.99	7.84	7.63	7.47	n/a	7.37	7.23	n/a
Year-on-year change	n/a	-1.8%	-2.0%	-1.9%	-2.7%	-2.0%	n/a	-1.4%	-2.0%	n/a

Source: CAA

H8 The CAA's assessment of the financeability of its Q6 final proposals for GAL indicated that the notionally financed airport operator would meet the requirements of a solid investment grade credit rating.

- H9 In response to the CAA's final proposals, Virgin noted that the ONS¹³³ had found that:
- RPI overstates actual inflation; and
 - the use of the RPI index inflates the airport charges.
- H10 The CAA's fair price calculations take into account an inflation assumption. The CAA examined the ONS findings in detail. The ONS concluded that the RPI does not meet international standards, and recommended that a new index be published. This could support the case for making an allowance to reflect an overstatement of the rate of inflation. However, the CAA noted that the ONS also commented that there was significant value to users in maintaining the continuity of the existing RPI's long time series without major change. Based on the ONS's recommendation and the CAA's own assessment, the CAA decided to continue the use of the RPI-based index, and not to adjust the treatment of inflation, for two reasons:
- the CAA saw considerable merit in regulatory consistency. This provided certainty for investors, management, and customers; and
 - many of GAL's cost items, such as wages, were calculated using RPI as it is currently comprised.
- H11 Accordingly, the CAA's proposed licence did not contain an adjustment for any overstatement of RPI. The RPI indices the CAA used were:
- the actual RPI indices (CHAW series) up to October 2013 published by the ONS;
 - monthly RPI indices obtained by interpolating the quarterly RPI forecasts from Oxford Economic Forecasting (OEF) for the period November 2013 to December 2017; and
 - annual RPI forecasts from Consensus Forecasts (CF) for 2018 (3.8%) and 2019 (3.2%).
- H12 In the proposed licence, the CAA smoothed the yield per passenger to avoid unnecessary fluctuations and to simplify the price control. Such smoothing or profiling was done in a Net Present Value (NPV) -

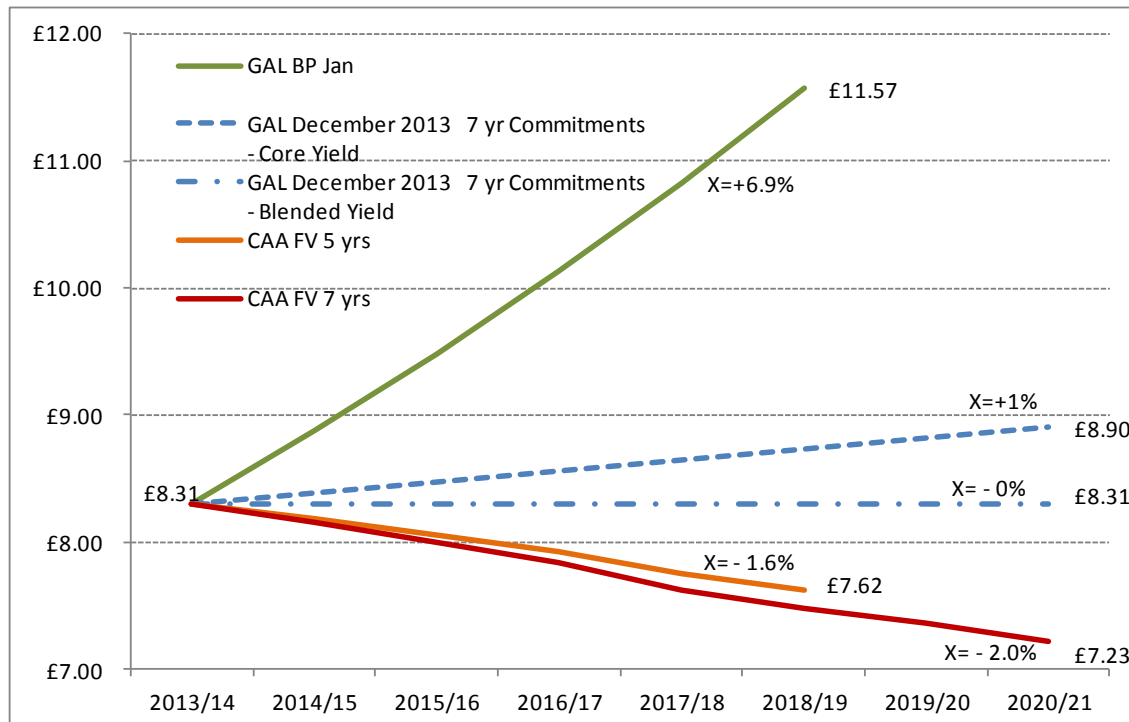
¹³³ <http://www.ons.gov.uk/ons/rel/mro/news-release/rpirecommendations/rpinewsrelease.html>

neutral manner, i.e. the NPV of the net revenue requirement was the same under both profiled and unprofiled prices.

- H13 The CAA was aware that a significant difference between the profiled and unprofiled prices may, in some circumstances, lead to a short-term mismatch between revenues and costs and create liquidity issues for GAL. These issues can have implications for the financeability assessment.
- H14 If the resulting yield per passenger was smoothed across a five year Q6 period, it equated to a price change of no more than RPI-1.6%¹³⁴ per year (see figure H.2). This compared to GAL's Business Plan of RPI+6.9% per year. Under the CAA's proposed licence, a fair price (in 2011/12 price base) was expected to be £7.62 per passenger in 2018/19 which was £3.94 (or 34%) lower than using GAL's projections.¹³⁵
- H15 If the projections were extended to 7 years, the price change was no more than RPI-2.0% per year (see figure H.2). This compared to GAL's commitment proposal of a blended yield of RPI-0% per year. Under the CAA's final projections, a fair price (in 2011/12 price base) was expected to be £7.23 per passenger in 2020/21, which was approximately 13% lower than using GAL's commitment proposal.
- H16 Figure H.3 shows how the CAA's final view as set out in the proposed licence compares to GAL's view of a RAB-based price cap using a simple average of the yield in each of the five years. Figure H.3 also compares GAL's view of price commitments and CAA's projections based on a RAB-based price cap over a 7-year period.

¹³⁴ In the formula $RPI \pm X$, RPI is the change in the index and can be negative or positive.

¹³⁵ GAL included a P0 adjustment in its RBP, which would reduce the difference at the end of the period but increase it at the start of the period.

Figure H.3: Yield per passenger (smoothed)

Source: CAA and GAL

H17 Figure H.4 compares the CAA's final view as set out in the CAA's proposed licence with the CAA's initial and final proposals, ACC's and GAL's responses to the CAA's initial proposals, and GAL's RBP. For example, the CAA's final view for opex was £1,393 million, which was 1.1% higher than the CAA's final proposals, 5.3% higher than ACC's response to the CAA's initial proposals, 0.6% higher than the CAA's initial proposals and 6% lower than GAL's RBP. The main changes from the final proposals were as follows.

- The WACC reduced from 5.95% to 5.70%. This was due to a reduction in the cost of equity reflecting a lower total market return assumption. The gearing and tax assumptions remained unaltered.
- Traffic forecasts increased by 4.2% over five years resulting from more up to date traffic data and the likely use of larger aircraft from easyJet's purchase of Flybe's slots.
- The opex efficiency assumption fell from 1.3% per year to 0.9% per year, due to higher passenger forecasts and an allowance for the CAA's aviation security charge (4.9p per departing passenger).

- Overall total commercial revenues increased by 6.0% to £1,077 million driven by the increase in traffic forecasts and the inclusion of revenue forecasts from improvements in GAL's capex schemes.
- Forecasts for ORCs increased, from £259 million to £261 million, or 1.0%, due to higher traffic forecasts.
- The opening RAB decreased by £3 million due to the update of actual capex spend in 2013/14 and the indexation of the pension commutation payment. The changes to the opening RAB and capex increased regulatory depreciation by 0.2% to £753 million.

Figure H.4: Comparison of building block assumptions over a 5-year Q6

	CAA's final view in the proposed licence (January 2014)	CAA's Final proposals (October 2013)	ACC's response to CAA's Initial proposals (June 2013)	GAL's response to CAA's Initial proposals (June 2013)	CAA's Initial proposals (April 2013)	GAL's Revised Business Plan (January 2013)
	£000	% increase (+) or decrease (-) relative to the CAA's final view				
Opening RAB	2,471	-0.1%	4.3%	4.3%	4.3%	4.3%
Capex	791	0.0%	82.3%	-25.7%	-0.4%	-13.2%
WACC (%)	5.70%	-0.3%	0.8%	-1.4%	0.1%	-0.8%
Cost of capital	717	-4.3%	29.0%	-12.1%	4.2%	-9.6%
Opex	1,393	1.1%	5.3%	na	0.6%	-6.0%
Regulatory Depreciation	753	0.2%	12.3%	9.8%	4.5%	10.4%
Commercial revenues	1,077	6.0%	-20.4%	na	9.7%	19.0%
ORCs	261	0.9%	na	na	-5.2%	-5.2%
Traffic	194	4.2%	1.7%	7.5%	7.1%	10.4%

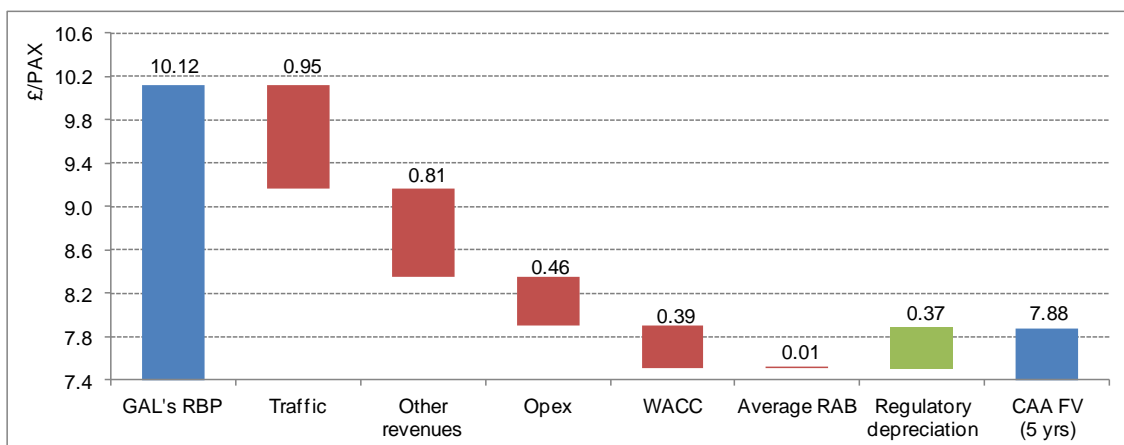
Source: CAA and GAL

H18 Figure H.5 shows the average yield between GAL's RBP (its last forecast of each of the individual RAB building blocks) and the CAA's proposed licence set out in the final view on average over a 5-year

period. Each bar in figure H.5 represents a 'building block' per passenger, calculated based on the CAA's final view of traffic. GAL's RBP proposed an average yield per passenger over a 5-year Q6 of £10.12, whereas the CAA's final view of an average yield per passenger over a 5-year period was £7.88. The difference in the yield was due to the difference in GAL's and the CAA's view on each 'building block', for example, the CAA's final view on traffic was higher than GAL's, which reduced the average yield by £0.95.

H19 The CAA's projected depreciation was higher than that of GAL's by, on average about £0.37 per passenger, because the CAA removed the depreciation profiling between Q6 and Q7. In the RBP GAL profiled depreciation between Q6 and Q7, in effect reducing the depreciation charge and therefore price in Q6 and increasing them in Q7. The CAA did not see merit of moving value from one period to another.

Figure H.5: Comparison of average annual yield over a 5-year Q6 between GAL's revised business plan and CAA's final view in the proposed licence



Note: Other revenues equal the sum of commercial revenues and non-regulated charges.

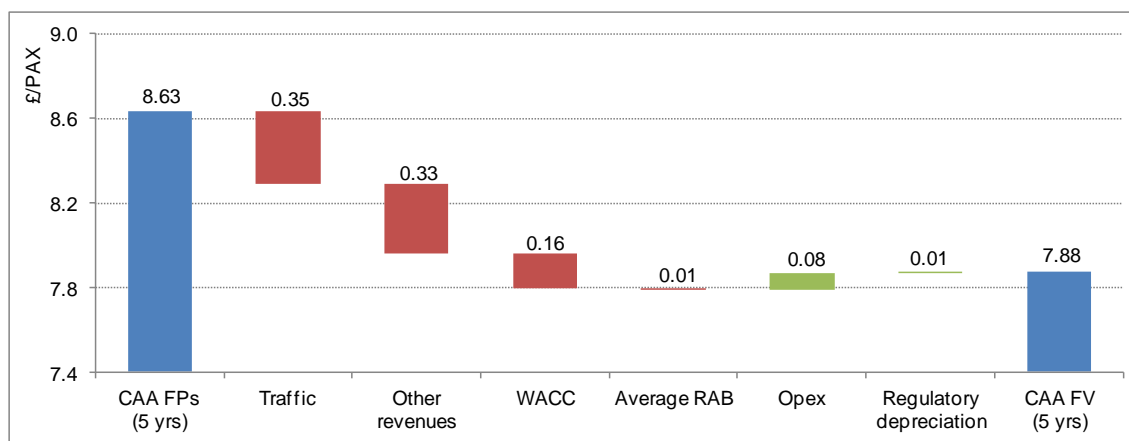
Source: CAA and GAL

H20 Figure H.6 shows the change between the CAA's final proposals and the proposed licence over a 5-year period. The most significant changes in the building blocks were traffic, cost of capital, other revenues, including commercial revenues and ORCs.

H21 The CAA's view of the fair price in the final proposals was an average of £8.63 over a 5-year period. Compare to the final proposals, the CAA's final view in the proposed licence had a higher traffic forecast,

which reduced the average yield by £0.35; the WACC decreased by 25 basis points, which decreased the average yield by £0.16, and opex was higher than its final proposals by £0.08 per passenger.

Figure H.6: Comparison of the average annual yield over a 5-year Q6 between the CAA's final proposals and final view as set out in the proposed licence



Note: Other revenues equal the sum of commercial revenues and non-regulated charges.

Source: CAA

Representations received

H22 The CAA did not receive any specific representations on the level of the fair price, although both GAL and the airlines continued to be concerned on the points they had previously made in so far as they had not been taken on board. The ACC stated that the CAA's view of the fair price was significantly above their view of the fair price.

CAA's response and decision

H23 None of the representations on the fair price in the proposed licence provided new information. The CAA therefore continues to consider that the fair price of RPI-1.6% per year over five years and RPI-2% per year over seven years remains appropriate for the reasons set out above.

Financeability

CAA's proposed licence

- H24 In the proposed licence the CAA assessed the financeability of its fair price calculations. In doing this, the CAA noted it must have regard to the need to ensure that licence holders such as GAL can finance their provision of airport operation services (in the area for which the licence is granted) when it comes to the exercise of the CAA's functions such as setting price caps. This cannot override the CAA's primary duty. However, the CAA considered that the setting of a price control condition that was aligned with an efficient operator being able to finance its business was consistent with, and not in conflict with, present and future passengers' interests.
- H25 The CAA considered it was appropriate to establish whether the Q6 proposed licence would enable an efficient GAL to finance its operations, including the capex programme in Q6 on reasonable terms in the banking and capital markets through some combination of debt and equity.
- H26 Standard & Poor's Ratings Services (S&P)¹³⁶ considered the CAA's initial proposals using a RAB-based approach for GAL as credit neutral and viewed the market-based commitments between GAL and the airlines as credit negative for GAL's securitisation. S&P's view was that the RAB represented the value of the securitised assets, which provided a reference point for investors. Without the RAB measure, investors might resort to typical business valuation approaches, which are sometimes volatile. S&P also commented that if the CAA's final decision supported the commitments regulatory framework, S&P would review GAL's earnings before interest, taxes, depreciation and amortisation (EBITDA) volatility or refinancing risk; significantly higher refinancing risk could affect S&P's ratings on Gatwick Funding Limited's bonds. Gatwick Funding Limited is a wholly owned subsidiary of GAL.
- H27 A key assumption in determining the appropriate level of gearing in the CAA's estimation of the WACC was that GAL should be able to obtain and maintain the requirements of a solid (sometimes known as

¹³⁶ Standard & Poor's Rating Services, *Initial regulatory proposals for UK airports are credit neutral*, 22 May 2013.

'comfortable') investment grade rating at an assumed gearing level of 55%.

- H28 A solid investment grade rating is interpreted as in the region of BBB/BBB+ (using S&P and Fitch Ratings Limited's terminology) and Baa2/Baa1 (using Moody's Investor Service terminology). This is a couple of 'notches' above the bottom of investment grade of BBB- or Baa3. The aim of the financeability assessment is for GAL to be in a position to absorb reasonable unanticipated downside risk and still retain an investment grade credit rating.
- H29 The CAA gathered evidence directly from three credit rating agencies; S&P, Moody's Investor Service and Fitch Ratings. In determining a credit rating, an agency typically considers both qualitative evidence (e.g. business risk and corporate governance) and quantitative evidence (e.g. financial risk and credit ratios).
- H30 In forming a view on the business risk of an airport operator, an agency will consider, among other things:
- the competitive position of the airport compared with airports owned by competitors, which in turn may include:
 - location (catchment area, local transport links); and
 - customer airlines and the passenger mix, (hub airlines, alliances, destinations of those airlines);
 - the regulatory regime, and in particular the rigour and predictability of the regime;
 - the diversity of the airports owned or operated by the company;¹³⁷ and
 - charges (for example landing, passenger and security charges).
- H31 The CAA considered that GAL would appear to have a stable position from a credit perspective. Gatwick is the world's busiest single runway airport and the second busiest airport in the UK. It has an attractive catchment area, convenient transport links and diversified revenue streams in terms of destinations and airlines.

¹³⁷ The CAA considers the airports on a standalone basis, so while this factor might be important for the credit rating agencies, the CAA's analysis ignores other airports in the same corporate group of companies.

- H32 One of the key assumptions of the CAA's financeability assessment was that the CAA's review would not affect GAL's business risk; therefore, the CAA assumed that the regulatory risk of GAL was unchanged from credit rating agencies' current views. However, the CAA recognised that the fair price could affect the financial risk of GAL.
- H33 With response to S&P's comment on the form of regulation, the CAA noted that the commitments framework was proposed by GAL in its RBP. The CAA considered that GAL had a duty of care to its shareholders and was expected to act in good faith to enhance shareholder value; therefore it would be unreasonable to assume the proposed commitments regulatory framework is financially unviable or materially worse than a RAB-based settlement. The CAA has a duty to have regard to the need to ensure the airport operator is financeable over the regulatory period, irrespective of the form of regulation chosen. The CAA's fair price set out in its proposed licence was calculated on a RAB-based regulatory framework; therefore, the CAA conducted financial risk analysis on such basis.
- H34 In forming a view on the financial risk of a business it is rating, an agency may consider matters such as:
- a) historical and forecast financial performance, including:
 - i) cash flow and profitability;
 - ii) revenue diversity and stability;
 - iii) liquidity and financial flexibility;
 - iv) capital structure of the company (including gearing);
 - v) covenants and security including securitisation; and
 - b) financial policy and strategy of management (including merger & acquisition activity, dividend policy, etc).
- H35 The rating agencies place different emphasis on the various ratios. Some of the agencies also differ in their benchmarks (e.g. the value the ratio needs to be for a certain credit rating).

CAA analysis of credit ratios

H36 The CAA considered whether the forecast performance of GAL under the CAA's proposed licence was consistent with a solid investment grade based on assumed gearing of 55% and considered six ratios used by the various agencies.¹³⁸

- a) interest cover;¹³⁹
- b) funds from operations (FFO¹⁴⁰) interest cover;¹⁴¹
- c) post-maintenance interest cover ratio (PMICR);¹⁴²
- d) adjusted interest cover (adjusted ICR¹⁴³);
- e) FFO to debt;¹⁴⁴ and
- f) regulatory asset ratio (RAR¹⁴⁵ or gearing) (debt divided by RAB).

H37 The CAA used a separate section in GAL's financial model, which was created to provide illustrative calculations of the above financial ratios. These were set out in nominal terms¹⁴⁶ as this tended to be the basis used by rating agencies.

H38 The CAA undertook the analysis on the basis of the notional capital structure consistent with the CAA's cost of capital proposals. This assumed:

¹³⁸ These ratios and some of the terms used in them do not have agreed definitions.

¹³⁹ $ICR = (EBITDA - \text{tax paid} - 2\% \text{ of total RAB}) / \text{interest paid}$. NB: the rating agencies using this metric assume that 2% of total RAB is required to maintain the regulatory assets.

¹⁴⁰ FFO = Net income from continuing operations adding back depreciation, amortisation, deferred income taxes and other non-cash items, less any changes to operating components of working capital.

