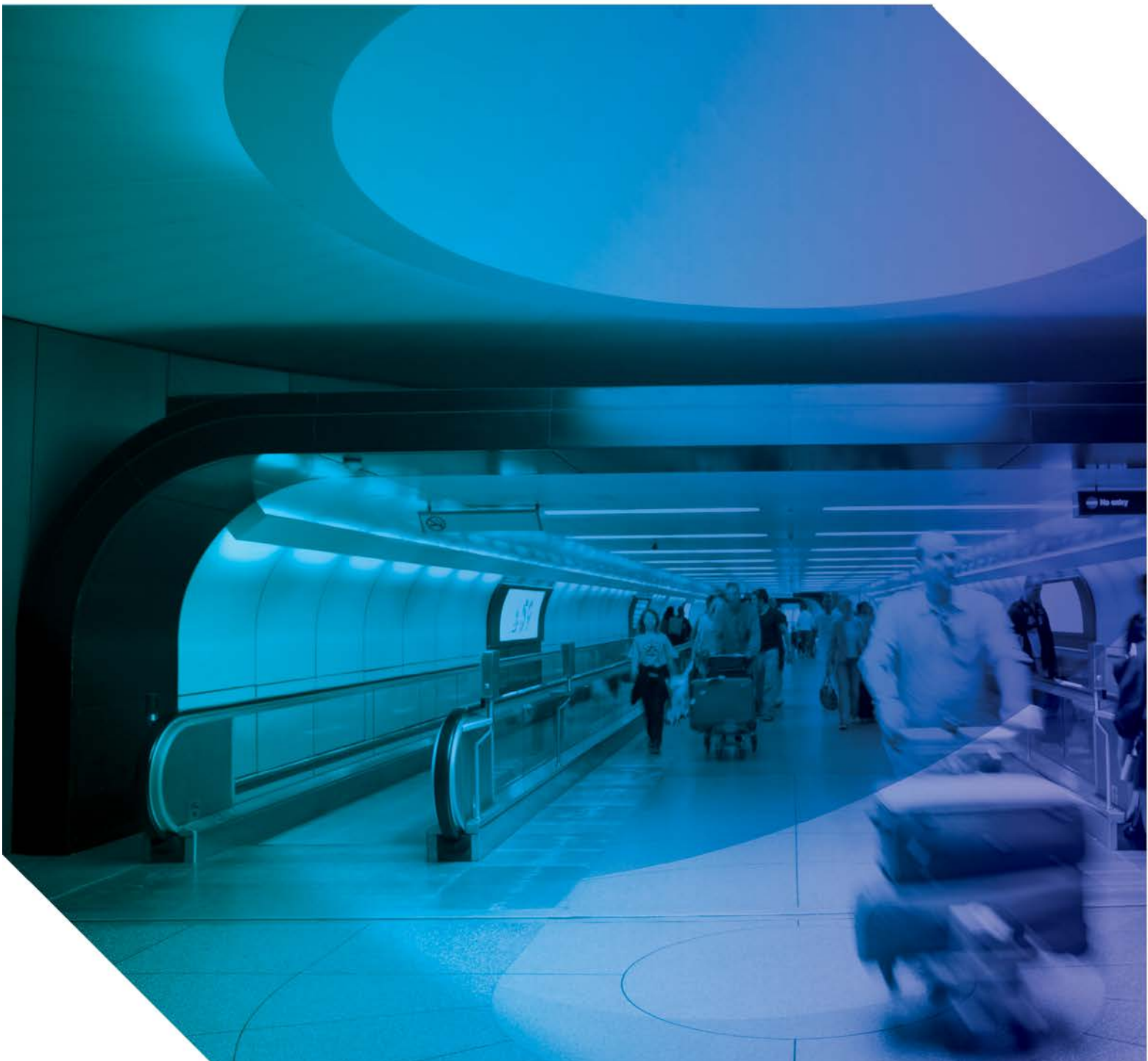


Future economic regulation of Gatwick Airport Limited: initial consultation

CAP 1684



Published by the Civil Aviation Authority, 2018

Civil Aviation Authority,
Aviation House,
Gatwick Airport South,
West Sussex,
RH6 0YR.

You can copy and use this text but please ensure you always use the most up to date version and use it in context so as not to be misleading, and credit the CAA

First published June 2018

Revised August 2018 to include extended response deadline.