¹⁴¹ $FFO / \text{interest expense} = FFO \text{ (as above)} + \text{gross interest paid on debt} / \text{gross interest expense on debt}$.

¹⁴² $PMICR = (EBITDA - \text{corporation tax paid} - \text{regulatory depreciation}) / \text{interest paid}$.

¹⁴³ Adjusted ICR is $FFO + \text{interest expense} - \text{regulatory depreciation} + \text{profiling adjustment}$ divided by interest expense.

¹⁴⁴ FFO/net debt, where FFO is as defined above and net debt = closing RAB x gearing ratio.

¹⁴⁵ $RAR = \text{debt less cash and authorised Investments} / \text{total RAB}$.

¹⁴⁶ In contrast, the rest of the GAL model used for the price control was specified in real terms.

- a) a constant gearing level of 55%, with the level of dividends being the balancing item used to keep gearing at this level;¹⁴⁷
- b) a nominal cost of debt of 5.9%. This is based on a real cost of debt of 3.0% (excluding fees) and an inflation rate of 2.9%;
- c) index-linked debt making up 35%¹⁴⁸ of the total debt balance; and
- d) a cost of index-linked debt of 3%.¹⁴⁹

H39 The CAA made some additional assumptions and adjustments in order to derive the financial ratios in figure H.7.

H40 Based on these results, the CAA considered that a notionally financed and efficient GAL would be likely to achieve and maintain a solid investment grade credit rating.

¹⁴⁷ The CAA relaxed this assumption and after allowing for a modest dividend yield, gearing was in the range of 55% to 56%.

¹⁴⁸ Ofgem assumes 25% of each network company's debt is index-linked. In the Q5 price control review, the CAA assumes that the proportion of index-linked debt is 25%. The CAA has also calculated the actual proportion of GAL's index-linked debt, based on GAL's financial statements. The calculated proportion is approximately 55%. Taking into account all the available evidence, the CAA takes the conservative point of 35% in the range of 25 per cent to 55 per cent.

Ofgem, 17 December 2012, '*RIO-GD1: Final Proposals - Finance and uncertainty supporting document*', page 25.

GAL, 'Report and unaudited interim financial statements for the six months ended 30 September 2012', page 15.

¹⁴⁹ The cost of index-linked debt of 3% is consistent with the CAA's point estimate of 3.32% less fees of 20bps (excluding fees). The nominal cost of debt includes inflation of 2.8%.

Figure H.7: GAL's financial ratios based on the CAA's proposed licence

Key financial ratios: benchmarks and calculations ¹⁵⁰								
Key financial ratios	Benchmark		CAA 5yr			CAA 7yr		
	Moody's (Baa2)	Fitch (BBB+)	Ave.	Min	Max	Ave.	Min	Max
PMICR a		1.5x	1.8x	1.8x	1.8x	1.8x	1.8x	1.8x
Net debt/EBITDA	n/a	7.0x	4.7x	4.6x	4.9x	4.7x	4.6x	4.9x
ICR	1.4x -1.6x	n/a	3.3x	3.2x	3.3x	3.3x	3.2x	3.3x
RAR - Net debt/RAB	68% - 75%	n/a	55%	55%	55%	55%	55%	55%
Other financial ratios								
FFO interest coverage	2.25x - 3.0x	n/a	3.3x	3.2x	3.4x	3.3x	3.2x	3.4x
FFO to net debt	6-10%	n/a	20%	19%	20%	20%	19%	20%

Source: CAA analysis

Note: Fitch's rating thresholds can be found on its credit report: 'Fitch affirms Gatwick Funding's bonds at 'BBB+'; outlook stable, 22 January 2013'.

- H41 The CAA evaluated a broad range of credit ratios (set out in figure H.7), in particular the PMICR and Net debt to EBITDA. The Net debt to EBITDA ratios were all below 7.0, indicating that GAL was able to generate sufficient earnings to finance its debt. The PMICR ratios were all above 1.5, which was Fitch's threshold of 'BBB+' rating, suggesting that the notionally financed airport operator would meet the requirements of a solid investment grade credit rating. In addition, the CAA assessed the ratios for a 7-year period, and conducted analysis by incorporating a variable dividend payout ratio. The CAA considered that its conclusions were not sensitive to changes in these assumptions.
- H42 The CAA used GAL's financial model to calculate the Q6 fair price and analyse price cap profiling and financeability. GAL's model, including assumptions, logic, internal consistency and formulae was externally audited.
- H43 The CAA's Q6 fair price calculations were internally audited and the excel model has been checked by calculating the price cap using alternative models.

¹⁵⁰ Unfortunately S&P does not share the details of key financial ratios which they consider important.

Representations received

H44 The CAA did not receive any specific representations on the financeability of the fair price.

CAA's response and decision

H45 As the CAA has not received any specific representations on financeability the CAA continues to consider that the fair price is financeable for the reasons set out above.

APPENDIX I

Form of Regulation

- I1 The overall model or form of economic regulation for GAL should be designed in a manner that furthers the CAA's statutory duties and reflects the market power held by GAL and the risk of abuse.
- I2 The current GAL Q5 price control is based on a RAB-based framework. As an alternative to licence regulation in future, GAL has put forward proposals for airport commitments to airlines. These commitments, which GAL is proposing to include in its COU set out limits on airport charges, a service quality scheme and commitments on consultation, investment, and operational and financial resilience. As part of its response to the final proposals GAL provided revised commitment proposals which reduced the price in the commitments to RPI+0% (blended) and RPI+1% per year (published), with improved terms regarding the treatment of second runway costs and premium charges and a number of other measures to meet the concerns identified by the airlines.
- I3 This appendix discusses the merits of GAL's proposed commitments and alternative forms of licence regulation that could apply from April 2014 for GAL. The appendix is structured as follows:
- process to date;
 - CAA's proposed licence;
 - representations received; and
 - CAA's response

Process to date

- I4 In November 2009, the CAA commenced work with stakeholders to identify and assess alternative forms of regulation.
- I5 In March 2011, the CAA issued a stock-take on this work and narrowed down the options and identified a number of potential

improvements to the regulatory design within, and beyond, a standard RAB-based framework. The CAA consulted on the merits of these options in its July 2011 setting the scene document.

- 16 In the May 2012 Q6 policy update, the CAA consulted on a further narrowed down set of potential options.
- 17 In the April 2013 Q6 initial proposals the CAA concluded that “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 were addressed through enforcement under the licence; and that the commitments were amended to address the other concerns ..., so that they are reasonable and effective. In the absence of a satisfactory proposal for commitments, and due to the concerns raised around the other potential options, the CAA considers that it would be most appropriate to base its initial proposals on a RAB-based framework.”
- 18 In the October 2013 Q6 final proposals, the CAA concluded that, on balance, it considered that commitments within a limited licensing framework and effective monitoring would better further passengers’ interests and, where appropriate, promote competition. In the case of GAL, commitments offered a number of benefits over a RAB-based framework from the additional flexibility and greater potential for bilateral contracts which could allow better tailoring of airport operation services by GAL to the needs of individual airlines and their passengers. That would not only enhance choice and value to passengers, but would also facilitate airport competition at the margin. The commitments would also provide other benefits above a RAB-based framework from:
- the greater certainty to airlines and their passengers as they are for seven rather than five years and would lock-in the benefits of lower charges in years 6 and 7;
 - the strengthening of the airline and airport operator commercial relationship as the commitments are given to airlines rather than the CAA; and
 - avoiding some of the direct costs and distortions to incentives that would be present under a RAB-based framework.

- I9 A supporting licence and monitoring regime would ensure that GAL would comply with the commitments in a manner that furthered passengers' interests. The licence and monitoring regime allowed the CAA to enforce the commitments so that the additional flexibilities in the commitments were furthering passengers' interests and not just the operator's or airlines' interests.
- I10 The CAA considered that the commitments, licensing and monitoring regime would be consistent with the better regulation principle that regulation should be proportionate and targeted only in cases where action was required. It would mean that the CAA could step in to increase regulation if GAL could not develop the positive relationships with airlines that would be important for an effective regime. On this basis, the CAA's final proposals recommended commitments within a licensing and monitoring framework.

CAA's proposed licence

- I11 The CAA considered the issues around the form of regulation structured into the following areas:
- the evaluation criteria;
 - the assessment of the commitments and the benefits of licence regulation, in particular around the enforcement of the commitments, the comparison of the fair price and the commitments price and other terms in the commitments; and
 - the assessments of other forms of regulation.
- I12 The following sections set out the CAA's consideration of these issues, particularly around the commitments and the fair price. Where new issues have not arisen, the CAA has not repeated its assessment and its assessment which was as set out in the final proposals.

Evaluation criteria

- I13 The CAA continued to consider that it had addressed GAL's concerns on the evaluation criteria. In summary, the CAA considered that the evaluation should be based on its statutory duties and should take account of stakeholder confidence. The CAA agreed with GAL that price protection should focus on passengers and that reductions in

price to airlines would, to some extent, be passed onto passengers. However, the CAA did not accept GAL's arguments that it had placed too little weight on the promotion of competition as:

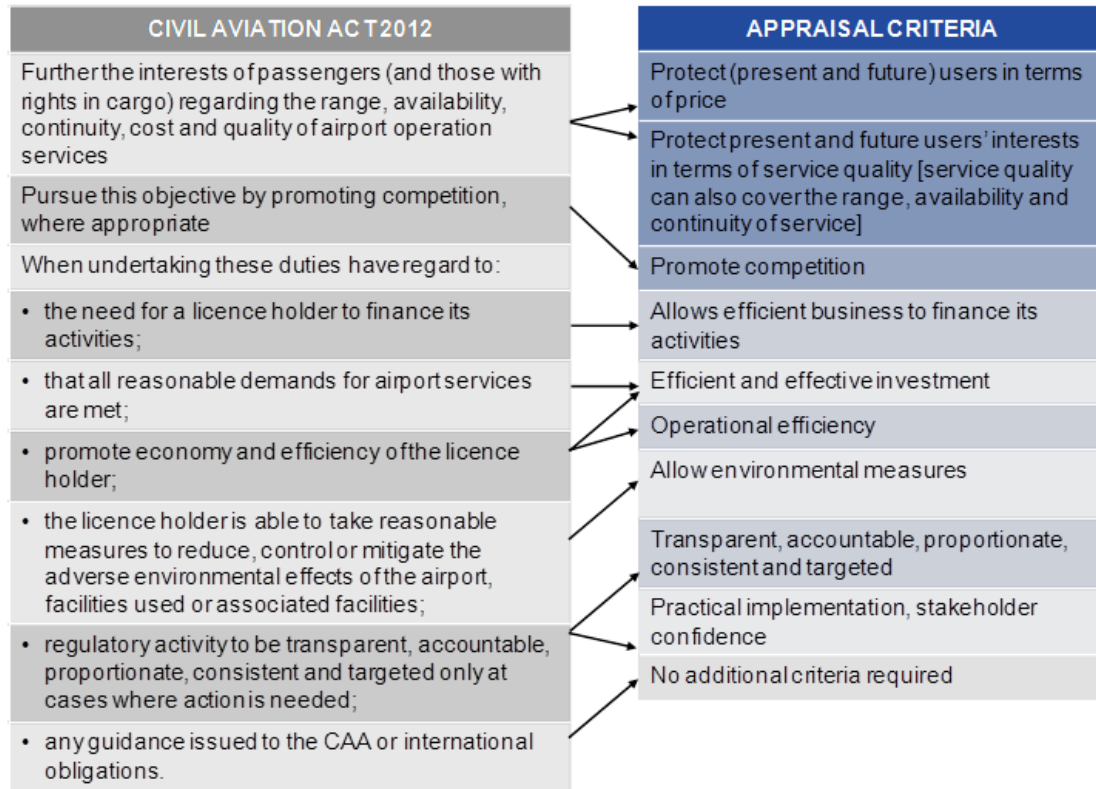
- the CAA had included the promotion of competition as one of the key criteria in its evaluation framework;
- the duty to promote competition includes the term "where appropriate" and so is subsidiary to furthering passengers' interests;
- when evaluating passengers' interests the CAA had placed greatest weight on the cost of airport operation services as this is where the risk of abuse of SMP was greatest;
- when evaluating the benefits to different groups of passengers the CAA had sought the outcome that provided the greatest overall benefit;
- while GAL stated that the CAA should take account of increasing competition, the CAA had been conscious of the need to prevent the risk of abuse of SMP, while promoting competition where it was appropriate to do so, and noted that additional capacity at Gatwick over the next control period is unlikely to alleviate the severe capacity constraints at Heathrow and to a lesser extent Gatwick;
- while the CAA accepted that bilateral agreements were less likely under RAB-based regulation, they were not prevented and the CAA did not accept that its regulatory process had frustrated the agreement of bilateral contracts or GAL's ability to attract and retain new customers;
- the CAA did not accept GAL's argument that the CAA's proposals had held it back from the delivery of its vision of the airport and considered that regulation needed to provide adequate protection against the risk of abuse of SMP, which could lead to too little investment; and
- RAB-based regulation had not prevented some service innovations, such as self service check-in.

I14 The CAA's reasons are set out in more detail in paragraphs 10.13 and 10.19 to 10.47 of the final proposals.

- I15 In addition, Section 1 of the Act requires the CAA to have regard to the regulatory objectives and principles whenever it carries out its functions in Chapter 1 of the Act and when it complies with its general duty to further users' interests and promote competition.¹⁵¹ Those functions include the decision to grant a licence, the assessment of alternative forms of regulation and determination of the content and effect of any licence conditions imposed. In carrying out its functions, the CAA must have regard to the principle of its regulatory activities being transparent, accountable, proportionate and consistent as well as targeted where necessary. Those requirements apply just as much to process as they do to the substance of the form of regulation and the regulatory outcome. The CAA had not confined itself to procedural compliance but has had regard to those regulatory objectives and principles in determining the most appropriate and proportionate form of regulation for GAL.
- I16 On stakeholder confidence, the CAA considered it was difficult for the CAA to be accountable and consistent if its regulatory activities, substantive decision making and procedures did not instil stakeholder confidence. Furthering passengers' interests required both airlines and the airport operator to put effort into optimal operations. So the conflict and distraction in constant stakeholder arguments via formal regulatory processes is an indicator that passenger outcomes are likely to be neglected. In addition, the CAA did not consider that numerous complaints under the ACRs, AGRs or competition law would provide adequate protection to users and would not be consistent with accountable and consistent regulatory activities. The CAA reviewed its other evaluation criteria and its assessment, and for the reasons set out above, continued to consider it appropriate. The CAA's evaluation criteria were therefore unchanged from the final proposals and are set out in figure I.1.

¹⁵¹ Sections 1(3)(g) and (4) of the Act.

Figure I.1: Appraisal criteria for assessing regulatory design



Source: CAA

CAA assessment of GAL's commitments proposals in the absence of a licence

GAL's revised commitments proposals

117 The CAA continues to consider that GAL's airport commitments are a positive step. The commitments could potentially provide a number of safeguards for airlines and passengers against the potential risk of abuse of SMP. The key features of GAL's revised commitments proposals submitted on 5 December 2013 are set out in figure I.2. GAL considered that these revised December 2013 commitments proposals have sought to address previous concerns expressed by the airlines and the CAA regarding second runway costs, premium services, the security cost pass through and consultation with the PAG.

Figure I.2: GAL's revised December 2013 commitments proposals

Issue	Commitments proposal
Contractual basis	GAL commits to include the commitments in the COU
Duration	7 years, with GAL providing 2 years' notice of its intention with regards the continuation of the commitments
Change mechanism	Ability to change price path profile and service quality scheme following consultation and if agreed by GAL and airlines carrying at least 67% of passengers (and paying by reference to published charges) and 51% of airlines responding to the consultation
Price	No price cap but the average revenue yield limited to RPI+1.0% per year based on published charges and RPI+0% per year based on average charges over the duration of the commitments, with a limit on over or under recovery in any one year. Variations to price cap to pass through changes in security costs (either way) and the costs of the second runway and hold baggage screening
Capital Consultation	Publish rolling five yearly capital plan, consult on major projects and report on annual expenditure. Consultation with airlines and the PAG
Service quality regime	Similar rebate scheme as Q5, with introduction of new outbound baggage measure and reweighting of attributes (both agreed with airlines). Monthly rebates the same as Q5 and would be increased by 25% if service quality failures persist for more than six months (although no rebates if there are more than six failures in a financial year). Airline service quality penalties on check-in and arrivals bag performance, which would be funded by netting off airport rebates. There is no bonus for outperformance. Rebates on passenger-facing measures are capped at 2.85% of charges.
Investment	Minimum capex spend of £100m and explain material differences between the latest forecast, the prior year forecast and the forecast included in the CAA's price review
Operational resilience	Develop, maintain and consult on an operational resilience plan and so far as reasonable and practical coordinate and cooperate with all relevant parties to deliver the operational resilience plan
Financial resilience	Provide an annual confirmation of adequate financial resilience, prepare and maintain a CSP, and not to amend, vary or supplement any of its finance documents in respect of credit rating requirements unless it has given prior written notice to the CAA
Accounts	Publish same information as in the 2011/12 statutory accounts

Approach to the assessment

- I18 The CAA considered that GAL's commitments could, in principle, be taken into account within the statutory framework as evidence to support a conclusion that it was not appropriate to introduce licence regulation. For this to be the case, the regime created by the commitments would need to be suitable and effective for passengers, so that the benefits of licence regulation would be outweighed by the adverse effects.
- I19 The CAA stated that its assessment of the commitments in the absence of a licence was set out in detail in Appendix J of the MPD in relation to Gatwick.
- I20 In response to GAL's concern that its commitments placed it in a similar position to STAL, the CAA noted that at Stansted bilateral agreements had been freely agreed between the airport operator and airlines. The CAA understood that at Gatwick the terms of bilateral contracts have been agreed or are in late stage negotiations with airlines representing 56% of passengers; Norwegian, Emirates, Thomson, ~~✕~~ and ~~✕~~.¹⁵² However the bilateral contracts that have been agreed or are currently in discussion appeared to be a function of the commitments and the CAA's final proposals rather than being pursued in their own right.
- Under the commitments framework, if GAL did not agree bilateral contracts then the published yield would be the same as the average yield. Consequently, GAL would have an incentive to agree bilateral contracts as this was more likely to deliver traffic growth and higher overall revenues. Airlines would also have an incentive to agree bilateral contracts as GAL only needs some airlines to agree bilateral contracts, with other airlines paying the higher published tariff.
 - GAL appeared to have actively pursued bilateral contracts only since the CAA published its final proposals which supported a commitments framework. The CAA noted that GAL indicated at the start of 2011 that it wanted to agree bilateral contracts in that year. The CAA subsequently structured its process so as to allow time for these negotiations to take place. Over two years elapsed and no

¹⁵² CAA statistics, 2012, ~~✕~~

bilateral contracts were concluded which contrasted with the rapid progress that Manchester Airports Group had made in reaching agreement with easyJet and Ryanair at Stansted since it acquired STAL in February 2013. GAL stated that progress in agreeing long term contracts was made after the CAA published its final proposals and airlines became substantially more engaged. Airline responses have indicated that it is only since the publication of the CAA's final proposals that GAL has actively pursued bilateral contracts. Regardless of whether GAL or airlines became more involved in bilateral contract discussions after the CAA published its final proposals for licence-backed commitments, this indicated that the discussions were strongly linked to the CAA's final proposals.

- The bilateral contracts were conditional on the CAA's acceptance of the commitments. If the CAA's final proposals for a commitments and licensing approach changed, or if the price in the commitments changed, then the bilateral agreements would not stand.
- A number of terms in the bilateral contracts were explicitly linked to the commitments, both in terms of price and service offering (for example in relation to airport charges, charges for ancillary services, airport service quality standards etc).

I21 The commitments themselves were GAL's proposals rather than being agreed by the airlines or the CAA. Importantly there was some airline opposition to the commitments as they did not accept that they went far enough. Consequently the CAA considered that it was important to review the enforceability and the substantive terms of the commitments to identify whether they were likely to displace the benefits of licence regulation with the effect that the potential adverse effects of licence regulation were no longer justified.

Potential benefits of the commitments

I22 In the final proposals the CAA considered that the commitments were more likely than a RAB-based price control to lead to bilateral contracts which would facilitate growth and increase choice and value for users. The commitments would also provide additional flexibility which would allow greater tailoring of airport operation services by GAL to the particular needs of individual airlines and their passengers.

I23 GAL proposed that commitments might be combined with bilateral contracts for some individual airlines. GAL considered that the

conclusion of bilateral contracts will be more likely with the airport operator's commitments in place than under a traditional price cap as the commitment is longer term (7 years compared to a traditional 5-year price cap).

I24 The CAA considered BA's point that a RAB-based framework could be extended for a period of more than five years. The CAA acknowledged that the Act provided the CAA with the potential to either shorten or lengthen the duration of the price control and it raised this issue in earlier consultations. In the Q6 policy update the CAA noted that most regulators tended to adopt a standard 4 or 5-year duration for price controls, although there were variations. In the case of energy network regulation, Ofgem recently decided to consider durations of up to eight years for a RAB-based control to encourage greater investment certainty where there are significant infrastructure investment requirements. Equally, where the price control is seen as a transitional safeguard pending competition being sufficiently effective to protect consumers, the duration of the price control might be shorter as was the case with retail energy price controls and retail telecommunications price controls. The CAA noted that Ofgem's approach allows a review of key parameters after four years and so may not lead to price certainty over the entire period. The CAA also noted that:

- the investment requirements for GAL were lower than in the previous control period;
- no airlines have actively supported a longer duration RAB approach for GAL, for example in response to the CAA's initial proposals, which used a 5-year RAB-based control; and
- all previous price controls were for a period of five years.

I25 The CAA therefore considered a 5-year RAB-based assessment as the most likely counterfactual.

I26 The CAA considered that bilateral contracts were not ruled out under a RAB-based approach, and the CAA notes that GAL itself has provided discounts for new long-haul routes under the existing RAB approach. However the CAA continued to consider that bilateral contracts were more likely under commitments than under a RAB-based framework, as the commitments would:

- include a specific average price cap relating to the blended price, which is below the average published price cap, thereby providing a financial incentive to both GAL and airlines to enter into bilateral contracts;
- reduce the risk for GAL and the airlines concerned that the terms offered in a typical 10-year bilateral might not be consistent with regulation over more than one control period;
- provide a longer period for an early sacrifice of margin to be compensated later; and
- enable a more flexible capital plan which would support differentiated services under bilateral contracts.

I27 The CAA noted that the bilateral contracts that have been agreed or are being discussed appeared to be a function of regulation as well as the commitments themselves.

I28 The CAA considered that bilateral contracts were likely to enable price/volume deals which would facilitate growth, increasing choice and value for passengers. Airlines and passengers at Gatwick are more diverse than at other airports where the operator is subject to economic regulation. It is therefore unlikely that one size would fit all and the commitments may provide benefits over a licence in the form of additional flexibility which would allow better tailoring to the needs of individual airlines and their passengers.

I29 A combination of airport commitments and bilateral contracts could therefore better further the interests of passengers as it could be tailored more to the business needs of individual airlines and their passengers, providing greater flexibility while still providing protection to all passengers. There could also be advantages from a reduction in complexity and a refocus of relationships towards airlines and away from the CAA.

I30 The commitments would also provide **more certainty** to airlines and GAL as the commitments would last for seven rather than five years, providing GAL with **greater incentives to outperform** assumptions on commercial revenues and efficiency and to grow traffic.

I31 The CAA continued to consider that the additional flexibilities under the commitments may help to promote competition in airport operation

services, due for example to the increased potential for bilateral contracts, although the CAA acknowledged that GAL has SMP and any competition was likely to be limited in scope.

I32 The CAA considered that the commitments would have benefits over a licence, in that they would avoid the **direct costs** of staff and consultancy associated with a regulatory review. GAL estimated that its costs associated with RAB-based regulation are currently around £8 million per year (excluding CAA costs), although the CAA considered that these costs were overstated.¹⁵³ The CAA considered that there could be cost savings from a commitments approach and while it acknowledged that the burden of enforcement of the commitments would rest with airlines rather than the CAA, it considered that this would be more in line with normal commercial practice where bilateral contracts are enforced by the parties. Consequently if the commitments were operating effectively the incremental burden on airlines should be small compared to a normal commercial environment. However potential cost savings from commitments would be significantly reduced if there was not effective partnership working between the airport operator and airlines, and for example there were numerous complaints to the CAA under competition law, the ACRs or the AGRs. The CAA acknowledged that airline feedback on the commitments has been mixed.

I33 The commitments would also have benefits in terms of: **avoiding management distraction**, as the enforcement of the commitments would be linked to commercial negotiations; and removing **some perverse incentives** that may occur under a regulatory regime, for example potential distortions to capex incentives under a RAB-based framework (which could lead to capex being taken forward that is not in passengers' interests), or the potential for regulatory gaming (although the CAA notes that a bid and counter-bid approach is present in normal commercial negotiations and has been reflected in the improvement of the commitments offer over time).

Enforcement of the commitments

I34 The CAA continued to have concerns over the enforceability of the commitments in the absence of a licence.

¹⁵³ See Appendix J of the MPD in relation to Gatwick.

- I35 The commitments are with, and **enforced by, airlines**. Passengers are not privy to those contractual arrangements and have no contractual rights as third parties. Without a licence, the CAA would have no right to enforce the commitments on their behalf. It could not be assumed that airlines would challenge GAL for altruistic motives. While airlines' interests may generally be aligned with those of passengers, this may not always be the case.¹⁵⁴ GAL's position that the CAA's concerns over enforceability were theoretical rather than practical as airlines' and passengers' interests aligned and GAL would be incentivised to meet the interests of airlines as it was competing was an over-simplification of the issues which may vary from airline to airline and from issue to issue. It cannot be assumed that airlines will necessarily stand in the same position as passengers nor that GAL will address divergent interests over range, price and quality of services in one step.
- I36 In addition, an airport operator with SMP would not be subject to the same incentives to satisfy passengers' interests as an airport operator in a competitive situation. The CAA considered that the commitment to consult with the PAG on the capital plan did not offer appropriate protection to passengers as passengers' interests will be affected by much more than the level of capital investment. Consequently the CAA did not consider that the commitments would offer the same level of protection to passengers compared to a licence enforceable by the CAA, which has a statutory duty to protect their interests.
- I37 The commitments did not provide **adequate protection against repeated service quality failures**. The commitments included a requirement to increase service quality rebates by 25% if failures continue for more than six months and to develop an improvement plan. The CAA continued to have concerns in this area, for example as the increased rebates would only apply if failures are spread across two financial years and that rebates reduce to zero if there are six consecutive months' of failure in one financial year. The CAA also noted that the user detriment could be many times the rebate paid. This did not appear to be in passengers' interests unless, as with Q5, there was a backstop of a CAA investigation if failures persist for more than six months.

¹⁵⁴ See, for example, paragraph 3.24 of Q6 policy update, CAA, May 2012. This document can be accessed at: <http://www.caa.co.uk/docs/5/Q6PolicyUpdate.pdf>

- I38 The commitments did not include **sufficient protection** in certain areas, for example in terms of the pass through of second runway costs and financial resilience, and if problems arose in these areas then significant consumer detriment could occur before issues could be rectified. The CAA did not consider that the fact that a specific policy has not been finalised on second runway costs negated the benefits of a licence and makes it disproportionate. Licence-backed commitments provided GAL with a number of flexibilities which can be used to create an appropriate and targeted approach to particular policies. While these flexibilities contributed towards the benefits of commitments they also created risks for passengers, providing a further reason for the backstop of licence regulation if these risks transpire.
- I39 The commitments were put forward by GAL following discussions with the CAA and airlines. If airlines did not agree with the terms in the commitments, then there was no mechanism (similar to that for licence conditions) for them to appeal the conditions in the commitments to the CMA, **removing important protections in the Act**. This could work against passengers' interests and be detrimental to passengers as it would make the process both more expensive and lengthy.
- I40 In the absence of a licence there were concerns over the **speed of regulatory intervention** which can only take place once abuse against passengers' interests has occurred. The commitments provided GAL with considerable flexibility, for example in terms of the capital plan. If GAL used this flexibility to abuse its market power then, in the absence of a licence, the CAA may need to undertake a full market power assessment to introduce potential controls in the form of a new licence (without a licence, the CAA would have no ability to amend the commitments directly). The whole process of introducing a licence was likely to take two years including appeals. A long period to reintroduce controls could allow abuse to go unchecked for some time with potentially significant user detriment.
- I41 In contrast, by incorporating the terms of the commitments within the statutory licensing framework, the CAA would have a range of **regulatory and enforcement measures**, for example by either enforcing the commitments as a condition of the licence itself or modifying and/or introducing new licence conditions as required

(subject to the safeguard of appeals). In appropriate cases, the CAA would be entitled to proceed with interim remedies or to impose penalties for breach. A licence was therefore likely to lead to a quicker, more efficient resolution of issues. Importantly, a breach of the licence-backed commitments could lead to a directly actionable right of damages for any person affected by the breach (including passengers and cargo owners as well as airlines).¹⁵⁵ Accordingly, there were real benefits from the licence framework in terms of enforcement and deterrence that were not provided by the contractual commitments on their own.

- I42 Based on the above the CAA did not consider that, in the absence of a licence, the commitments on their own offered sufficient protection in terms of enforceability to be able to operate in passengers' interests.

The comparison of the fair price with the commitments price

Approach

- I43 GAL's December 2013 commitments include a limit on the average revenue yield of RPI+1% on published charges and RPI+0% based on the blended yield of published charges and bilateral contracts. The CAA undertook a fair price calculation for both five and seven years, based on a single till RAB-based approach to compare with the price in GAL's commitments.

Time period for the assessment

- I44 The fair price is based on a single till RAB approach. For the reasons set out in paragraph I24 to I25 the CAA considered that a five yearly RAB was the most likely counterfactual.
- I45 Second, the CAA's calculations for a 5-year fair price were based on a detailed bottom-up assessment of individual building blocks. The 7-year fair price was developed for comparison with the commitments and took into account changes forecast by GAL in the two years following a traditional 5-year control (2019/20 and 2020/21). There were also some issues that might point to a higher 7-year price that were not included in the calculations, for example the impact of the greater traffic risk over seven years on the cost of capital. The 7-year

¹⁵⁵ Civil proceedings can be brought following a breach of a CAA enforcement order or urgent enforcement order.

price could therefore be regarded as less certain. The CAA therefore considered that it was relevant to take into account both comparisons, but to place the greatest weight on the 5-year price as this was the effective RAB alternative.

Comparison of the fair price with the blended price in the commitments

- I46 The CAA considered that the most appropriate comparison between the CAA's fair price and GAL's commitments should be between the fair price and the blended price under the commitments as:
- the fair price was calculated on the basis that this would be the average charge paid by airlines and their passengers;
 - the blended price was the average price under the commitments, which would be paid by airlines and ultimately their passengers.
- I47 The blended price under the commitments also took into account prices under bilateral contracts. Lower prices under bilateral contracts often result from volume/growth discounts. The CAA did not consider it appropriate to value the price paid to passengers that benefit from growth deals as being any lower than that paid by other passengers. The CAA also noted that if bilateral contracts were not agreed with airlines then the blended price would apply to all passengers.
- I48 The CAA acknowledged that bilateral contracts may have different terms than the commitments. While the CAA acknowledged that these terms could benefit passengers, for example through the provision of a more tailored service offering, or place constraints on airlines, the CAA did not consider it was possible to quantify these benefits beyond those reflected in the blended price and considered these benefits in the round.

Potential impact of the bilateral contracts agreed/being discussed

- I49 GAL provided details of the bilateral contracts that it had agreed or was in the process of discussing with airlines. Based on the agreed and discussed bilaterals, GAL was forecasting that it would obtain an average blended price between \times per year over the commitments period. \times . Bilateral contracts provide GAL with significant flexibility to vary the level of discounts by altering the structure of charges as in general the discounts to airport charges are on winter charges only. The CAA also noted that GAL did not need to agree all of the bilateral contracts currently being discussed, and the commitments only

required GAL to obtain a blended price of RPI+0% per year. The CAA did therefore not take account of any incremental reductions in price from bilateral contracts being discussed.

Capital expenditure assumptions under the commitments and licensing approach

I50 The CAA acknowledged BA's concern that the commitments only included a minimum capex spend of £100 million per year, compared to around £160 million per year in the fair price calculation. While the commitments capex was a minimum and GAL could spend more, without a licence there was no guarantee that this would take place. Under a licence the CAA would monitor GAL's capex and if GAL was not undertaking capex which would be in passengers' interests then it could undertake enforcement action or introduce new licence obligations. A capex difference of around £60 million per year would reduce the fair price by 2% per year over five years.

The impact of differential terms in the commitments

I51 The CAA acknowledged that the commitments included different terms, for example on the treatment of second runway costs, than those that would apply under a licensing approach, which could impact on the overall price paid by airlines and their passengers. The CAA's consideration of the impact of these terms is set in the following section which examines the terms in the commitments.

The basis of the commitments price

I52 The CAA accepted that the commitments price was calculated on a different basis to the RAB-based fair price as it included selected ancillary services (staff ID, airside licences, FEGP, airside parking and hydrant refuelling). These ancillary services increased the base net yield in the commitments by 1% (core service charges are £8.80 per passenger and selected ancillary service charges are £0.094 per passenger). In the absence of the commitments, airlines would still be required to pay for selected ancillary services, although this would be outside the fair price cap. On this basis the CAA did not consider that the inclusion of selected ancillary services in the commitments average yield cap materially affected the comparison with the RAB-based fair price.

Comparing the 7-year commitments price with the 5-year fair price

I53 The CAA compared the 7-year blended price in the commitments with the 5-year fair price. The CAA considered that there were some issues that pointed towards accepting a commitments price that was below the fair price:

- the greater flexibility to GAL in pricing where it could recoup any previous shortfalls over the 7-year period, although the resulting increase in uncertainty to airlines was likely to be relatively small compared to the flexibility GAL has to set its structure of charges within the current price cap; and
- the greater flexibility to GAL from being able to flex its capital plan rather than having to deliver projects to meet specific trigger dates.

I54 There were also some issues that pointed towards accepting a commitments price that was above the fair price.

- The longer time period (seven years as opposed to a 5-year control period) provided a greater period of certainty to airlines and consequently greater risks to GAL. While GAL would benefit from the greater incentive to outperform from a 7-year control period, it would also bear increased risks from the longer time period, in particular around traffic growth. The CAA had not taken account of the greater risks to GAL in for example the cost of capital in its 7-year fair price calculation. The potential for GAL to demand additional payments is considered in the section on other price benefits of a licence.
- The commitments would lock in the forecast reductions in prices in the subsequent control period. In GAL's RBP its RAB-based price for Q6, the next 5-year control period was RPI+6.9% per year with falling real prices for the following control period. By extending the Q6 control period for seven years this locked in the assumed lower increase in prices for the following control period, which often have a tendency of not transpiring, with new cost pressures emerging so the actual price ends up higher, for example due to the emergence of new risks and/or obligations.

incurred. Given the potential scale of costs, which GAL estimated at £5 billion to £9 billion, there was no mechanism for users to secure adequate protection in terms of value for money from the cost of this development.

- I60 The commitments did not include a commitment to any outputs from the **capital plan** apart from maintenance of the service quality regime and a commitment to a minimum spend of £100 million per year over the term of the commitments. GAL's proposed spend under a RAB-based framework was around £200 million per year and many of the schemes produce outputs that were not reflected in the service quality scheme, for example the early bag store would provide the ability for early check-in; the IDL schemes would provide increased circulation space and new children's and outside areas; the check-in schemes will provide new bag drop facilities; the NT arrival scheme provided a much enhanced arrival area etc. While GAL committed to provide an explanation as to any material differences between the latest CIP forecast and both the prior year forecast and the forecast incorporated in the CAA's 2013 price control review, it had not committed to any programme of specific capex. The CAA was therefore concerned that GAL could significantly reduce capex and not deliver the outputs that the CAA considered were in passengers' interests.
- I61 The **service quality scheme** in the commitments included monthly rebates at the same level as those included in the Q5 settlement. The CAA was concerned that if failures continued for more than six months in a financial year, the absence of rebates might reduce GAL's liability for repeated service quality failures, which may act against passengers' interests.
- I62 The status of **pier service standards** in the commitments was unclear. The CAA understood that GAL and the airlines had not been able to agree pier service standards and this raised the risk that GAL could impose pier service levels that were opposed by the airlines and inconsistent with the funding provided.
- I63 GAL stated the service quality measurement and exclusions process remained the same as in Q5 and the subsequent joint letter from GAL/ACC on 7 August 2013, unless GAL and the ACC subsequently agree to changes. This addressed earlier CAA concerns in this area although the CAA noted that there appeared to be a lack of precision in the latest version that could lead to disputes.

- I64 The service quality regime included **airline service quality penalties** on check-in queues and arrivals bag performance. The CAA supported coordination on service standards across the airport campus where this did not distort the functioning of an effective market.
- I65 The CAA continued to have concerns about the **financial resilience** conditions in the commitments.
- The commitments included a requirement to notify the CAA of any variations in the banking ring fence that related to the credit rating requirement. However if the protection in the banking ring fence changed, in the absence of a licence, there would be nothing the CAA could do to replace that protection. This commitment therefore would only be effective if the commitments were underpinned by a licence.
 - The commitments included a requirement for the directors to provide an annual certificate of adequate financial resources. There was no indication in the heads of terms or the COU of the time period to be covered, although GAL's response stated that this could be 12 months or possibly as much as 18 months. The CAA considered that the certificate should cover a period of at least two years otherwise there would a risk that there would be insufficient time for remedial action to be taken if issues arose.
 - The commitments did not include a requirement to obtain a holding company undertaking. GAL questioned the benefit of a holding company undertaking given the ownership structure of GAL. The CAA considered that a holding company undertaking was required to prevent the airport operator from being open to pressure by a holding company to do something which was not consistent with passengers' interests. The CAA did not consider that GAL's current ownership, which could change during Q6, negates the need for this requirement.
- I66 The commitments did not include a restriction on business activities as GAL stated that the finance documents include a similar restriction. The CAA was concerned that the finance documents could change, and in the absence of licence protection, remove the protections to passengers.

- I67 The commitments included a requirement to publish the value of the **asset base** and the underlying assumptions and calculations. GAL had stated that, although it did not consider it necessary for GAL to prepare a shadow RAB, GAL would maintain such a calculation for the benefit of the CAA as part of its ongoing monitoring regime, up to the review scheduled for late 2016. This provision did not appear in the COU. The CAA continued to consider that a shadow RAB calculation was required throughout the period should any subsequent re-regulation be required.
- I68 The commitments included **operational resilience** conditions. However these included a requirement to have regard to, rather than comply with, any guidance issued by the CAA when developing operational resilience plans. The CAA considered that this could allow GAL to develop operational resilience plans that were not in passengers' interests.
- I69 The CAA did not consider the commitments raised issues in other areas identified by the airlines.
- **Definitions of key price/revenue terms.** The CAA considered that the change in the definition of core service charges addressed the principal concerns of the airlines around premium services.
 - A failure to protect **selected ancillary charges** from the annual price increase cap. Under the commitments selected ancillary service charges would be subject to fair, reasonable and non-discriminatory provisions and so would not necessarily increase in line with the average price cap in the commitments.
 - The airlines stated that changes in security requirements should only be passed through if **security costs** are higher than the 2013/14 base year. The CAA did not consider that this is correct. GAL's security costs will vary year by year, in particular as a result of changes in the level of efficiency. These costs would also vary up or down with changes in security requirements. The security cost pass through allowed security requirement cost increases and decreases to be passed subject to a deadband. The CAA considered that this was the correct approach and was consistent with the approach used for HAL's price control. If only cost increases above the base year were passed through then GAL would be exposed to the risk that it would lose some of the

efficiency gains that it had made since the base as these would be used to offset the increased cost of security requirements.

- **Service quality requirements under bilateral contracts.** The CAA considered that the commitments provided backstop protection to all airlines on price and service quality. It was up to airlines if they wanted to agree a service quality scheme within a bilateral contract and it was not for the CAA to dictate whether they should do so.
- The CAA considered that the **threshold for airline support** at 67% for making changes to the price and service quality schemes was sufficient to prevent a single airline or two airlines being able to push through changes to the regime that would not be in the interests of passengers in general. The CAA considered that the modification provision should therefore not act against passengers' interests.
- The airlines remained the **insurer of last resort**. GAL had removed the indemnity from the December 2013 commitments. The CAA noted that the waiver and operator liability arrangements remained, although these were part of the COU rather than the commitments themselves.

Overall assessment of the commitments

- 170 When undertaking the assessment the CAA had considered airlines' concerns on the assessment of the commitments. While the CAA considered that GAL had addressed airlines' concerns on the treatment of premium service charges in the revised December 2013 commitments, the CAA had concerns about whether the price in those commitments or the treatment of second runway costs would operate in the interests of passengers. The CAA considered that in the absence of a licence, there was no guarantee that investments that do not directly impact on outputs covered in the service quality scheme or that do not generate net financial revenues would be taken forwards. The CAA also acknowledged the ACC's concerns over whether the commitments in themselves would lead to efficient and effective investment given the lack of output commitments provided by GAL.
- 171 The CAA acknowledged that the commitments initially failed to inspire stakeholders with confidence although it noted that GAL has made a number of improvements to the commitments to address earlier

concerns voiced by the airlines and the CAA. The CAA also noted that a number of airlines had been having bilateral discussions with GAL under the framework of commitments (albeit on the assumption it was backed by a licence). However, if there was a concern with the commitments from passengers' perspectives, the CAA acknowledged that it would not be able to alter the terms of the commitments as these were GAL's commitments to airlines.