Enquiries regarding the content of this publication should be addressed to: stuart.holder@caa.co.uk

The latest version of this document is available in electronic format at www.caa.co.uk

Contents

Contents	3
About this document	5
Views invited	5
Executive summary	6
Introduction	6
Process and timetable	7
Protecting consumers' interests	8
Key questions for consultation and next steps	8
Our duties	8
Structure of this document	9
Chapter 1	10
Background	10
Overview of our regulation of GAL	10
Summary of our 2016 review	11
Recent trends	12
Chapter 2	14
The process and timetable for replacing the current commitments	14
Introduction	14
Possible process	14
Possible timetable	16
Views invited	18
Chapter 3	19
Protecting consumers' interests	19
Introduction	19
Identifying consumers' interests	19
Reflecting consumers' interests in the commitments	20
Views invited	22

Appendix A	23
Our duties	23
Appendix B	25
Overview of our current economic regulation of GAL	25
Our reasons for accepting GAL's commitments	27
Monitoring the commitments	27
Appendix C	29
Summary of recent developments	29
Traffic growth	29
Investment	30
Airport charges	31
Service quality	32

About this document

This consultation discusses the process and timetable for reviewing the economic regulation of Gatwick Airport Limited (GAL) and possible issues to be addressed during this process. The current regulatory arrangements are based on a set of commitments made by GAL during the course of the 'Q6' price control review that are also conditions of GAL's licence. These are due to expire in March 2021.

While we are launching this initial consultation, we are encouraging GAL and the airlines operating from Gatwick to discuss the best way forward and develop joint proposals on their preferred process for the review and, in due course, agreed proposals for new regulatory arrangements. We would consider whether any such proposals offer appropriate protection for the interests of consumers at Gatwick.

Views invited

We welcome views on all the issues raised in this document.

Please note that we have extended the original deadline for consultation responses to 28 September 2018.

Please e-mail responses to economicregulation@caa.co.uk no later than 28 September 2018. We cannot commit to take into account representations received after this extended date.

We expect to publish the responses we receive on our website as soon as practicable after the period for representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to information under section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.

If you would like to discuss any aspect of this document, please contact Stuart Holder (stuart.holder@caa.co.uk).

Executive summary

Introduction

1. In 2014, following the introduction of a new legal framework for our economic regulation of airports, we completed a market power determination for GAL. We concluded that GAL met the market power test set out in section 6 of the Civil Aviation Act 2012 (CAA12) and should therefore be regulated by means of an economic licence. We are not currently planning to carry out a further market power determination for GAL.
2. Since 2014 our economic regulation of GAL has been based on a set of commitments given by GAL during the course of the 'Q6' price control review. These cover, among other things, the maximum level of airport charges that GAL can levy over the seven years from April 2014 to March 2021, and a system of rebates if GAL misses certain service quality targets.
3. The commitments also set out the basis on which GAL will consult airlines and passenger representatives each year on its rolling investment programme and on operational resilience. This is in addition to regular multilateral consultation meetings with airlines on strategic and operational issues, and bilateral discussions between GAL and individual airlines.
4. The intention was that the commitments regime would be a proportionate and targeted approach to the economic regulation of Gatwick. By encouraging bilateral contracts it could support more targeted service offerings, better incentivise traffic growth and promote competition. All these considerations suggested that the commitments would be in the best interests of consumers.¹
5. The experience of the commitments since 2014 has included a number of positive developments at Gatwick, including stronger than expected traffic growth and generally high levels of passenger satisfaction. To date GAL has held its charges below the 'fair price' benchmark that we calculated during the Q6 review. However, on-time performance has been worse than it was in the period before 2014, particularly during peak summer periods.
6. We carried out an early review of the new regulatory framework in 2016, to consider whether any aspect was operating against passengers' interests. We found that many aspects of the framework appeared to be working well, and none of the airlines we spoke to suggested that there should be a return to the

¹ In this document we use the term 'consumers' to refer to passengers and cargo owners. This is equivalent to 'users' of air transport services as defined in the Civil Aviation Act 2012.

previous form of regulation. But we also identified some potential concerns about the progress of airfield investment projects, on-time performance and some aspects of GAL's relationships with airlines.

7. We are now seeking stakeholders' views on the process and timetable for determining the economic regulation that will apply to GAL after March 2021, and on possible issues to be addressed during this process. To allow time for the required licence modifications, we will need to reach final decisions on the new regulatory arrangements by the end of 2020 at the latest.