- 172 The CAA considered that commitments could, if they provided adequate protection, be capable of being more proportionate than RAB-based regulation. The better regulation principles required regulation to be targeted only at cases where action is required. The CAA also saw benefits from commitments as they would strengthen the airline and airport operator relationship and would better reflect a normal commercial environment where airlines would protect their own interests. However the CAA had concerns over the enforceability of the commitments in the absence of a mechanism allowing the CAA to enforce the commitments in passengers' interests.
- 173 Overall the CAA welcomed GAL's commitment proposals. However, despite a number of improvements made by GAL, the CAA continued to consider that in the absence of a licence the enforcement and the terms of the commitments would not provide sufficient protection to be in passengers' interests. Consequently the CAA considered that the benefits of licence regulation were likely to outweigh the adverse effects. The CAA set out full details of its assessment of commitments in the absence of a licence in Test C of the MPT in relation to GAL.

Figure I.3: Appraisal of GAL's proposed commitments

Criteria	Assessment
Price protection	The price in the commitments is above what the CAA considers to be a fair price, and while bilateral contracts might deliver a lower price there is no guarantee that this will be the case.
Service quality protection	The commitments include much the same of the SQR scheme as used for Q5. In the absence of a licence the commitments do not provide adequate protection against repeated service quality failure.
Promote competition	The commitments could avoid distortions to competition, for example if a price cap is set too low then this could distort charges and investment at other airports and bilateral contracts could be more likely under commitments, although they are not ruled out under licence regulation. However as GAL has SMP any competition in airport operation services is likely to be limited in scope.
Allows efficient business to finance its activities	GAL is unlikely to propose commitments that would not allow it to finance its activities.
Efficient and effective investment	Investment would be driven by the service quality scheme and GAL's vision for the airport. Commitments would avoid some of the perverse incentives from RAB-based regulation particularly around investment incentives. Consultation arrangements are similar to those in Q5. However there is no guarantee that investments that do not directly impact on outputs covered in the SQR scheme would be taken forwards.
Operational efficiency	Potential benefits to efficiency incentives from the retention of benefits for longer (at least seven years compared to a typical 5-year RAB-based control).
Allows environmental measures	The commitments do not prevent the introduction of environmental measures.
Transparent, accountable, proportionate, consistent and targeted	The commitments would only be enforceable by airlines and so may not offer the adequate protection to passengers. There is no direct enforcement or intervention mechanism by the CAA. Commitments could provide substantial cost savings compared to licence regulation, although cost savings would be significantly reduced if there is not effective partnership working between the airport operator and airlines. Given the concerns over enforceability, the process for reintroducing a licence could take two years, allowing significant user detriment to occur during this time. The process of reintroducing price controls

Criteria	Assessment
	would be hampered as GAL has not committed to calculating a RAB throughout the commitments period.
Practical implementation and stakeholder confidence	The concerns over the enforceability of the commitments could make practical implementation difficult. Airline feedback on the commitments has been mixed and while some stakeholders have expressed support for commitments, most have raised concerns over the terms of the commitments. Nevertheless a number of airlines have been discussing and/or agreed bilateral contracts with GAL, and GAL appear to have addressed some of the more significant stakeholder concerns with the commitments.

Source: CAA analysis

Commitments backed by a licence framework

- 174 The CAA considered the points raised by GAL, which did not think a licence was required as it had improved the commitments and would introduce them in the absence of a licence. It also considered points raised by other stakeholders, who had concerns with the commitments and questioned whether a commitments based regime would reduce costs, target regulation or promote competition. Given the concerns the CAA had highlighted with the commitments, it continued to consider that there were good grounds for commitments to be backed up by a licence. The CAA considered that such a framework could provide clear benefits in terms of enforceability and speed of response. It could also allow the concerns highlighted with the terms in the commitments set out in paragraphs 157 to 169 to be addressed through a licensing and monitoring regime.
- 175 Under such a framework the CAA considered that as a minimum a licence should include:
- a condition that made the commitments a licence condition. This would enable the CAA to enforce the commitments within the statutory framework, including interim remedies, penalties for breach and an actionable right of damages for any person affected by the breach;
 - a condition that GAL shall comply with the commitments in a manner designed to further the interests of passengers. This would allow the CAA to enforce the commitments in passengers' interests; and

- a condition that prevented GAL from unilaterally varying the commitments and prevented modification outside the instances set out in the commitments as it was a requirement under the Act that the type and circumstances of licence condition self modification provisions were set out in the licence.
- I76 Given the ACC's concerns about the CAA's ability to amend the commitments, the CAA included a licence condition that required GAL to amend the commitments so that they were consistent with the provisions in the licence.
- I77 The CAA considered that with the above licence conditions, if the commitments-based approach was not working the CAA could, if the statutory tests were met, undertake urgent enforcement action to prevent passenger detriment while a full price control condition was introduced.
- I78 While the CAA considered that the above conditions would address a number of concerns associated with the enforceability of the commitments, they would not address concerns associated with the terms on offer in the commitments themselves. Under a licence there is the potential for the CAA to monitor GAL's performance, investigate any underperformance, enforce the commitments and introduce additional licence requirements if required. This could be used to address the CAA's (and the ACC's) concerns over the flexibility in the capex plan, service quality performance and the areas where GAL would only have regard to rather than follow CAA policy, for example on operational resilience. The CAA could also ask GAL to continue to calculate a RAB beyond the period specified in the commitments.
- I79 Given the scale of difference between the fair price and the commitments blended price of 1.6% per year and the scope for GAL to amend bilateral contracts that are yet to be agreed and for altering the level of discount through variations in the structure of charges, the CAA considered that its concerns over the price in the commitments would be best addressed through monitoring the price in the commitments to ensure that it reflected the CAA's view of the fair price. This would avoid cutting across existing bilateral contracts and would provide GAL with an added incentive to meet the needs of passengers and airlines so it could increase passenger growth, so allowing airlines to take advantage of discounts, reducing the delivered average price. If GAL did not reduce prices in line with the

fair price then the CAA considered that it could introduce licence conditions to cap price changes or prevent GAL from altering the structure of charges.

- I80 There were two areas where the CAA considered additional licence conditions were required given the scale of passenger detriment that could occur. Firstly on second runway costs, the CAA considered that the pass through of expenditure over a set minimum, even if it followed CAA guidance, should be subject to a licence amendment. This would allow the CAA to properly consider the appropriate costs to pass on to users and provide both GAL and airlines a right of appeal if they considered that the CAA had not treated the costs appropriately. The other area where the CAA considered additional licence protection was required was financial resilience, given the implications for passengers if problems arose in this area.
- I81 The CAA did not see a licence associated with commitments covering airline service quality performance, as the licence is for GAL rather than airlines, nor GAL's pricing principles, as this could fetter the CAA's discretion as the CAA is the appeal body under the ACRs and AGRs.
- I82 The CAA considered that licence-backed commitments would make use of the flexible and pragmatic forms of regulation intended by the Act. The CAA considered that such an approach would be more proportionate than RAB-based regulation as the airline enforcement would be more closely aligned with normal commercial negotiations and management distraction and perverse incentives would be reduced. The CAA considered that the main incremental cost of the monitoring regime would be to the CAA as much of the information required for monitoring would already be produced by GAL under the commitments. The main additional information required under the monitoring regime would be the shadow RAB calculation. Given that GAL had already committed to identifying changes to the asset base (and in its response committed to producing a shadow RAB calculation up to 2016) the CAA did not consider that this would impose significant additional costs. Over time, if the regime was successful the CAA considered that its costs could reduce as the required level of monitoring would reduce.
- I83 Based on the above analysis the CAA continued to consider that a framework of commitments backed by a licence could provide a

suitable form of regulation for GAL. Figure I.4 summarises the appraisal of a commitments and licensing framework for GAL.

Figure I.4: Appraisal of commitments and licensing framework for GAL

Criteria	Assessment
Price protection	By monitoring prices, with the potential to introduce additional licence conditions if GAL is not pricing in line with the fair price the CAA considers that this would provide adequate protection to passengers. The additional licence condition on the treatment of second runway costs would ensure that the pass through of these costs would be in line with passengers' interests.
Service quality protection	GAL's good recent track record, combined with service standards in the commitments, should ensure good continued service. The ability of the CAA to monitor service quality performance with the potential for introducing additional licence conditions if required should provide adequate protection to passengers.
Promote competition	The additional flexibility under the commitments approach should promote competition in airport operation services.
Allows efficient business to finance its activities	GAL is unlikely to propose commitments that would not allow it to finance its activities.
Efficient and effective investment	The ability of the CAA to monitor investment and introduce additional licence conditions if required should provide adequate protection to passengers.
Operational efficiency	Potential benefits to efficiency incentives from the retention of benefits for longer (at least seven years compared to a traditional 5-year RAB-based control).
Allows environmental measures	The commitments would not prevent the introduction of environmental measures.
Transparent, accountable, proportionate, consistent and targeted	Including licence conditions that allow the CAA to enforce the commitments prevents GAL from amending the commitments without good reason or withdrawing them and should ensure that GAL is held properly to account for its actions. These licence conditions are focused on areas of concern and so are proportionate. Even with the changes outlined above a commitments and licence framework should provide cost savings compared to other forms of licence regulation. Sharing information with airlines on costs and revenues, cumulative revenue difference calculations, the transparency of costs of

Criteria	Assessment
	specified activities and investment consultation should provide the necessary transparency.
Practical implementation and stakeholder confidence	Allowing licence enforcement of the commitments should overcome the concerns over practical implementation and increase stakeholder confidence, although some stakeholder concerns are likely to remain.

Source: CAA analysis

RAB-based regulation

- I84 The CAA had stated that throughout the Q6 process, where it applied a RAB-based approach in the future, it stated it would consider doing so flexibly, which would take advantage of the flexibilities under the Act, for example in terms of duration, capital incentives and the ability to respond to exceptional circumstances.
- I85 Many regulators use a RAB-based framework to set price caps. A RAB approach is widely used across regulatory sectors. The CAA considered that one of its main advantages was that it set prices equal to a measure of costs. Where other regulators have departed from a RAB approach, for example Ofcom, this was generally to facilitate competitive entry and the development of competition. As set out in the market power assessment, the CAA considered that there was limited scope for competition at Gatwick, in particular due to capacity constraints. Consequently the CAA did not consider that allowing prices to be significantly higher than determined through a RAB approach would have a significant impact on competition. Consequently the CAA did not consider that applying a RAB-based price control to GAL would be inconsistent with the approach used by other regulators.
- I86 The CAA considered that a RAB-based framework at Gatwick had advantages in that it was well understood by stakeholders, and supported by airlines (but not GAL). There was also less uncertainty on individual building blocks, in particular traffic, than there was at Stansted. Also unlike Stansted, the historic investment, and consequently the value of the RAB, did not appear to be out of line with the needs of the airlines and passengers that use Gatwick. A RAB-based approach could provide good protection to passengers

through a price cap, SQR scheme, efficiency incentives and capex triggers and consultation requirements.

- 187 The CAA acknowledged that there were drawbacks with a RAB-based approach. A RAB-based price cap can be costly and time consuming to calculate as it required the regulator to have a lot of information to overcome information asymmetries. It could distort investment incentives, either by encouraging too much investment (which would need to be addressed in the periodic review by the regulator) or by distorting investment decisions at airports that potentially compete with Gatwick. Neither of these problems appeared to be the case in practice for the current control period. A RAB-based approach could also introduce rigidities into the capital planning approach and from the SQR scheme. The CAA considered that, using the flexibilities in the Act it may be possible to overcome these, to a degree, through a more flexible RAB-based approach, for example using a core and development capex approach. The CAA acknowledged that under the Act it may be possible to extend the duration of a RAB-based price control, however for the reasons set out in paragraphs I24 to I25 it did not consider it was appropriate at this time. However for the reasons set out in paragraph I26 the CAA considered that bilateral contracts may be less likely under a RAB-based price control, although they would not be prevented.
- 188 The CAA considered that GAL had SMP and this would endure for Q6. Given the protections provided by a RAB-based approach, the CAA considered that such an approach could be an appropriate form of regulation for GAL, although it may not be the most appropriate approach.

Figure I.5: Appraisal of flexible RAB-based approach for GAL

Criteria	Assessment
Price protection	A RAB-based price cap can ensure that users only pay for efficiently incurred costs, and provides both users and the airport operator with certainty and stability. At Gatwick there is a reasonable level of certainty over key inputs, increasing the robustness of RAB-based calculations.
Service quality protection	Service quality requirements can be specified as part of a decision/licence although care is needed to ensure that they meet the needs of users. This provides a one size fits all approach, which may

Criteria	Assessment
	not be right for individual airlines or their customers. Nevertheless it secures a minimum level of service which can be effectively enforced.
Promote competition	Depending on how it is set, RAB regulation can distort investment incentives at both regulated and unregulated airports which can have an adverse impact on competition. This does not appear to be the case for GAL given the investment plans of GAL and airports which potentially compete with Gatwick. A RAB approach could discourage commercial agreements, although it does not prevent such agreements. In cases where the airport operator has SMP, by setting an appropriate price cap, a RAB-based approach can help to ensure that any commercial agreements are fair.
Allows efficient business to finance its activities	The regulated business would receive a preset return on current and future investment although it would be subject to some traffic risk.
Efficient and effective investment	A RAB approach can promote investment as the regulated business will earn a return on investment and lead to the promotion of investment over opex-based solutions. A more flexible RAB approach may improve incentives for the planning, delivery and efficiency of capex.
Operational efficiency	Some incentive to outperform regulated settlement due to the retention of gains during the regulatory period.
Allows environmental measures	A RAB-based framework would not prevent environmental measures from being introduced.
Transparent, accountable, proportionate, consistent and targeted	Setting of a price cap is transparent and consistent. The focus of regulation can be targeted on areas of harm, although a RAB approach can be complex, time consuming and introduce rigidities into processes. Nevertheless a RAB-based framework should provide some certainty and stability for stakeholders and is proven in other markets where operators have SMP.
Practical implementation and stakeholder confidence	A RAB-based framework is well understood by stakeholders and is used in relation to airports and across a number of other regulated sectors. A RAB approach has strong support from airlines although it is not supported by GAL.

Source: CAA analysis

Long-run incremental costs approach

- I89 The CAA stated that price caps based on a long-run incremental costs approach (LRIC) have been used by some UK sector regulators. LRIC can be calculated in a number of ways. Typically, these include:
- future incremental costs divided by future incremental demand over the asset life, which can involve a small increment, such as changes to make the maximum use of existing facilities, or a large increment such as a new terminal or runway; and
 - using the modern equivalent asset value (MEAV) or replacement cost of the existing assets. Ofcom has used current cost accounting for its review of mobile termination charges. This could also be seen as an amendment to a RAB-based approach.
- I90 A LRIC-based price cap can include many of the aspects that characterise the current RAB-based framework, such as a SQR scheme, although features such as capex triggers would not be included given the focus on future rather than current investment.
- I91 GAL stated that the CAA and its consultants Europe Economics (EE) had not addressed sufficiently GAL's previous concerns with the CAA's analysis. In the proposed licence document the CAA further reviewed EE's response and the assessment set out in the final proposals. The CAA considered that it had sufficiently addressed the points raised by GAL and noted that GAL has not been specific about which concerns it considered the CAA had not addressed. For the reasons set out below the CAA continued to consider that LRIC-based prices are not an appropriate basis for setting price controls for GAL.
- I92 The CAA considered that the main potential benefit of a LRIC approach was that, in principle, it could signal the long-term average price that might emerge from a 'competitive' market, in that it reflects the costs that a new entrant would have to incur to provide equivalent capacity.¹⁵⁷ Price protection for users was assured by setting a price cap based on LRIC and fixing it for a number of years.

¹⁵⁷ LRIC has tended to be used to set the cost standard for multiproduct firms to test potential abuse of SMP.

- I93 The CAA's consultants EE provided advice on the application of LRIC estimates to Gatwick and Stansted.¹⁵⁸ EE suggested that LRIC provides the best indication of the competitive price where it is based on the MEAV.¹⁵⁹ In addition EE suggested a LRIC approach may increase efficiency as the regulated company will only be reimbursed for efficient investment.
- I94 The CAA raised a number of concerns associated with using a LRIC approach to proxy the competitive price.
- As LRIC was a long-term forward-looking measure, there was a risk of over- and under-recovery in a particular period. This meant LRIC may not be well-suited as a benchmark to indicate whether a particular price was proximate to the competitive price at any given time. Charging a flat LRIC price over time also raised similar issues as any other 'smoothing' effect, which was that existing passengers may resist being asked to pay for future improvements where they may not benefit.
 - A LRIC approach was data intensive and required regulatory judgement to define the increment (although this might be less for a replacement cost approach). This could lead to significant uncertainty over future price profiles and it may be possible to generate large price increases or decreases depending on the assumptions used, limiting the protection to users and introducing variability owing to regulatory judgements.
 - It has been argued that it was not an effective proxy for competitive airport prices where investments are very lumpy.¹⁶⁰ The CAA continued to consider that when setting prices it was important to take account of the effects of the capital-intensive nature of airports and of the 'lumpiness' of capacity increments.¹⁶¹

¹⁵⁸ Europe Economics, December 2012, *Advice on the application of long run incremental cost estimates for Gatwick and Stansted*, <http://www.caa.co.uk/docs/1350/Europe%20Economics,%20Advice%20on%20the%20application%20of%20long%20run%20incremental%20cost%20estimates%20for%20Gatwick%20and%20Stansted%20-%20nonconfidential%20version.pdf>

¹⁵⁹ Although this to some extent depends on how demand relates to available capacity.

¹⁶⁰ CAA, Review of price regulation at Heathrow, Gatwick and Stansted airports, (Q6) Policy update, May 2012.

¹⁶¹ In principle, short-run prices in a well-functioning airport market would be expected to

- I95 EE identified a number of drawbacks from using a LRIC approach for GAL which included the following issues.
- Difficulties in determining the appropriate increment to use. As noted above, EE considered that the most credible increment would be the replacement of an airport (rather than, for example, a small amount of incremental capex or a new runway).
 - Greater uncertainty (and loss of accuracy) due to the need to make a judgement as to the efficient levels and types of investment required rather than using historical values that were spent.
 - The potential for greater uncertainty of remuneration of investment. As charges are not related to historical investment costs, then this increases uncertainty to the regulated company over the remuneration of investment, particularly if the current configuration of the airport is not ideal.
 - Greater potential for volatility, for example if input prices or technology changes.
- I96 EE's analysis identified that any model that is used to estimate LRIC would be sensitive to the inputs and the assumptions that underpin it. In particular, EE's sensitivity analysis indicated that changes to the inputs and assumptions could lead to quite significant changes in a LRIC estimate. More fundamentally, the relevance of a LRIC-based price, given the level of government involvement in planning of airport capacity particularly in the south east of England is substantially reduced.¹⁶²
- I97 With respect to GAL's specific concerns with EE's methodology, the final proposals examined these issues.¹⁶³

fluctuate around a long-term average, depending on the level of spare capacity available in the market: when capacity tightens, prices could be expected to increase with the resulting high prices triggering the development of new capacity by competing airports and subsequent fall in prices. Under such circumstances, pricing above the competitive price for a period of time might be considered a normal feature of a well functioning market.

¹⁶² EE, 'Advice on the application of long run incremental cost estimates for Gatwick and Stansted'.

¹⁶³ EE, 'Advice on the application of long run incremental cost estimates for Gatwick and Stansted; Response to comments by Gatwick Airport Limited, pages 1 to 18'.

- The dismissal of increment 2 was based on a concern about the relationship between the incremental cost of additional capacity and assessing the competitive price level for an airport as a whole.¹⁶⁴
- EE's approach did not include quality uplift as part of any new build as a hypothetical entrant would offer exactly the same experience as the exiting airport and its inclusion would not be appropriate.
- EE's LRIC calculations were based on a 'brownfield site', which assumes that the land is already set up for an airport, including all planning permission, land acquisition and connection utilities – an approach consistent with the approach adopted by GAL's consultant (FTI Consulting LLP (FTI)).
- The costs associated with transport links are already included in the accounts of GAL, upon which the airport replacement costs are based (and only where the airport operator incurs these costs can they be reimbursed via the RAB).
- The index that GAL proposed to increase land values by was quite high and was not appropriate. Furthermore, EE indicated that a more appropriate index may be lower than the one that it used in its modelling (but which it had retained in the revised version of its model).

I98 Importantly, the assumption that a replacement airport would be full from day one was based on the premise that this airport would replace Gatwick (or in other words Gatwick would close), with all existing traffic migrating to the new airport. This assumption is not unreasonable and a similar assumption was used by FTI in its estimation of a replacement cost airport for Gatwick.¹⁶⁵

I99 EE's study also highlighted that LRIC estimates using additions to capacity could be used in certain circumstances, such as a comparison of the costs of additional capacity at different airports, but

¹⁶⁴ It also noted that its LRIC estimate for increment 2 of £17 was the upper estimate and that this should be lower as the construction of the runway would most probably be phased over more time in line with demand. Source: EE, 'Advice on the application of long run incremental cost estimates for Gatwick and Stansted; Response to comments by Gatwick Airport Limited', page 6.

¹⁶⁵ FTI Consulting, 'LRAIC for Gatwick Airport: Presentation to CAA workshop', 7 December 2011.

that using the costs of a replacement cost airport speaks directly to the cost of providing these services.¹⁶⁶

- I100 The CAA does not, therefore, agree that EE has softened its position with respect to the appropriate increment. Rather, EE has indicated that the use of a non-replacement increment could be useful in specific circumstances, circumstances that do not currently include the one that the CAA is currently facing.
- I101 On GAL's concern with the cost of capital assumption, the CAA does not consider that this is too low. A range of factors were carefully considered in determining this assumption and these factors were outlined in detail in the initial proposals.¹⁶⁷
- I102 On GAL's concern with the low capital investment cost assumption, EE based its estimates on the 'minimum cost option' devised by ASA consultants for the CC for the SG2 Plan at Stansted. This decision was made in agreement with the CAA, and is justified as ASA was in a better position than BAA (or GAL) to provide a third party independent assessment of likely costs.¹⁶⁸
- I103 GAL has also suggested that 'the high costs associated with the building of an airport in the South East is also evident from the various cost estimates emanating through the Airports Commission process, including [its] own submissions on the costs of additional capacity.'¹⁶⁹ In addition, GAL has 'estimated that the costs for a second runway and associated facilities at Gatwick are likely to range between £5 billion and £9 billion (in 2013 prices), depending on the option selected.'¹⁷⁰
- I104 The CAA considered that in the current circumstances GAL was not best placed to provide an independent assessment of the likely costs

¹⁶⁶ EE, 'Advice on the application of long run incremental cost estimates for Gatwick and Stansted; Response to comments by Gatwick Airport Limited', page 7.

¹⁶⁷ This document is available on the CAA's website:
<http://www.caa.co.uk/docs/33/CAP%201027%20Economic%20regulation%20at%20Heathrow%20from%20April%202014%20initial%20proposals.pdf>

¹⁶⁸ EE, 'Advice on the application of long run incremental cost estimates for Gatwick and Stansted; Response to comments by Gatwick Airport Limited', page 18.

¹⁶⁹ Source: GAL.

¹⁷⁰ GAL, Airports Commission: Proposals for providing Additional Runway Capacity in the Longer Term, Gatwick Airport Limited response, July 2013, page 37.

associated with airport replacement. In addition, GAL had indicated that the estimates that it provided to the Airports Commission carry a large contingency:

- I105 *“At this stage Gatwick has produced a series of estimates at a facility level, which is consistent with a class 5 – conceptual estimate and relevant for strategic planning. This type of estimate therefore carries a risk/contingency level of 20% or greater.”*¹⁷¹
- I106 Given the above, the CAA considered that GAL's estimates had to be treated with the appropriate level of caution and are not suitable for use in estimating a LRIC, which already has a number of concerns associated with it.
- I107 Options associated with Gatwick expansion were also appraised as part of the South East Regional Air Services (SERAS) study. In this study, the £1.8 billion (in 2000 prices) for the narrow spaced option increases to £2.8 billion once adjusted for construction price inflation (2012 prices). This was slightly above the costs used by EE (£2.3 billion) but was broadly reflective of the costs that have been used.
- I108 GAL also considered that any estimate of LRIC should be considered a lower bound estimate of the competitive price as it did not consider factors such as location, brand and scarcity. The CAA did not agree with this view and considered that the evidence suggested that any LRIC should instead be the higher bound estimate. This view was outlined by EE, who noted that, taking increment 2, the increment that generated the highest LRIC estimate for GAL, that:
- I109 *“[T]he figure calculated by our model for Increment 2 (£17.00) is already an overestimate as the model does not take into account the phasing of capital expenditure. Our model assumes that the full capital costs of the second runway at Gatwick would be incurred upfront, with demand growing slowly over time. In reality, the construction of the runway would most likely be phased over time more in line with demand. Thus, the present value of capital costs*

¹⁷¹ GAL, Response to long term option, proposal clarification questions – Commercial submission by Gatwick Airport Limited, August 2013, page 4.

*should be lower, and the LRIC estimate for Increment 2 would be below £17.00.*¹⁷²

I110 With respect to GAL's concerns regarding location, brand and scarcity the CAA considered that these issues had also been addressed and did not consider that EE's model should be changed:

- EE considered *'certain factors beyond resource costs may add value to services, but in a competitive market it does not necessarily follow that higher prices can be charged. Particularly where an operator has market power, regulators should not be concerned with what can be charged for a service, but with what it costs to provide the service.'*¹⁷³
- Scarcity may mean that the market clearing price is likely to be significantly above the competitive price. However, the competitive price should be the price that would hold under conditions of competition in which operators are able to vary capacity in response to excess demand.
- While the value of non-price factors may be able to be passed through (ultimately to consumers), this will depend on the level of available capacity at Gatwick and at other airports (see Appendix E), the level of competition in downstream markets and how sensitive passengers are to price changes. As GAL is not operating in a perfectly competitive market, and as Gatwick is not currently full, these non-price factors may be more appropriately captured through other mechanisms such as the value of slots or the value of the airport (when exchanged).
- Assuming that these factors have not been captured and the CAA considered it appropriate to do so, estimating these factors would introduce a level of subjectivity which could lead to significant uncertainty and therefore large price increases or decreases depending on the assumptions used, limiting the protection to users and introducing greater variability.

¹⁷² EE, 'Advice on the application of long run incremental cost estimates for Gatwick and Stansted'; Response to comments by Gatwick Airport Limited, page 18.

¹⁷³ EE, 'Advice on the application of long run incremental cost estimates for Gatwick and Stansted'; Response to comments by Gatwick Airport Limited, page 18.

- I111 In response to Professor Littlechild's comments which queried whether LRIC reflected a theoretical competitive price and stated that setting prices in relation to long run costs was not what markets did in practice, EE stated that a LRIC approach can reflect prices in a normally competitive market as it would reflect the forward-looking avoidable costs of supply.¹⁷⁴ However, for the reasons stated in paragraph I94 above, the CAA does not consider that for airport operators LRIC would necessarily reflect the competitive price.
- I112 The CAA considered that the primary conceptual benefit of using a LRIC approach was to set price caps that proxy the price that might emerge from a competitive market over the long run.¹⁷⁵ However, the CAA continued to consider that there were a number of concerns associated with using LRIC for airport operators. The CAA continued to be concerned that a combination of the following will mean that the implementation of a LRIC-based control for GAL could undermine its primary duty: the practical difficulties in its calculation; the specifics of airport capacity in the South East that may render it inappropriate; the significant sensitivity of the calculation to regulatory judgement; and the data intensive nature of the calculation. On balance, therefore, the CAA considered that this option was not suitable for regulating GAL's airport charges in Q6 given the risk it could undermine, rather than support, protection for users and the promotion of competition.

¹⁷⁴ Littlechild, May 2013, Regulation of an increasingly competitive airport sector, http://www.gatwickairport.com/Documents/business_and_community/Public%20Regulation%20Pages/Economic%20regulation/2013/LGW-BQ5-238%20-%20Regulation%20of%20an%20increasingly%20competitive%20airport%20sector%20-%2026%20May%202013.pdf, paragraph 21.4.

¹⁷⁵ CAA, Review of Price Regulation at Heathrow, Gatwick and Stansted airports ("Q6"), Policy update, page 56 and Europe Economics, <http://www.caa.co.uk/docs/1350/Europe%20Economics,%20Advice%20on%20the%20application%20of%20long%20run%20incremental%20cost%20estimates%20for%20Gatwick%20and%20Stansted%20-%20nonconfidential%20version.pdf>, page 7.

Figure I.6 Appraisal of a LRIC approach for GAL

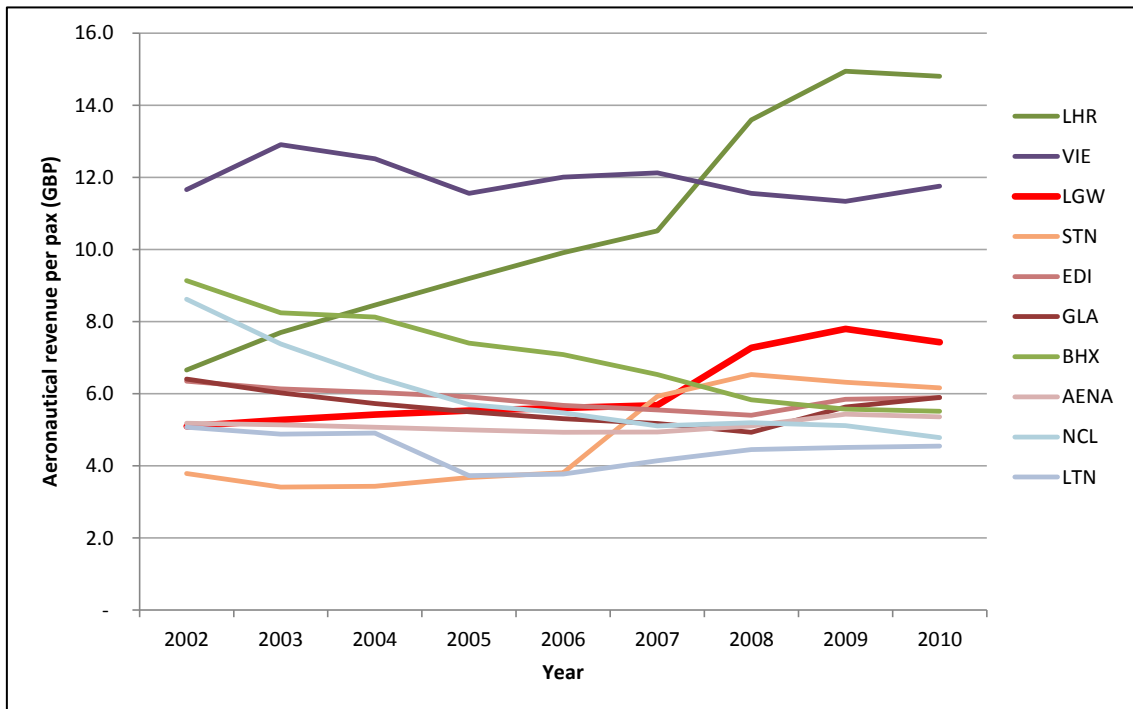
Criteria	Assessment
Price protection	Provides some protection against charges above the competitive level over the long term (although noting for airport operators it may not reflect competitive prices at a specific time), although calculations are subject to considerable uncertainty.
Service quality protection	Service quality requirements can be specified as part of a decision/licence although need to ensure users' interests are considered.
Promote competition	In theory LRIC better reflects competitive outcomes, although the practical issues highlighted above may limit the extent to which this is the case. A LRIC approach may not reflect the dynamic aspects of competitive prices although, given the constraints on new capacity, this may be less relevant issue for airports in the South East.
Allows efficient business to finance its activities	The move away from a historical cost RAB would create the risk of capital gains and losses, which would increase business risks and financing costs.
Efficient and effective investment	A LRIC approach would reduce the incentives towards inefficient capex spending as the company would not be compensated for over-spending.
Operational efficiency	If used within fixed term control periods then there should be an incentive to outperform the regulatory settlement (and as with a RAB approach roll-over provisions could ensure that incentives are maintained towards the end of the control period).
Allow environmental measures	Would allow individual prices that contribute towards the cap to be adjusted to incentivise improved environmental performance. Environmental measures could be included within the future capital programme as long as additional outputs are explicit.
Transparent, accountable, proportionate, consistent and targeted	LRIC estimates require judgements about the most appropriate increment or the modern equivalent values. Some stakeholders are concerned that a LRIC approach can be complex, time consuming and lead to uncertain future price paths with a high level of regulatory discretion. This may reduce transparency and consistency
Practical implementation and stakeholder confidence	Introducing a LRIC price cap would require a long-term commitment from the regulator to move from the current RAB approach and to even out under- and over-recovery over time. Stakeholders raised concerns whether sufficiently precise results could be obtained and whether the transfer from a RAB to a LRIC control had sufficient benefits to justify it given the long-term horizons.

Source: CAA analysis

Price caps based on pegging tariffs to comparator airports

- I113 Pegging tariffs to comparator airports would set a price cap based on an index of the airport charges of a set of comparator airports. Airports within the index could be weighted in relation to their relevance to the comparator, for example size, type of traffic and level of underlying demand.
- I114 Pegging tariffs in this way should provide some protection to passengers by setting a direct link between charges and a proxy for the competitive price. It avoids the complexities of scrutinising the bottom up cost and revenue information required by price caps based on RAB and LRIC type methodologies. As well as a price cap, the regime could also include other output requirements such as a SQR scheme and investment requirements.
- I115 In its May 2012 policy update document, the CAA considered that a comparator benchmark approach had some merit. In particular, the CAA wanted to explore further whether it could allow the setting of sufficiently precise and appropriate price caps, or whether it would be more helpful as a cross check on a price control calculated by another approach.
- I116 The CAA commissioned consultants LF to identify whether it was possible to benchmark prices at comparable airports in order to regulate airport charges at Gatwick and/or Stansted. LF identified a potential comparator set of airports separately for Stansted, Gatwick and Heathrow. The comparator set for Gatwick reflects the range of airlines that use Gatwick and includes Heathrow, Edinburgh, Glasgow and Barcelona which are used by BA and Luton and Stansted which are predominately used by Low Cost Carriers (LCCs).
- I117 Based on this comparator set, LF benchmarked GAL's aeronautical revenues over the last ten years. This showed that GAL's average aeronautical revenues per passenger increased over the period and were now around average for the group. The results however are sensitive to the inclusion or exclusion of Heathrow from the comparator group. If Heathrow was excluded from the group then GAL's charges would be above the average, although still within the 10 to 15% range of uncertainty identified by LF.

Figure I.7: Aeronautical revenue per passenger for the Gatwick comparator basket



Source: LF: Note: AENA includes both Madrid Barajas and Barcelona which are both comparators to Gatwick

I118 In developing the comparator basket LF found that trends in aeronautical revenue per passenger were robust against variations in the airports chosen (apart from Heathrow) and changes in the way the index was calculated. However, if used for setting a price cap, due to the additional precision that would be required, LF identified a number of issues that would need to be addressed, in particular:

- whether the comparator basket is held constant or is allowed to change over time, depending on how different airports evolve;
- how the comparator basket is chosen, in particular the cut-off for the inclusion of airports, and whether particular parameters are included;
- how the index is calculated, for example whether airports should be weighted and the treatment of exchange rates;
- inherent uncertainties in the accuracy of the data, especially where estimates have had to be made for example in relation to air traffic control costs and freight revenues; and

- ensuring that the precise portfolio of activities that generate revenue is consistent across airports to ensure a like for like comparison.

I119 In total, LF considered that the resulting range of uncertainty from the benchmarks was ± 10 to 15%. LF stated that this range did not reflect the inclusion or exclusion of additional comparator airports. LF considered that potential issues with comparator based price caps could be reduced by averaging across airports and be resolved through agreement on the comparator set and/or parameters between the airport operator and airlines. Nevertheless LF recommended that it may be better for the comparator benchmark to be considered as a range rather than a point estimate.

I120 LF responded to the concerns raised by GAL on the initial proposals.¹⁷⁶

- Size and composition of the comparator sample. LF stated that the comparator sample reflects not only airport characteristics but also the traffic mix and the diverse range of airlines that use Gatwick. The choice of comparators reflects the purpose of the study (and so is therefore different to that undertaken by LF at Melbourne) and that airport size is only one of a range of factors that is important in determining the comparator sample.
- Exclusion of significant variables. LF repeated the points raised in their final report: that different types of airlines have different service quality demands and so the inclusion of traffic mix in the determination of comparators should reflect different customer demands; that the study was benchmarking prices and not costs and the inclusion of costs could create a circularity where inefficient costs could be used to justify high prices, investment will not impact on prices in any one year but will be spread over time and the benchmarking has been considered over a period of ten years; the balance between capacity and demand is reflected in the criteria through runway utilisation; the impact of affordability of charges has been taken into account by adjusting charges by purchasing power parity exchange rates; and regional subsidies reflect the matching of charges to demand and can often affect costs as well as

¹⁷⁶ Leigh Fisher, August 2013, Addendum Note: Comparing and Capping Charges at Regulated Airports, <http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279>

charges.

- The assessment of regulation was undertaken at a high level to allow the drawing of general conclusions and there are a myriad of different arrangements across airports.
- The assessment is based on like for like comparisons and the revenue data has been normalised across airports based on the experience of publishing airport benchmarks over many years.
- LF acknowledged the practical difficulties in benchmarking aeronautical revenues but do not consider the 18-month timelag is that significant and audited results for all airport operators were not available for the most recent year. LF also acknowledged the difficulties in using group level data but considered that time series data was required to allow a reliable split of group data and to avoid compromising other parts of the analysis. LF considered that the 15% uncertainty range accounted for these factors.
- LF stated that any approach to benchmarking is open to interpretation and it is easy to assemble a different set of comparators to draw different conclusions. LF stated that this does not mean that the CAA should not use benchmarking as part of its analysis but it should be used carefully and as stated in the final report, definitive conclusions based on spot prices should not be drawn. LF stated that it had considered an approach similar to one that it had used at Melbourne but were concerned that this could be criticised as too simplistic. LF considered that the 15% range around the comparator benchmark provides a basis to inform the CAA's work.
- LF considered that outputs from the benchmarking could usefully inform the consideration of the competitive price within a range and noted that during the consultation process there was general support for the use of price benchmarking to inform the regulatory process.
- LF considered that their assessment of catchment areas is appropriate, that runway utilisation is the ultimate constraint on airport capacity and that the consideration of the regulatory environment is necessary broad brush but is appropriate for the purposes of the study.

- LF considered that the goodness of fit of the regression is reasonable for this kind of cross sectional analysis and disagreed that signs of the coefficients were counterintuitive and that the specification of the regression was inappropriate to inform the choice and weighting of variables in the selection of comparators.
- LF considered that they could have introduced more variables into the analysis and greater complexity in the weightings but considered that could add greater uncertainty in the results and considered the simple average approach taken, together with the 15% uncertainty band covered a range of outcomes under different approaches and so would be appropriate.
- LF considered that the multivariant regression approach which calculated a norm for each airport would avoid some of the problems of the simple benchmarking approach used in the report but would require a significant data gathering exercise to produce time series estimates and could also introduce problems associated with the regression itself.

- I121 LF did not change their benchmarks for each of the airports or the conclusions that they drew.
- I122 The CAA considered the concerns raised by GAL's consultants FTI. These concerns appeared in the main to be related to the CAA's use of airport comparators to establish a range for the competitive price which has been used in the market power assessment. These concerns were therefore dealt with in more detail in the market power determination for GAL.¹⁷⁷ The CAA noted that FTI's concerns repeated many of the concerns previously considered by LF. The following paragraphs summarise the CAA's response.
- I123 **The purpose and status of the analysis.** The terms of reference were clear that the work was to "identify suitable comparator airports that would provide an indication of airport charges at Heathrow, Gatwick and Stansted in a reasonably competitive environment". LF was clear that "reasonable inferences can be drawn from the identified ranges for each airport". The terms of reference also required LF to "Identify issues and appropriate mitigating measures in the development of a basket of comparator airport charges for capping

¹⁷⁷ See Appendix H of the Gatwick market power determination.

charges at Gatwick and Stansted". The CAA considered that the LF report had addressed these issues.