Process and timetable

8. As we are at the initial stage of the review there is an opportunity for the airlines and GAL to propose the process and timetable, and then to lead that process by negotiating a new set of regulatory arrangements. We would welcome a process that is both designed and implemented by agreement between the airlines and GAL.
9. Nevertheless, we have an important role to carry out to protect the interests of consumers. We will need to review any set of proposals agreed between the airlines and GAL to consider whether they are in consumers' interests. And we will need to be ready to play a more prominent role in the process if the airlines and GAL are not able to reach agreement in some areas.
10. If the process is led by negotiations between the airlines and GAL, then one possible high-level timetable is shown below. It will be important to retain flexibility so that the timetable and process can be adapted as negotiations progress. There is scope for the process to finish sooner, for example if negotiations are successful and the agreed proposals do not raise any material issues for consumers' interests.

Figure 1: A possible timetable for a process led by airline-GAL negotiations



11. We would welcome specific proposals from stakeholders (either separately or jointly) for the timetable and process to be followed for the review, bearing in

mind the backstop of the end of 2020 for us to reach a final decision on the arrangements to take forward as proposed licence modifications.

Protecting consumers' interests

12. The expiry of the current set of commitments provides a good opportunity to consider whether the framework can be refined in order to work more effectively and better promote consumers' interests. GAL has already started consulting airlines and passenger representatives on its current service quality targets and rebates. This review is welcome, and we would expect that it will be underpinned by a strong evidence base.
13. We also consider that it would be useful for there to be a wider dialogue about the services and infrastructure that GAL should be delivering for airlines and consumers, and how these should be reflected in the new regulatory arrangements. Future traffic growth could pose challenges for punctuality and other aspects of service quality. Any new regulatory arrangements are more likely to be effective if they are underpinned by a shared understanding of the most suitable way of maintaining services to consumers in such an environment.
14. In reviewing whether any agreed proposals are in consumers' interests, we will also consider whether they are likely to provide value for money for consumers. We will look to GAL to provide compelling evidence that this will be the case under a range of plausible scenarios for the next regulatory period.

Key questions for consultation and next steps

15. We are inviting views on how best to improve the current commitments, including both the timetable and process to be followed and how best we can ensure that this process protects the interests of consumers. Chapter 2 highlights key issues for consultation on the timetable and process and chapter 3 highlights key issues for consultation on how best we can protect consumers' interests.
16. Views are welcome on all these issues, including any responses jointly agreed between the airlines and GAL, or individual submissions from any stakeholder. We are also happy to meet with stakeholders to discuss issues raised in this consultation paper.
17. We expect to publish an update once we have considered the responses to this consultation in October 2018.

Our duties

18. In developing this consultation we have had full regard to our statutory duties under CAA12, which are summarised in Appendix A.

Structure of this document

19. The structure of this document is as follows:
- Chapter 1 sets out the background to this consultation, including our current regulation of GAL, our 2016 review and recent trends at Gatwick;
 - Chapter 2 describes some high-level options for the timetable and process to support the introduction of new regulatory arrangements by April 2021; and
 - Chapter 3 discusses some of the issues that we might need to take into account to best protect the interests of consumers.

Chapter 1

Background

Overview of our regulation of GAL

- 1.1 In 2014, following the introduction of a new legal framework for our economic regulation of airports, we completed a market power determination for GAL. We concluded that GAL met the market power test set out in section 6 of CAA12 and should therefore be regulated by means of an economic licence. For the avoidance of doubt, we are not currently planning to carry out a further market power determination for GAL.²
- 1.2 Following this determination and our Q6 price control review we introduced a new form of economic regulation for GAL in 2014. This is based on a set of commitments offered by GAL covering the seven years to March 2021.³
- 1.3 Although the commitments form part of GAL's Conditions of Use, they are also conditions of GAL's licence and therefore enforceable by us. Appendix B describes the commitments in more detail. In summary they include:
- a price commitment – this is based on price paths of the Retail Price Index (RPI) +0% for the average blended price (which takes accounts of discounts agreed in bilateral contracts) and RPI+1% for the average published price;
 - a service standards commitment – a system of rebates payable if GAL misses certain service quality targets;
 - continuity of service plan, operational and financial resilience – this includes an obligation to prepare and maintain plans on continuity of service and operational resilience;
 - an investment and consultation commitment – GAL will maintain the airport to comply with safety/environmental requirements and develop the infrastructure to allow it to meet service quality targets. It will invest at least £700 million during the seven years of the commitments; and

² We have discretion to carry out a market power determination whenever we consider it appropriate to do so. Interested parties can also request that we carry out a market power determination. In this case we can decide not to carry out a determination in situations where we have already made a market power determination and we consider that there has not been a material change of circumstances since then. For further details see CAP 1433, Market Power Test Guidance. Available at www.caa.co.uk/cap1433.