- I124 **The conceptual robustness of the analysis.** The CAA had reviewed the draft guidance provided by the EC on the use of airport benchmarks to assess relevant market prices. While the EC raised some concerns with using benchmarks at the present time it did not rule it out in the future. In many ways the LF analysis built on rather than was inconsistent with the concerns raised in the draft guidance.
- I125 **The uncertainty in the LF analysis.** FTI's concerns in this area largely repeated earlier points made by stakeholders and were previously addressed by LF in their addendum report and were summarised in paragraphs I118 to I121 above and set out in detail in Appendix H of the market power determination. LF considered that the range identified reflected the uncertainty in the estimation of the benchmarks. LF stated that reasonable inferences could be drawn from identified ranges for each airport, although it accepted that its results were not sufficiently robust to draw inferences on the spot charge estimates or to use as the basis for pegging tariffs at regulated airports.
- I126 **How the CAA had taken into account the uncertainty in the LF analysis.** The CAA had taken into account the uncertainty in the LF analysis and has only made inferences on the competitive price from the ranges estimated by LF and it only formed part of the CAA's analysis of the competitive price. The CAA had also undertaken a number of sense checks on the LF analysis in terms of the comparators selected and the robustness of the analysis (for example if specific airports are removed and the stability of the analysis over time). Further the CAA noted that the LF analysis was subject to an industry workshop and consultation. The LF analysis also took account of the impact of regulation and the scarcity of runway capacity.
- I127 **The weight placed on benchmarks of aeronautical revenue and published charges.** Part of the rationale for single till regulation was that an airport operator in a competitive environment took into account non aeronautical revenue when setting the level of airport charges. The CAA, however, set caps on airport charges and not total revenues. Consequently, it was the level of airport charges that was being benchmarked as part of this process rather than total revenues

and hence the CAA focused on the benchmark of aeronautical revenues (which for the most part are made up of airport charges). Furthermore the CAA did not consider weight should be placed on published charges as these did not include discounts. The CAA was concerned about the interests of all users and was therefore interested in the average charge paid by users whether the airline they are travelling with is receiving a discount or not. The CAA therefore placed weight on the benchmarks of aeronautical revenues rather than published charges.

- I128 **The criteria used to select comparator airports.** LF considered whether to include quality of service, input costs and investment cycles and rejected these for the reasons set out in their report and briefly in paragraph I120 above
- I129 **The robustness of the econometrics employed.** The issues raised by FTI appeared to be a list of common problems that could arise out of any regression and FTI did not provide any evidence that these were problems in this case. In addition the regression was only used to inform the selection of variables which were used as an input to the weighting process and was not used to define the benchmark itself. LF did not consider that the regression was sufficiently robust for this latter purpose.
- I130 **The use of a dynamic process to identify comparators.** The benchmarks were based on the most recent years of data, the same year in which weights were derived. The time series analysis was used to identify robustness.
- I131 Based on the above response, the CAA continued to consider that comparator benchmarks provided a useful indicator of the possible range for the competitive price. This was consistent with the purpose of the LF work, which was in part "to identify suitable comparator airports that would provide an indication of the level of airport charges at Heathrow, Gatwick and Stansted in a reasonably competitive market". The CAA did not consider that it would be appropriate to set precise price caps based on comparator benchmarks. The CAA noted that this view was consistent with that of Littlechild in his paper for GAL, who considered that the comparator benchmark could be used as a cross check against the terms offered in the commitments. A summary of the CAA's evaluation against its criteria is given in figure I.8.

Figure I.8: Appraisal of pegging tariffs to comparator airports for GAL

Criteria	Assessment
Price protection	In principle the price cap ensures users only pay a proxy for the competitive price, however due to potential measurement and statistical issues the benchmark may not be sufficiently precise to set price caps. There is no guarantee that charges are cost reflective.
Service quality protection	Service quality requirements could be specified as part of a licence although care will be needed to ensure they meet users' requirements. The choice of the comparator group implicitly takes account of the needs of different users by including structural criteria such as the passenger, carrier and destination mix, and airport size in the choice of comparator airports. If higher than typical service quality standards are set then there may be a need for prices to be adjusted. If service quality requirements are not specified then improvements may be avoided if they result in higher prices.
Promote competition	Setting prices in relation to comparator airports could remove distortions from a RAB-based approach as prices would be based on a proxy for the competitive price.
Allows efficient business to finance its activities	Pegging tariffs removes the direct link between charges and costs and so care will be needed to allow an efficient business to finance its activities.
Efficient and effective investment	As the price cap is essentially reactive to changes in charges at other airports there may be uncertainty over future prices which might disincentivise investment.
Operational efficiency	As prices are delinked from costs then this should create incentives for efficiency as GAL will effectively be a price taker rather than price maker. GAL will therefore retain any gains made from reducing opex, it would extend over the long term and would not be limited to a 5-year regulatory period.
Allow environmental measures	While it should be possible to pursue environmental measures such as the differentiation of charges according to noise impact, funding specific environmental investment may be more difficult if the same requirements are not present across the comparator set.
Transparent, accountable, proportionate, consistent and targeted	As the price cap is based on tariffs at other airports it should be transparent and the costs of regulation may be greatly reduced. Maintaining the same comparator set across the control period may provide consistency.

Criteria	Assessment
Practical implementation and stakeholder confidence	LF has demonstrated it is possible to identify a set of comparator airports for Gatwick, which include a number of airports that operate under light handed regulation. The comparator benchmark is also robust to some changes in the comparator set, although the inclusion or exclusion of Heathrow can have a significant impact. Nevertheless the choice of comparators is likely to be disputed by those parties that do not agree with the resulting benchmark. The benchmark could be vulnerable to unexpected shocks, which might be considered unfair by the airport operator and other stakeholders.

Source: CAA analysis

Price monitoring (in the absence of GAL's commitments)

- I132 Price monitoring would not involve the CAA setting an explicit price cap to apply from April 2014. Instead, the CAA would expect GAL to exercise self-discipline and self-regulate its actions and take steps to ensure that it does not abuse its market power against a framework of a regulatory backstop to incentivise this behaviour.
- I133 The CAA's role would be to monitor GAL's performance including its prices, service quality, investment and efficiency - with the threat of reintroducing tighter regulation if GAL's performance raised concerns about the exercise or abuse of its SMP.
- I134 In principle, where there is a need for regulation to address a risk of exercise or abuse of SMP but that risk is relatively low, the threat of the regulator intervening may be sufficient to incentivise GAL to act as if it faced effective competition. If monitoring is effective, it would incentivise GAL to act as if it were subject to competitive constraints so as to bring acceptable prices and performance to customers without the need for direct regulatory intervention.
- I135 Monitoring, if effective, has a number of benefits in terms of greater flexibility, reduced regulatory specification and reduction of the regulatory burden. If effective, it would also encourage GAL and the airlines to develop a more cohesive relationship than relying on the regulatory process for setting prices.
- I136 The CAA's consultants FE developed and assessed alternative forms of a monitoring regime. FE identified three generic types of monitoring regime.

- Option A: a regulatory regime where the airport operator's charges are monitored against an external price, benchmarked and automatically capped if beyond a pre-defined level.
- Option B: an annual ex-post review of prices and outcomes, without a prescriptive ex-ante price cap but with transparency on a range of monitoring indicators on charges, financial performance, investment and service quality and a set of high level criteria against which CAA would assess performance.
- Option C: a light touch approach, with the airport operator entering into a voluntary code of conduct before the start of Q6 with less frequent reviews of prices and outcomes. Such a code of conduct would go well beyond the requirements of the ACRs and would involve meaningful commitments to cost transparency, information provision, dispute resolution and agreement on charges.

I137 FE considered that of the three options, option A, would be less beneficial than the other options. FE considered that as option A included an automatic movement to ex-ante price control regulation it would effectively be considered by the airport operator as a price cap. The cap could also be subject to unexpected shocks or changes in charges at individual comparator airports. In addition the time lag to comparative data becoming available would mean that assumptions would need to be made on prices in individual years, with adjustments in subsequent years. This would create uncertainty for the regulated airport operator, its investors and customers.

I138 FE did not express a preference between options B and C, although it suggested that option C, the lightest touch option, would require the airport operator to face meaningful competitive constraints across a significant proportion of its revenue base. The CAA would also need to be convinced that the airport operator was committed to working with its customers in a normal commercial manner and could reach agreement with them without regulatory involvement.

I139 The CAA's market power assessment for GAL indicated that it was likely that it will not face effective competitive constraints across a significant proportion of its revenue base. Given the diverse mix of airline business models at the airport, GAL was more likely to reach bilateral agreements with individual airlines rather than an agreement with all airlines on overall charges as required under option C.

Consequently the CAA has focused its assessment on option B, price monitoring based on an annual ex-post review of prices and outcomes.

- I140 FE considered that price monitoring could be an effective form of regulation, if:
- the airport operator accepts and understands the need for self-regulation (within a price monitoring regime);
 - there is a credible and understood threat of price control re-regulation, if the airport operator is found to be abusing its market power;
 - the reputational consequences to an airport operator of being found to have abused its SMP are unattractive; and
 - the financial consequences of ex-ante price control regulation should be unfavourable.
- I141 The CAA considered two options for price monitoring: price monitoring in the absence of commitments, and price monitoring with commitments. The CAA considered it unlikely that GAL, with its degree of market power, would discipline itself and withstand the temptation to take advantage of the freedoms that the removal of ex-ante price controls and a switch to ex-post monitoring would give it. The CAA noted GAL's behaviour identified in the market power determination, in particular that:
- GAL has argued throughout the review that its prices are too low, i.e. below the competitive level, and would need to increase; and
 - airlines that represent a significant volume of traffic at Gatwick appear to have little countervailing buyer power, with GAL largely setting the terms that an airline will receive in any negotiations so that the scope for negotiation is limited. The CAA notes that the bilateral contracts that have so far been agreed appear to be a function of the commitments and the CAA's final proposals.
- I142 Against this backdrop, the CAA did not consider it was clear how a switch to a price monitoring regime, in the absence of reasonable and effective commitments at Gatwick, could work.¹⁷⁸ GAL had clearly set

¹⁷⁸ If the CAA considered that GAL's commitments were reasonable and effective in the absence

out its reading of the market and signalled its pricing intentions. If the CAA were to remove GAL's price cap and give the airport operator the freedom to set prices at a level of its choosing, in the absence of reasonable and effective commitments, subsequent disagreements between GAL and the CAA about the exercise of market power could be inevitable. This would most likely cause the CAA to challenge GAL's price increases and seek some form of remedy or tighter regulation.

- I143 The CAA considered that it was better for all parties to resolve the difference of views that GAL and the CAA had about prices now as part of the Q6 review process (for example through the use of an explicit benchmark price) rather than in 1-2 years' time as part of an ex-post investigation into actual pricing behaviour under a monitoring regime. This would ensure that avoidable detriment is not imposed on users. It would also give greater certainty to GAL and users about the appropriate price path for the next five years.

Figure I.9: Appraisal of price monitoring type ex-post licence conditions for GAL

Criteria	Assessment
Price protection	Price monitoring leads to self-regulation of prices. If self-discipline is not evident then there will be a switch to default price caps and more formal price control regulation, although given the issues identified in the market power assessment significant passenger detriment could occur before price controls are reintroduced.
Service quality protection	Service quality could be transparently monitored where poor performance could lead to a switch to default price caps and price control re-regulation. Although given the issues identified in the market power assessment significant passenger detriment could occur before price controls are reintroduced.
Promote competition	The intention of this option is that the airport operator would behave in the same way as airport operators without SMP. From the market power assessment it is not clear that GAL would behave in this manner.
Allows efficient business to	There is no reason why an airport operator would set prices at a level

of a licence and therefore in passengers' interests then it is unclear why a licence was required at all.

Criteria	Assessment
finance its activities	that does not permit it to finance its activities.
Efficient and effective investment	An airport operator would not be constrained from bringing forward efficient new investment plans, which could be taken into account when setting prices.
Operational efficiency	Cost efficiency would be one of the indicators that could trigger a switch to default price caps and, ultimately, ex-ante price control regulation. Although again this would depend on the level of prices and the incentive they place on being efficient.
Allow environmental measures	There is no reason why environmental measures could not be introduced under a price monitoring regime.
Transparent, accountable, proportionate, consistent and targeted	There should be no reason why the rules in this option would not be understood clearly by all parties, it therefore is capable of satisfying the better regulation principles. There could however be uncertainty over when the CAA may choose to introduce greater regulation. Airlines are likely to argue that the controls in price monitoring are likely to be insufficient to control the market power held by the airport operator.
Practical implementation and stakeholder confidence	This option requires stakeholders to believe that an airport operator will behave responsibly. It cannot be guaranteed that stakeholders will have this belief.

Source: CAA analysis

Price monitoring combined with GAL's commitment proposals

- I144 In the final proposals the CAA stated that price monitoring (which would be in a licence) combined the GAL's commitments regime (which would be outside the licence) would have benefits above price monitoring alone from the additional protection provided by the commitments but much would rest on the commitments themselves and a commitments and licensing regime would have additional benefits from greater enforceability.
- I145 In the proposed licence the CAA considered that 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.

- I146 GAL stated that given its commitments a price monitoring regime was unnecessary. GAL did not provide reasons why it considers that price monitoring was unnecessary with the commitments. The CAA noted that this is contrary to the position of GAL's own consultant Professor Littlechild who supported a monitoring regime to be associated with the commitments. The CAA also noted that in response to the initial proposals GAL stated that the CAA should have placed more evidence on the presence of the commitments in its assessment of price monitoring. As set out earlier in this appendix the CAA considered that the commitments provide GAL with a number of flexibilities. While these flexibilities provide GAL with scope to tailor the offer to individual airlines and their passengers, they also increase risks that GAL could abuse its position of SMP.
- I147 The CAA considered that given the points raised above on the potential risks of abuse, much of the burden from preventing abuse of SMP would rest on the commitments rather than the price monitoring regime itself, in particular as the commitments provide a range of protections normally provided in a regulatory settlement. Consequently the CAA considered it would be important to ensure that the terms in the commitments were reasonable and effective from the perspective of users. As set out above the CAA had concerns with the enforceability of the commitments and with a number of terms within the commitments. Consequently, price monitoring with commitments was likely to suffer from as many of the enforceability issues as commitments alone, albeit that the monitoring would improve transparency and the licence would provide some benefits from being able to intervene in the interests of end users and improving the speed of response. Nevertheless, there would continue to be issues with the enforcement of the commitments in the absence of effective licence conditions. It would also not be clear to GAL or the airlines whether the CAA considered the price or terms in the commitments were consistent with an effective market. The CAA therefore stated that this option was likely to be less beneficial than a commitments and licensing framework on grounds of enforceability. It would also not include the licence protections proposed for the licence-backed commitments regime on second runway costs and financial resilience. There would also be similar costs from the price monitoring regime itself. Consequently, the CAA did not consider that price monitoring with commitments should be taken forward.

Figure I.10: Appraisal of price monitoring with commitments for GAL

Criteria	Assessment
Price protection	Given the issues identified above, much of the burden for preventing the abuse would rest on the commitments and the terms in the commitments would need to be fair to airlines and users. Price monitoring will not be able to enforce the commitments directly and so is likely to be less effective than a commitments and licensing framework.
Service quality protection	Much of the burden for preventing the abuse would rest on the commitments and the terms in the commitments would need to be fair to airlines and users. As above price monitoring would not be able to directly enforce the commitments and so is likely to be less effective than a commitments and licensing framework.
Promote competition	The intention of this option is that the airport operator would behave in the same way as airport operators without SMP. While the commitments would provide some additional protection they would need to be reasonable and effective for airlines and users. The CAA does not consider that this is the case.
Allows efficient business to finance its activities	There is no reason why an airport operator would set prices in commitments at a level that does not permit it to finance its activities.
Efficient and effective investment	The commitments or the price monitoring regime would not constrain the airport operator from bringing forward efficient new investment, although consultation arrangements would be needed to ensure that this would be in users' interests.
Operational efficiency	Operational efficiency incentives are more likely to be dependent on the terms in the commitments rather than the threat of re-regulation through price monitoring.
Allow environmental measures	There is no reason why environmental measures could not be introduced.
Transparent, accountable, proportionate, consistent and targeted	There should be no reason why the rules in this option would not be understood clearly by all parties, it therefore is capable of satisfying the better regulation principles. Airlines may have greater confidence in this regime than in price monitoring or commitments alone, however much of the protection would come from the commitments themselves and licence enforcement of these may be a more proportionate response although it may not be transparent when the CAA would intervene.

Criteria	Assessment
Practical implementation and stakeholder confidence	This option requires stakeholders to believe that an airport operator will behave responsibly. The commitments provide an indication of what can be expected from GAL, however as a price monitoring regime would not directly enforce the commitments, concerns with enforceability may remain.

Source: CAA analysis

Conclusions

- I148 In the proposed licence the CAA stated that the Act provided an opportunity for the CAA to introduce flexible and pragmatic forms of economic regulation that are better tailored to the risks of abuse of SMP and the interests of passengers. The CAA's market power assessment found that GAL holds SMP.
- I149 While not acknowledging that it has SMP, GAL has put forward airport commitment proposals which offer many of the same protections to airlines and passengers that would be available under a regulatory settlement. The CAA welcomed these proposals, and in particular the changes that GAL had made to the commitments to address the previous concerns raised by airlines and the CAA. However, the CAA remained concerned that the enforceability and some of the terms of the commitments were such that, in the absence of a licensing and monitoring framework, they would not offer sufficient protection against the risk of abuse and/or would not further passengers' interests.
- I150 The CAA therefore considered what form of regulation should be implemented under a licence. The CAA considers a 7-year commitments and limited licensing framework could be an effective form of regulation for GAL. This was on the basis that:
- the enforcement concerns about the commitments concept would be addressed through the statutory enforcement process applicable from the licence;
 - there would be additional licence conditions to ensure that significant costs incurred on the second runway costs are subject to full regulatory treatment and enforce financial resilience; and

- there would be an effective monitoring framework to ensure that the additional flexibility of the commitments promotes passengers' interests.
- I151 As set out in the final proposals the CAA did not consider that LRIC, airport comparator benchmarks or price monitoring would provide adequate protection and they would not be in passengers' interests.
- I152 Given the degree of market power held by GAL, the CAA continued to consider that a RAB-based framework could also be an appropriate form of regulation for GAL. A RAB-based framework was well understood and widely used across regulatory sectors. It provided price and service quality protection to passengers, while providing incentives for efficiency and has support from airlines. Unlike at Stansted, there was less uncertainty over individual building blocks and the value of the RAB does not appear to be out of line with the investment requirements of passengers.
- I153 On balance, the CAA considered that a commitments plus limited licensing framework and effective monitoring would better further passengers' interests and, where appropriate, promote competition (although the CAA acknowledged the scope for competition was limited). In the case of GAL, commitments offered a number of benefits over a RAB-based framework from the additional flexibility and greater potential for bilateral contracts which could allow better tailoring to the needs of individual airlines and their passengers. This would not only enhance choice and value to passengers, but would also facilitate airport competition although given that GAL has SMP this is likely to be limited in scope. The CAA considered that commitments would also provide other benefits above a RAB-based framework from:
- the greater certainty to airlines and their passengers as they are for seven rather than five years;
 - the strengthening of the airline and airport operator relationship as the commitments are to airlines rather than the CAA which would reduce management distraction; and
 - avoiding some of the distortions to incentives that would be present under a RAB-based framework, for example in relation to investment incentives, and it would encourage rather than crowd

out a more commercial approach.

- I154 A commitments and licensing and monitoring regime would also reduce the direct costs of regulation compared to RAB-based regulation. In particular the CAA considered that GAL's costs of regulation would be reduced from less management distraction, a greater focus on airport operator-airline relationships and the increased flexibility around capex. The CAA considered that the additional costs to GAL and airlines from licence-backed commitments would be small compared with a commitments only regime given the main focus of the licence is to ensure the enforceability of the commitments. In this regard a licence could actually reduce costs as it would reduce the risk of legal disputes. This contrasted with a RAB-based approach which would still involve significant costs even if costs could be reduced through improved flexibilities and a less onerous capex consultation process. The CAA did not however consider that a licensing and monitoring regime would reduce its annual direct costs compared to a RAB given the need for on-going monitoring, however these costs should reduce over time if the regime was successful and the costs of any periodic review would be spread over seven rather than five years.
- I155 The CAA considered that a supporting licence and monitoring regime would ensure that the commitments furthered passengers' interests by requiring GAL to comply with the commitments in a manner that furthered their interests. In addition it would allow the CAA to enforce the commitments and so ensure that the additional flexibilities in the commitments were furthering passengers' interests. The statutory framework applicable to a licence confers a range of intervention tools, ranging from modifying and/or introducing new licence conditions to enforcement. In appropriate cases, the CAA would be entitled to proceed with interim remedies or to impose penalties for breach. Importantly, a breach of the commitments would result in a direct actionable right of damages for any person affected by the breach (including passengers and cargo owners as well as airlines). Accordingly, the CAA considered that there were real benefits from the licence framework in terms of enforcement and deterrence that are not provided by the voluntary contractual commitments on their own.

- I156 The CAA considered that the commitments, licensing and monitoring regime would be consistent with the better regulation principle that regulation should be targeted only in cases where action is required, for example on second runway costs and financial resilience, while allowing the CAA to increase regulation if GAL could not develop the good relationships with airlines that would be important for an effective regime. On this basis the CAA considered that the proposed licence for GAL should be based on commitments and a licensing and monitoring framework.
- I157 The CAA emphasised that the conclusion that a commitments, licensing and monitoring regime was the most appropriate form of regulation for GAL was based on the specifics of the airport operator and its market position. It was also based on the regime as a whole and there should not be any read across that any elements of the regime, for example the service quality or operational resilience requirements, would be relevant to the specific circumstances of other airport operators or regulatory regimes.

Representations received

- I158 The CAA did not receive any specific representations to the proposed licence on the form of regulation. In general parties reserved their position and stated that in so far previous points made had not been taken on board, they remained of concern. In particular the ACC stated that it continued to consider that the CAA should be comparing GAL's commitments price with the seven rather than five year fair price and that its view of the fair price was significantly below this.

CAA's response

- I159 The CAA considers that it has addressed previous points raised by stakeholders. As the CAA has not received any specific additional new evidence, the CAA's maintains its views on the form of regulation, i.e. to take forward GAL's commitments proposals but backed with a licence and monitoring regime, for the reasons set out above.

- I160 The CAA notes that GAL has now agreed the terms in bilateral contracts or is in late stage negotiations with airlines covering 60% of passengers at the airport. As set out in paragraph I20, the CAA considers that bilateral contracts are a function of the commitments and so while the extension of bilateral contracts is welcome the CAA does not consider that the agreement of bilateral contracts put GAL in the same position as STAL, where bilateral contracts have been freely agreed and were not directly linked to commitments.
- I161 The CAA also notes that on 31 January 2014¹⁷⁹, GAL stated that it would increase published charges by RPI-1% in 2014/15 rather than RPI+1% as allowed under the commitments. GAL also stated that it expected that the increase in published charges for 2015/16 would be below RPI. While again this change is welcome the CAA does not consider that this changes the CAA's assessment of the commitments, not least as the price in the commitments has not changed and under the commitments, the price commitment is to an average price over the commitments period, and so any under recovery in one year could be made up in subsequent years.

¹⁷⁹ Gatwick Airport Limited, 31 January 2014, 2014/15 Airport Charges Tariff Decision Advice Paper.

APPENDIX J

Rolling forward the Regulatory Asset Base

Purpose and basis of the calculation

- J1 This appendix specifies the detail of the formulae that GAL will need to use for tracking the RAB.
- J2 The equations set out below are based on the projections made by the CAA in reaching its final decision on the charge conditions for the control period after 1 April 2014.
- J3 Each year, each RAB is expressed in actual end year price levels. The modelling used fixed 2011/12 price levels and the figures below must be uplifted to current price terms each year.

Retail Price Index ("RPI") Growth t from 2011/12 = The RPI (as defined in the Condition) at the end of the financial year t divided by the average of the monthly RPI figures for the financial year 2011/12, which (based on the All Items index¹⁸⁰ and based on 13 January 1987 = 100) equals 237.3

Annual RPI Growth t = The RPI at the end of the financial year t divided by the RPI at the end of the financial year t-1

Within Year RPI Growth t = The RPI at the end of the financial year t divided by the average of the monthly RPI figures for the financial year t

¹⁸⁰ All Items (CHAW) index, source ONS.

J4 This section describes how GAL's RAB will be rolled forward from one year to another.

Opening RAB t = For the financial year 2014/15, this figure will be set according to the following formula:
 $\text{£ } 2,471.402 \text{ million} \times \text{RPI Growth from } 2011/12$
 + Actual Capex 2013/14 x RPI Growth from 2013/14
 - $\text{£ } 189.215 \text{ million} \times \text{RPI Growth from } 2011/12$
 - (Actual proceeds from Disposals 2013/14) x RPI Growth from 2013/14
 = For the remaining financial years, this figure will be set according to the following formula:
 Closing RAB t-1 x Annual RPI Growth t

Closing RAB t = Opening RAB t
 + (Total Actual Capex t x Within Year RPI Growth t)¹⁸¹
 - (Proceeds from Disposals t)
 - (CAA's Assumed Depreciation t x RPI Growth from 20011/12)

Assumed Depreciation t in 2011/12 prices = For each financial year this figure will be fixed at the following values:

Financial year 2014/15:	£149.795 million
Financial year 2015/16:	£156.459 million
Financial year 2016/17:	£153.593 million
Financial year 2017/18:	£142.077 million
Financial year 2018/19:	£151.243 million
Financial year 2019/20:	£153.505 million
Financial year 2020/21:	£153.923 million

¹⁸¹ Accrued capex with no adjustment for movements in working capital.

APPENDIX K

The December 2013 Commitments

The commitments, as set out in the Gatwick Conditions of Use

Condition 2.1.2 of the Conditions of Use (Applicability and Enforceability of Conditions of Use)

- 2.1.2 The publication of these Conditions of Use constitutes an offer by Gatwick Airport Limited to permit the use of its facilities on the terms set out herein. The use of any facilities at the airport whether airside or landside other than as a passenger constitutes acceptance of these Conditions of Use. It is intended that these Conditions of Use constitute a contract as between Gatwick Airport Limited and each and every Operator or in relation to obligations relevant to them, other users using the facilities at the airport other than as passengers.

Condition 2.1.3 of the Conditions of Use (Variation)

- 2.1.3 Gatwick Airport Limited may at its sole discretion vary amend or add to these Conditions of Use and any such variation, amendment to, or addition may be promulgated by means of a GAD save that no variation which has effect before 1st April 2021 may be made to the following Conditions and Schedules:

Condition 1.1.23 (Term)

This Condition 2.1.3 (Variation)

Conditions 2.1.12-2.1.21 (Dispute Resolution)

Condition 5 (Price Commitment)

Condition 6 (Service Standard Commitment)

Condition 7 (Continuity of Service and Financial Resilience Commitment)

Condition 8 (Investment and Consultation Commitment)

Condition 9 (Financial Information Commitment)

Schedules 2, 3 and 4 other than in accordance with the variation provisions contained in paragraph 6 of Schedule 2 and in paragraph 5 of Schedule 3.

Conditions 2.1.11-2.1.20 of the Conditions of Use (Dispute Resolution Procedure)

- 2.1.11 Either party may refer any Dispute to an Expert for determination by serving notice in writing to that effect on the other party. The notice shall contain sufficient particulars of the Dispute to be referred to an Expert.
- 2.1.12 The parties shall agree the identity of the Expert to be appointed. In default of agreement, within ten working days of the date of service of a notice referring a Dispute to an Expert for determination, the Expert shall be appointed on the application of any party to the President of the Law Society or the Chairman of the Bar Council.
- 2.1.13 The Expert shall not act as an arbitrator and the provisions of the Arbitration Act 1996 shall not apply.
- 2.1.14 The Expert shall determine the Dispute referred to him impartially and acting reasonably. The Expert will establish the procedural rules to be applied to the determination which must include the following steps:
- 2.1.14.1 each party will be entitled to make submissions to the Expert;
- 2.1.14.2 the Expert may request any party to provide him with any further information as he may require in order to determine the Dispute provided any such information is made available to the other party to comment;
- 2.1.14.3 all communications between a party and an Expert shall be copied to the other party;
- 2.1.14.4 any failure by a party to respond to any request or direction by the Expert shall not invalidate the Expert's determination.
- 2.1.15 Unless a shorter period is agreed between the parties at the time of the Expert's appointment, a fully reasoned written determination must be delivered to the parties within 21 working days of the Expert's appointment.
- 2.1.16 The fees and expenses of the Expert shall be borne by the parties in equal shares unless the Expert determines otherwise. Each party

shall be solely responsible for bearing its legal and other costs arising out of any reference of a Dispute to an Expert.

- 2.1.17 Any decision of the Expert shall be binding until the Dispute is finally determined by legal proceedings or by agreement.
- 2.1.18 Neither party shall make any application to a competent court in relation to the conduct of the determination or the Expert's determination or the Dispute after ninety days from the date of the Expert's determination or, in the event the Expert has failed to reach a decision, the date on which the Expert should have reached a determination.
- 2.1.19 The dispute resolution procedure set out in Conditions 2.1.12 to 2.1.18 above is without prejudice to, and does not impact upon, Gatwick Airport Limited's right to exercise its power to detain aircraft for the non-payment of Airport charges, pursuant to the Civil Aviation Act 1982. Gatwick Airport Limited may at all times exercise that power without recourse to this dispute resolution procedure
- 2.1.20 Subject to clause 2.1.18 the dispute resolution procedure set out in Conditions 2.1.10 to 2.1.18 above shall not prevent either party from applying to a competent court for relief.

Condition 5 of the Conditions of Use (Price Commitment)

- 5.1 Gatwick Airport Limited agrees to comply with the price commitments set out in Schedule 2 throughout the Term.

Condition 6 of the Conditions of Use (Service Standard Commitment)

- 6.1 The Airline Service Standards are set out in Appendix II to Schedule 3. An Operator that has not met the applicable Airline Service Standards Target Level as set out in Appendix II to Schedule 3 will have its entitlement to Core Service Rebates reduced, in accordance with paragraph 3 of Schedule 3.
- 6.2 The Core Service Standards are set out in Appendix I to Schedule 3.
- 6.3 The Core Service Rebate is the amount payable by Gatwick Airport Limited to Operators paying Core Service Charges for commercial

passenger services operated under the Conditions of Use or similar charges for commercial passenger services under the terms of Bilateral Contracts where the application of the Core Service Standards have not been waived or replaced ("Qualifying Operators"), for a failure by it to meet the Core Service Standards Rebate Level as set out in Appendix I to Schedule 3 and calculated in accordance with Schedule 3 paragraphs 1 and 2. In any Relevant Year the Service Rebate Percentage shall not exceed 7% of revenue from Core Service Charges payable by Qualifying Operators in that year.

- 6.4 The Core Service Rebate shall be paid quarterly, within one month of the end of each quarter (being June, September, December, March). The rebates shall be calculated by terminal (with the exception of airfield availability which will be calculated at an airfield level and the same percentage applied to both terminals) by month and allocated to the Operators that used the terminal pro-rata with the Core Service Charges payable in that month.
- 6.5 Rebates payable within a relevant year will be based on a forecast of Core Service Charges revenue for that year, for each terminal. To the extent that actual revenues differ from forecast revenues, rebates will be recalculated and under- or over- payments of rebate will be reconciled and paid or invoiced (as appropriate) within 1 month of the publication by Gatwick Airport Limited of its annual report & accounts.

Condition 7 of the Conditions of Use (Continuity of Service Plan, Operational and Financial Resilience)

- 7.1 Gatwick Airport Limited shall prepare and at all times maintain a continuity of service plan. The plan shall describe such legal, regulatory, operational and financial information that an administrator, receiver, or new management might reasonably be expected to require, in addition to the aerodrome manual and other statutory or regulatory documents which Gatwick Airport Limited is required to maintain, in order for it to efficiently carry out its functions and to remain compliant with its aerodrome licence. Gatwick Airport Limited shall supply such continuity of service plan to the CAA by 1 October 2014 and shall make such reasonable amendment to the form, scope and content of the plan as the CAA may reasonably require. Gatwick

Airport Limited shall provide the CAA with details of any material variations to the continuity of service plan.

- 7.2 Gatwick Airport Limited will develop and maintain an operational resilience plan which will set how it intends to operate an efficient and reliable airport to the levels required by the Core Service Standards or otherwise agreed with users and, in particular, how it will secure the availability and continuity of airport operation services, particularly in times of disruption. Gatwick Airport Limited will consult annually on the resilience plan with all interested parties including the CAA.
- 7.3 In pursuance of the above obligation Gatwick Airport Limited will by 1 October 2014 publish one or more plan(s) or other documents setting out the principles, policies and processes by which it will comply with Condition 7.2. Such plans and any amendments will have regard to any relevant guidance issued by the CAA.
- 7.4 Prior to publishing any plans or other documents under Condition 7.2 Gatwick Airport Limited shall consult all relevant parties on those plans or documents in a fair and timely manner providing consultees with an adequate level of information.
- 7.5 Gatwick Airport Limited shall so far as is reasonably practicable coordinate and cooperate with all relevant parties at the airport to meet the requirements of this operational resilience commitment and shall at least twice a year hold a meeting to which all relevant parties or organisations representing them shall be entitled to attend to discuss any issues pertinent to this operational resilience commitment.
- 7.6 All providers of air transport services and ground handlers shall use best endeavours to cooperate with Gatwick Airport Limited in implementing the plan(s).
- 7.7 During periods of service disruption Gatwick Airport Limited shall use reasonable endeavours to coordinate the communication of operational information and to ensure the provision of timely, accurate and clear information about its operations to users of air transport services as well as information as to their rights under denied boarding regulations.
- 7.8 The Directors of Gatwick Airport Limited will provide an annual confirmation of adequate financial resources to operate the airport and provide the Core Services; and

- 7.9 Gatwick Airport Limited shall not amend, vary, supplement or modify or concur in the amendment, variation, supplementation or modification of any of its finance documents in respect of credit rating requirements (whether in each case in the form of a written instrument, agreement or document or otherwise (a “Variation”) unless it has given prior written notice thereof to the CAA. Gatwick Airport Limited shall, as soon as reasonably practicable notify the CAA of the possibility of any such Variation; and provide a summary of the executed change. The provisions of this Condition shall not apply to any administrative or procedural variation.

Condition 8 of the Conditions of Use (Investment and Consultation Commitment)

- 8.1 Gatwick Airport Limited shall maintain the airport to comply with all applicable safety and environmental requirements and to maintain and develop the infrastructure of the airport to enable the Core Service Standards to be met. In complying with the immediately preceding obligation Gatwick Airport Limited shall invest at least £700m (Seven Hundred million pounds) during the Term.
- 8.2 Gatwick Airport Limited will undertake consultation in relation to the capital investment to be undertaken during the Term in accordance with the provisions of Schedule 4.

Condition 9 of the Conditions of Use (Financial Information Commitment)

- 9.1 To ensure there continues to be the provision of sufficient information for Operators to understand whether charges are reasonable, Gatwick Airport Limited will ensure that throughout the Term it provides either through its statutory accounts or through a separate audited statement a level of disclosure in relation to operating costs, revenues, fixed asset base, depreciation and capital expenditure equivalent to the level of disclosure in its statutory accounts for the year ended 31 March 2012.
- 9.2 During each year of the Term Gatwick Airport Limited shall publish a statement of its assessment of the value of its asset base. This will set out the underlying assumptions and calculations, including: the initial

asset based (carried forward from the end of the prior year); depreciation; additions; disposals; indexation factors; other adjustments that may be relevant; and the closing asset base (carried forward to the start of the next year).

Schedule 2 to the Conditions of Use: Price Commitment

- 1 For the purposes of this Schedule, the following definitions apply:
 - 1.1 'Aggregate Blended Revenue' or 'R_t' is the sum in a Relevant Year of:
 - 1.1.1 revenue arising from Core Service Charges and Selected Ancillary Service Charges for relevant commercial passenger services operated under the terms of the published airport tariff set out in the Conditions of Use; and
 - 1.1.2 revenue arising from charges equivalent to the Core Service Charge and Selected Ancillary Service Charges for relevant commercial passenger services operated under the terms of Bilateral Contracts but excluding revenue from any other charges not included within the definition of Core Service Charges or Selected Ancillary Service Charges whether levied under the terms of these Conditions or under the terms of Bilateral Contracts or separate commercial arrangements.
 - 1.2 'Aggregate Core Revenue' or 'T_t' means the sum in a Relevant Year of:
 - 1.2.1 revenue arising from Core Service Charges and Selected Ancillary Service Charges for relevant commercial passenger services operated under the terms of the published airport tariff set out in the Conditions of Use; and
 - 1.2.2 revenue arising from charges equivalent to the Core Service Charge and Selected Ancillary Service Charges for relevant commercial passenger services operated under the terms of Bilateral Contracts, but substituting for the actual revenue received the revenue that would have been received if such services had been offered and charged under the terms of the Schedule of Charges set out in the then applicable Conditions of Use but excluding revenue from any other charges not included within the

definition of Core Service Charges or Selected Ancillary Service Charges whether levied under the terms of these Conditions or under the terms of Bilateral Contracts or separate commercial arrangements.

- 1.3 'Bilateral Contracts' means any contract relating to Airport Charges payable between an Operator and Gatwick Airport Limited other than the Conditions of Use.
- 1.4 'Core Services' means such services and facilities in connection with the landing, parking or taking off of aircraft at the airport as were provided as at 1st April 2013 in consideration of charges, whether specifically referable to such services or facilities or not, levied under Appendix I (Schedule of airport charges) of the Gatwick Airport Conditions of Use effective from 1st April 2013 including those charges determined by reference to number of passengers on board the aircraft, any separate charge for aerodrome navigation services and charges levied on aircraft passengers with their arrival at, or departure from, the airport by air. Services or facilities which would have been provided for such charges as at 1st April 2013 but for the facility or service being unserviceable or subject to refurbishment shall fall within the definition of Core Services.
- 1.5 'Core Service Charges' means those charges referred to in Appendix I of the Schedule of Charges as may be varied from time to time with the exception of any charges levied in respect of whole plane cargo flights, positioning flights and general and business aviation.
- 1.6 'Core Yield' means the Aggregate Core Revenue divided by the total number of Passengers using the airport in any Relevant Year.
- 1.7 'Blended Yield' means the Aggregate Blended Revenue divided by the total number of Passengers using the airport in any Relevant Year.
- 1.8 'Cumulative Gross Revenue Difference' or 'CGRD_t' is calculated as follows:

$$\text{CGRD}_t = (T_t - Q_t \cdot \text{GY}_t) + \text{CGRD}_{t-1} (1 + I_{t-1}) \text{ and where } \text{CGRD}_{2013/14} = 0$$

- 1.9 'Cumulative Net Revenue Difference' or 'CNRD_t' is calculated as follows:

$$\text{CNRD}_t = (R_t - Q_t \cdot \text{NY}_t) + \text{CNRD}_{t-1} (1 + I_{t-1}) \text{ and where } \text{CNRD}_{2013/14} = 0$$

- 1.10 'Indicative Net Yield Profile' for a Relevant Year or 'NY_t' is calculated as follows:

$$\text{NY}_t = U_t + S_t$$

- 1.11 'Indicative Gross Yield Profile' for a Relevant Year or '(GY_t)' is defined as:

$$\text{GY}_t = W_t + S_t$$

- 1.12 'I_{t-1}' means the annual percentage interest rate equal to the sum of:

- 1.12.1 the average of the UK Treasury Bill Discount Rate (expressed as an annual percentage interest rate) published weekly by the Bank of England, during the 12 months from the beginning of September in t-1 to the end of August in the Relevant Year; and
- 1.12.2 if the CNRD_{t-1} or the CGRD_{t-1} to which the indexation rate is being applied has a positive value, 3%, otherwise, 0%.

- 1.13 Selected Ancillary Service Charges means charges for other services provided by Gatwick Airport namely;

- Staff ID
- airside licences
- FEGP (net of the cost of electricity)
- Airside Parking
- Hydrant Refuelling

- 1.14 'Q_t' means the total number of Passengers using the airport in a Relevant Year.

- 1.15 'Relevant Year' or 't' means the period of twelve months ending on 31 March in each year and 't-1' means the year immediately preceding 't'.

- 1.16 'RPI_{t-1}' means the percentage change (positive or negative) in the RPI All Items Index (CHAW): Jan 1987=100 published by Office for National Statistics between August in year t-1 and the immediately preceding August.
- 1.17 'S_t' means the permitted security cost per passenger in relevant year t, if any, being:
- the aggregate of:
- 1.17.1 90% of the amount by which the increase, or decrease, in security costs at the airport in year t, which arise as a result of a change in required security standards at the airport, exceeds £1.75m; and
- 1.17.2 the cost of installing new hold baggage screening equipment in order to meet the requirements of the Department for Transport, the European Commission or other aviation security regulator consulted on by Gatwick Airport Limited in accordance with the capital investment programme consultation process. The cost in year t will be calculated by amortising the capital costs and associated funding costs over the assessed life of the equipment, in equal annual amounts.
- divided by (Q_t):
- 1.18 'U_t' is the underlying net yield in Relevant Year t, calculated as follows:
- $$U_t = U_{t-1} (1 + RPI_{t-1}) \text{ where } U_{2013/14} = \text{£ } [8.894]$$
- [Airports Charges yield uplifted to include yield from Selected Ancillary Service Charges]
- 1.19 'W_t' is the underlying gross yield in Relevant Year t, defined as:
- $$W_t = W_{t-1} (1 + RPI_{t-1} + 1\%)$$
- and,
- $$W_{2013/14} = U_{2013/14}$$

- 2 The amount by which the actual Core Yield differs from the Indicative Gross Yield Profile in a Relevant Year will generate a revenue difference which, over the course of the Term, will give rise to the Cumulative Gross Revenue Difference (CGRD_t). Gatwick Airport Limited shall ensure that the Cumulative Gross Revenue Difference does not exceed:
 - 2.1 £10 million in any Relevant Year during the Term; and
 - 2.2 nil at the end of the Term.
- 3 The amount by which the actual Blended Yield differs from the Indicative Net Yield Profile in a Relevant Year will generate a revenue difference which, over the course of the Term, will give rise to the Cumulative Net Revenue Difference (CNRD_t). Gatwick Airport Limited shall ensure that the Cumulative Net Revenue Difference does not exceed nil at the end of the term.
- 4 The Indicative Net Yield Profile and the Indicative Gross Yield Profile represent the intended yield profiles of Gatwick Airport Limited in setting the Core Service Charges. They are indicative only and actual yield profiles may vary due to unanticipated circumstances, deliberate business decisions including responses to market conditions or to adjust for prior year under or over recoveries.
- 5 GAL shall set the Core Service Charge in any Relevant Year with the intent that the Core Yield in that year shall not exceed the Core Yield in the prior year by more than RPI + 10% unless it is required to do so to attain a CGRD_{2020/21} equal to zero.
- 6 Any amendment to the Indicative Gross Yield Profile may be made by Gatwick Airport Limited if:
 - 6.1 consent to that amendment is given in writing by:
 - 6.1.1 Operators carrying at least 67% of passengers (in the 12 months immediately preceding the date on which Gatwick Airport Limited notified Operators of the proposed amendment to the Indicative Gross Yield Profile) on airlines operating at the airport paying the Core Service Charge or under Bilateral Contracts (where such contracts adopt the airport tariff as a reference price index) and
 - 6.1.2 by Operators representing at least 50% of the Operators responding in writing; or

- 6.2 following the completion of the work of the Airports Commission the Government supports the development of a second runway at Gatwick Airport, to allow for the recovery of the reasonable costs (capital, operating and financing) of applying for planning permission for a second runway and the subsequent development of the second runway and associated airport infrastructure. Any amendment to the Gross Yield Profile for recovery of such costs will follow any policy guidance that may be issued by the CAA in relation to the recovery of costs of new runway development for price regulated airports.
- 7 When undertaking the annual consultation on airport charges, Gatwick Airport Limited will publish the Cumulative Gross Revenue Difference and the Cumulative Net Revenue Difference for prior years updating using actuals data when available), and estimates of the Cumulative Gross Revenue Difference and the Cumulative Net Revenue Difference for the current year and the following year (including underlying assumptions and estimated data).
- 8 Gatwick Airport Limited shall notify the CAA and all Operators at the airport at least 2 years prior to the end of the Term of its intention with regards to the continuation of commitments, if any, on pricing, service standards, continuity of service, operational and financial resilience, investment consultation and financial information.
- 9 Gatwick Airport Limited shall make available Core Services to all Operators at the Core Service Charges rate as amended from time to time.
- 10 Subject to complying with paragraph 9 above Gatwick Airport Limited may offer enhancements or additions to the Core Services either under Bilateral Contracts or at charges separate from the Core Service Charges.

Schedule 3 Service Commitments

1. The Core Service Rebate to Qualifying Operators in the aggregate in month 'j' shall be calculated as:

$$\text{Core service rebate}_{T-j} = \text{Service Rebate Percentage}_{T-j} \times \text{Annual Core Service Charge}_T$$

Where:

Annual Core Service Charge_T =

in respect of terminal 'T', in relevant financial year ending 31 March, the annual revenue arising from Core Service Charges or equivalent charges under Bilateral Contracts for relevant commercial passenger services operated by Qualifying Operators under the terms of the published airport tariff set out in the Conditions of Use.

The rebate by each terminal will be allocated to Qualifying Operators that used the terminal pro-rata with the Core Service Charges or equivalent charges under Bilateral Contracts payable by each Qualifying Operator in relation to that terminal in that month. The deduction to be made from this rebate amount if a Qualifying Operator fails to meet airline standards will be calculated as:

$$\text{Deduction from Core Service Rebate}_{a,T,j} = \text{Airline Standard Reduction Percentage}_{a,T,j} \times \text{Core Service Charge}_{a,T,j}$$

For the avoidance of doubt, the deduction only operates to reduce the Core Service Rebate (if any) payable by GAL to a Qualifying Operator; it cannot result in a payment due from the Qualifying Operator to GAL.

2. The Service Rebate Percentage in month 'j' for each terminal 'T' shall be calculated as follows:

$$\text{Service Rebate Percentage}_{T,j} = \sum 2 \times (p_{i,T} / 12) \times (x_{i,T,j})$$

standard i

Where:

$p_{i,T}$ = the maximum potential Core Service Standard rebate percentage for standard 'T', for terminal 't', as set out in Appendix 1 to this Schedule, if the standard 'i', for terminal 'T', in month 'j' is greater than or equal to the Core Service Standard rebate level, as set out in Appendix 1 to this Schedule then $x_{i,T,j} = 0$ if the standard 'i', for terminal 't', in month 'j' is less than the Core Service Standard rebate level, as set out in Appendix 1 to this Schedule, then $x_{i,T,j} = 1$ or, 1.25, in relation only to Selected Passenger Facing Measures, if the relevant standard "i", for terminal "T", in months 'j' and in each of the six immediately preceding months (i.e. 'j-1', 'j-2', 'j-3', 'j-4', 'j-5', 'j-6') is or was less than the Core Service Standard rebate level, as set out in Appendix I to this Schedule 3. Provided that the maximum aggregate Service Rebate Percentage payable in relation to all Selected Passenger Facing Measures shall not exceed 2.85% in any financial year ending 31

March; or 0, if prior to month 'j' there have been any six or more months in a relevant financial year ending 31 March in which the standard 'i', for terminal 'T' was less than the service rebate level, as set out in Appendix 1 to this Schedule. This provision applies in precedence to, and overrides, the provisions above providing for the calculation of $x_{i,T,j} = 1$ or 1.25

For the purposes of this calculation, the Selected Passenger Facing Measures comprise: Departure Lounge Seat Availability; Cleanliness; Way-Finding; Flight Information; Central Passenger Search (times < 5 minutes, times < 15 minutes); Passenger Sensitive Equipment (General); Passenger Sensitive Equipment (Priority); and Arrivals Reclaim (Baggage Carousels).

3. Airline Standard Reduction Percentage for each airline "a" shall be calculated as:

$$\text{Airline Standard Reduction Percentage}_{a,T,j} = \sum \text{standard } k \text{ } r_{k,T} \times Z_{a,t,j,k}$$

Where:

$r_{k,T}$ = the potential Airline Service Standard Reduction Percentage per month for standard 'k', for terminal 'T', as set out in Appendix II to this Schedule.

$Z_{a,t,j,k}$ = 0 if the standard 'k', for terminal 'T', in month 'j' is greater than or equal to the Airline Service Standard Target Level, as set out in Appendix II to this Schedule; or

1 if the standard 'k', for terminal 'T', in month 'j' is less than the Airline Service Standard Target Level, as set out in Appendix II to this Schedule.

4. Gatwick Airport Limited shall be under no obligation to pay the Core Service Rebate to an Operator which has failed to pay Gatwick Airport Limited any amounts due and owing under these Conditions of Use.

Amendment

5. Any amendment to the Airline Service Standards or the Core Service Standards may be made by Gatwick Airport Limited following consultation with the Gatwick Airline Operators Committee and the

Gatwick Airport Consultative Committee if consent to that change is given in writing by:

- 5.1 Operators carrying at least 67% of passengers (in the 12 months immediately preceding the date on which Gatwick Airport Limited notifies Operators of the proposed amendment) travelling through the airport on airlines operating at the airport paying the Core Service Charge or operating under Bilateral Contracts which have not waived or replaced these Core Service Standards provisions and by
- 5.2 by Operators representing at least 50% of the Operators responding in writing.

Monitoring

6. Gatwick Airport Limited shall monitor and publish on the Gatwick Airport website and in the terminals a monthly report in relation to certain airport-wide activities including:
 - 6.1 The Core Service Standards
 - 6.2 The Airline Service Standards
 - 6.3 PRM service and notification
 - 6.4 On-time performance (departures and arrivals)
 - 6.5 Immigration performance; and
 - 6.6 ACI Airport Service Quality ranking.
7. If Gatwick Airport Limited fails to meet any Core Service Standard for any six consecutive months it will prepare an improvement plan to address the failure and will consult with the Gatwick Airline Consultative Committee and the CAA on its proposals and will then implement the improvement plan.

Schedule 3 Appendix I Core Service Standard (Rebates)

	Standard "i"	Metric	Rebate level		Maximum potential rebate (both terminals, unless noted)
(i)	Passenger satisfaction measures				0.80%

	Standard "I"	Metric	Rebate level		Maximum potential rebate (both terminals, unless noted)
1	Departure Lounge Seat Availability		3.8		0.20%
2	Cleanliness	Moving Average QSM Score	4.0		0.20%
3	Way-Finding		4.1		0.20%
4	Flight Information		4.2		0.20%
(ii)	Security				
5	Central Passenger Search	Times <5 Minutes and Times ≤15 Minutes	95% 98%		1.0%
6	Central Passenger Search*	Day when single time slice >30 Minutes	Single event per day		(0.05% per day) (0.7% max per month)
7	Transfer Passenger Search	Times <10 Minutes	95%		0.20%
8	Staff Search (Terminals and Crew)	Times <5 Minutes	95%		0.35%
9	External Control Posts Search	Times <15 Minutes	95%		0.35%
(iii)	Passenger operational measures				1.05% (ST) 1.55% (NT)
10	Passenger Sensitive Equipment (General)	% Time Available	99%		0.05%
11	Passenger Sensitive Equipment (Priority)	% Time Available	99%		0.50%
12	Inter Terminal Shuttle System	% Time 1 Car Available and 5 Time 2 Cars Available	99% 97%		0.50% (NT)
13	Arrivals Reclaim (Baggage Carousels)	% Time Available	99%		0.50%
(iv)	Airline operational measures				1.60%
14 a	Outbound Baggage	OBP** Daily	TBA		TBA

	Standard "i"	Metric	Rebate level		Maximum potential rebate (both terminals, unless noted)
14 b	Outbound Baggage	OBP** Monthly	99%		0.70%
15	Stands	% Time Available	99%		0.05%
16	Jetties	% Time Available	99%		0.30%
17	Pier Service	Moving annual average % passengers pier served	tbd		0.50%
18	Fixed Electrical Ground Power	% Time Available	99%		0.05%
(v)	Aerodrome congestion term				0.70%
19	Airfiled congestion / availability	[maximum cumulative movements deferred following a material event which has a material impact]	>3**		0.70%
	Total				7.25% (NT) 6.75% (ST)

* In a day when the single time slice is greater than 30 minutes the maximum daily penalty is 0.05% with a maximum monthly penalty of 0.70%

** Refer to Gatwick Airport Core Service Standards Handbook for detail.

Calculation of the passenger satisfaction measures, the security queues, the Passenger operational measures and the Airline operational measures shall be undertaken in accordance with the "Gatwick Airport Core Service Standards Handbook" annexed to these Conditions which may be amended from time to time by agreement between Gatwick Airport Limited, the Gatwick Airline Operators Committee and the Gatwick Airport Consultative Committee.

CAA addition: TBA/tbd - to follow through self modification process or modification under section 22 of the Act.

Schedule 3 Appendix II – Airline Service Standards

Standard “k”	Metric	Target Level	Reduction Percentage
Check-in performance - queue time	Times <30 Minutes	95%	1.0%
Arrivals bag performance - last bag on carousel	Times <50 Minutes (long-haul) Times < 35 Minutes (short-haul)	95%	0.50%

Calculation and measurement of the Airline Service Standards will be undertaken in accordance the “Gatwick Airport Airline Service Standards Calculation Guide” annexed to these Conditions which may be amended from time to time by agreement between Gatwick Airport Limited, the Gatwick Airline Operators Committee and the Gatwick Airport Consultative Committee.

Schedule 4 (Capital Investment Consultation)

1. Definitions

For the purposes of this Schedule the following definitions apply:

- 1.1 ‘Major Development Projects’, means those individual projects or individual programmes of projects in excess of £10m (excluding the Asset Stewardship Programme) and the Second Runway Project;
- 1.2 ‘Minor Development Projects’ means those individual projects or individual programmes of projects less than £10m (excluding both the Asset Stewardship Programme and Second Runway Project); and
- 1.3 ‘Asset Stewardship Programme’ means all asset maintenance and replacement projects in the following asset groups: Airfield, Commercial, IT, Facilities and Compliance/Risk.
- 1.4 ‘Commercial Return Project’ is any project with associated commercial revenues that has a positive Net Present Value not taking into account incremental Airport Charges.
- 1.5 ‘A Dedicated Airline Project’ is a project undertaken for the benefit of one or more specified airlines and which is remunerated by a separate

commercial arrangement or specific airport charge payable by users of the project

1.6 'ACC' means the Gatwick Airport Consultative Committee

2. Airline consultative groups

2.1 Consultation with the airlines will need to be undertaken at a number of different levels, with groups formed appropriately:

2.1.1 ACC: to consider strategic matters involving the medium- to long-term development of the airport;

2.1.2 Capital sub-committee of ACC: to consider tactical matters involving the delivery by GAL of the capital development programme; and

2.1.3 Working groups (informal and formal): to consider operational impacts of projects on the day-to-day activities of the airlines operating at the airport. These working groups (where required) will be project specific, involve affected airlines, and may require a formally constituted working group for significant projects requiring a high degree of airline input into the design and execution planning (e.g. check-in transformation).

3. Master Plan

Before publishing a revised Master Plan for the Airport GAL will consult with Operators and the ACC as well as other business partners and the local community.

4. Capital Investment Programme

4.1 GAL will publish annually a rolling five year Capital Investment Programme (CIP). Before publishing the CIP GAL will consult with the ACC and with the Gatwick Passenger Advisory Group such consultation to address:

4.1.1 the principal business drivers behind the airport's development strategy, including service levels;

4.1.2 forecast traffic demand and associated demand for airport capacities and services;

4.1.3 the capacities that the airport intends to provide, taken in the context of forecasted demand; and

- 4.1.4 the cost of the capital investment programme, and the resulting effect on the asset base of the airport.
- 4.2 The forecast cost of the capital investment programme will:
 - 4.2.1 summarise expenditure on each of the Major Development Projects;
 - 4.2.2 summarise aggregate expenditure on the Asset Stewardship Programme (across all five elements);
 - 4.2.3 summarise aggregate expenditure on Minor Development Projects;
 - 4.2.4 be at a level of detail that reflects the planning horizon and Tollgate status for projects, with those in the short-term being more granular and certain than those in the final years of the forecast; and
 - 4.2.5 provide an explanation as to any material differences between the latest forecast and both the prior year forecast and the forecast incorporated in the CAA's [2014 price control review].

5. Individual Major Development Project consultation

- 5.1 As part of the annual Capital Investment Programme consultation with the ACC, GAL will consult with airlines in relation to Major Development Projects (with the exception of Commercial Return Projects and Dedicated Airline Projects) covering:
 - 5.1.1 high-level options for the development of Major Development Projects and the trade-offs involved between alternatives;
 - 5.1.2 the outputs that are expected to be delivered in terms of service, capacity, operating cost, and revenue;
 - 5.1.3 scope, programme and cost of the project required to deliver the business objectives; and
 - 5.1.4 the business case for the project.
- 5.2 GAL will consult with the Capital sub-committee of the ACC in relation to the Major Development Projects at Tollgate 2, Tollgate 3, and Tollgate 4. This will require meetings on a more frequent basis than annually.
- 5.3 Following Tollgate 4, progress with the delivery of Major Development Projects will be reviewed by the Capital sub-committee of the ACC as part of its annual Capital Investment Performance Review (see below).

- 5.4 GAL will consult with the Gatwick Passenger Advisory Group in relation to Major Development Projects at appropriate times in the life cycle of such projects.
- 5.5 In this paragraph 5 of Schedule 4:
- 5.5.1 Master Plan refers to the plan prepared by GAL detailing how it intends to take forward its strategic framework in the form of airport specific proposals, designed to help inform the regional and local planning processes and facilitate engagement with a wide range of stakeholders and
- 5.5.2 Tollgates 2,3 and 4 respectively refer to the launch, design and deliver tollgate stages of GAL's current project development process or the similar stages of any revised process that GAL may adopt.

6. Annual Capital Investment Performance Review

- 6.1 GAL will meet annually with the Capital sub-committee of the ACC and members of the Gatwick Passenger Advisory Group to review GAL's delivery of the Capital Investment Programme, specifically:
- 6.1.1 in relation to the following 12 months:
- 6.1.1.1 the schedule and expenditure for each Major Development Project;
- 6.1.1.2 the priorities and aggregate expenditure of the Asset Stewardship Programme across each of the five broad elements (separately identifying individual projects in excess of £1m).
- 6.1.1.3 the expenditure on Minor Development Projects (separately identifying individual projects in excess of £1m).
- 6.1.2 in relation to the preceding 12 months, works undertaken and progress with:
- 6.1.2.1 each Major Development Project;
- 6.1.2.2 Minor Development Projects (separately identifying individual projects in excess of £1m); and
- 6.1.2.3 Asset Stewardship Programme across each of the five broad elements (separately identifying individual projects in excess of £1m).

Annex to the Conditions of Use (the Gatwick Airport Core Service Standards Handbook)

CAA addition: To follow through self modification process or modification under section 22 of the Act.

APPENDIX L

Glossary

Abbreviations	
1982 Act	Civil Aviation Act 1982
1996 Act	Housing Grants Construction and Regeneration Act 1996
AA86	Airports Act 1986
ACC	Airline Consultative Committee
ACL	Airport Coordination Limited
ACRs	Airport Charges Regulations
ACTM	Airport Commerce and Talent Management
AGRs	Airports (Groundhandling) Regulations 1997
AMD	archway metal detectors
ANS	air navigation services
AOC	Airline Operators Committee
ASA	Alan Stratford and Associates
ASQ	Airport Service Quality
ATCO	air traffic control officer
ATMs	air transport movements
BAA	BAA plc
BA	British Airways
BoE	Bank of England
capex	capital expenditure
CAT	Competition Appeal Tribunal
CC	Competition Commission
CE	Constructive Engagement
CEPA	Cambridge Economic Policy Associates
CF	Consensus Forecasts
CIP	capital investment programme
CL	Compass Lexicon

Abbreviations	
CMA	Competition and Markets Authority
COPI	construction price inflation
COU	Conditions of Use
CSP	continuity of service plan
DB	defined benefit
DC	defined contribution
DDA	Disabled Discrimination Act
DfT	Department for Transport
DL	Davis Langdon
DNOs	distribution network operators
EBITDA	earnings before interest, taxes, depreciation and amortization
EE	Europe Economics
EU	European Union
EU261	Regulation (EC) 261/2004
FE	First Economics
FEGP	fixed electrical ground power
FFO	funds from operations
FP	final proposals
FTE	Full Time Equivalent
FTI	FTI Consulting LLP
FV	final view
GAD	Government Actuary's Department
GAL	Gatwick Airport Limited
Gatwick	Gatwick airport
GDP	Gross Domestic Product
HAL	Heathrow Airport Limited
HBS	hold baggage screening
IATA	International Air Transport Association
IBP	initial business plan
ICR	adjusted interest cover
IDL	International Departures Lounge

Abbreviations	
IDS	IDS Thomson Reuters
IP	initial proposals
JSG	Joint Steering Group
LCCs	low cost carriers
LECG	LECG Corporation
LF	Leigh Fisher
LGW	London Gatwick Airport
Licensee	Gatwick Airport Limited
LRAIC	long-run average incremental costs
LRIC	long-run incremental costs
MDI	Managing Director's Instructions
MEAV	modern equivalent asset value
MPD	market power determination
MPT	market power test
NATS	NATS Holdings
NERL	NATS (En Route) plc
NIE	Northern Ireland Electricity Limited
NPV	net present value
NT	North Terminal
OBR	Office of Budget Responsibility
OFT	Office for Fair Trading
ONS	Office of National Statistics
opex	operating expenditure
ORCs	other regulated charges
ORR	Office of Rail Regulation
PAG	Passenger Advisory Group
pax	passenger
PMICR	post-maintenance interest cover ratio
PPP	Purchasing Power Parity
PRM	passengers with reduced mobility
PSL	pier service level

Abbreviations	
Q5/Q5+1	the fifth quinquennium
Q6	the sixth quinquennium
RAB	regulatory asset base
RAR	regulatory asset ratio
RBB	RBB Economics
RBP	revised business plan
RPI	retail price index
S&P	Standard & Poor's
SDG	Steer Davies Gleave
SERAS	South East Regional Air Services
SH&E	ICF SH&E
SLG	SLG Economics
SMP	substantial market power
SQR	Service Quality Rebate
ST	South Terminal
STAL	Stansted Airport Limited
TDA	Tobacco Display Act
TFP	Total Factor Productivity
the Act	Civil Aviation Act 2012
the airlines	the airlines operating at Gatwick airport
UKBF	UK Border Force
URS	URS Infrastructure & Environment UK Limited
Virgin	Virgin Atlantic Airways
WACC	weighted average cost of capital
WDF	World Duty Free
WICS	Water Industry Commission for Scotland