³ The commitments also state that GAL will notify airlines and us by 31 March 2019 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.

- a financial information commitment – GAL will ensure that it provides either statutory accounts or an equivalent audited statement to help airlines understand whether charges are reasonable.
- 1.4 The commitments also set out the basis on which GAL will consult airlines and passenger representatives each year on its rolling investment programme and on operational resilience. This is in addition to regular multilateral consultation meetings with airlines on strategic and operational issues, and bilateral discussions between GAL and individual airlines.
- 1.5 Our reasons for accepting the commitments rather than implementing a traditional price cap included that they would encourage bilateral contracts that could be better tailored to the needs of individual airlines and their passengers. This would promote more targeted service offers by GAL, incentivise volume growth and promote competition. GAL would also have greater flexibility to tailor its investment to the needs of airlines.
- 1.6 We said we would monitor some aspects of the commitments on an ongoing basis. We also said that GAL should calculate a shadow regulatory asset base in case tighter regulation needed to be reintroduced. The aspects of the commitments that we monitor include:
- the level of charges – we said we will compare GAL’s outturn blended price with the ‘fair price’ benchmark that we calculated ourselves during the Q6 review⁴;
 - service quality – we said we will undertake sufficient monitoring to allow us to identify an individual metric failing for more than six months; and
 - operational resilience – GAL is required to consult on and publish its operational resilience plan, and then to review the plan annually.

Summary of our 2016 review

- 1.7 When accepting the commitments in 2014, we also said that we would carry out a short and focused review in the second half of 2016 to ensure that the commitments, together with the licensing and monitoring framework, were operating in passengers’ interests. This represented an early health check on the new regulatory arrangements, rather than a reopening of the conclusions we reached during the Q6 review or a consideration of how GAL should be regulated after March 2021.
- 1.8 Overall we found that many aspects of the framework appeared to be working well, and none of the airlines we spoke to suggested that there should be a

⁴ Our fair price benchmark is a price path of RPI-1.6%, whereas GAL’s commitment for its blended price is a price path of RPI+0%.

return to the previous form of regulation. However, we also identified three potential areas of concern:

- while the total volume of investment each year had been close to the forecasts that underpinned our fair price benchmark, GAL had not yet expanded airfield capacity in response to stronger than expected traffic growth;
- GAL and airlines had quite different views on whether or not the resulting capacity constraints on the airfield were contributing to poor on-time performance; and
- while some airlines told us of good relationships at the commercial and strategic level, they also told us of poorer relationships at operating level and with airline representative bodies.

1.9 We did not propose any specific changes to the commitments framework. Instead, we said that we would include airfield investment projects and GAL's relationships with airlines in our ongoing monitoring of GAL's performance. We also stressed the importance of GAL making good progress with certain specific investment projects,⁵ adopting a proactive approach to identifying and addressing possible future airfield capacity constraints, and taking steps to improve its relationships with airlines, especially at operating level.

Recent trends

1.10 Appendix C summarises some of the main developments at Gatwick since the start of the current commitments in 2014. Traffic growth has been much higher than we (or other stakeholders) forecast during the Q6 review, with passenger volumes in 2017/18 being 16 per cent above our forecast. Partly in response to this strong traffic growth, GAL's investment expenditure has been higher than both our forecasts and the minimum investment set out in the commitments. There have also been some changes in the composition of the investment programme.

1.11 GAL has held its airport charges below both the level set out in the commitments and our own fair price benchmark (though the impact of strong traffic growth means that its revenues from regulated charges have been above our forecast). Many aspects of service quality have been good, with GAL missing only a small proportion of its service quality targets (and none since October 2016).

⁵ These are projects to provide additional pier capacity in the North Terminal and to accommodate passengers arriving in the South Terminal from the Common Travel Area.

- 1.12 On-time performance, which is affected by the actions of a range of stakeholders, has been worse than it was in the years before 2014.⁶ Punctuality declined in each of the first three summers of the commitments period though there was an improvement in summer 2017 which has been sustained into the first few months of 2018. GAL has continued to work with airlines and ground handlers to identify operational measures that could help to improve punctuality.
- 1.13 We expect that some of these trends may well continue in future. There is potential for further strong traffic growth if GAL can continue to increase the use of off-peak slots and attract long-haul services, and if airlines continue to increase aircraft size and/or load factors. And we expect that stakeholders will continue to face challenges in maintaining punctuality, especially in peak summer months when the airport is operating at close to full capacity and European airspace is congested. We expect GAL to play its full part in trying to improve on-time performance, including when the airport is busy.
- 1.14 In addition, we note that GAL has announced that it is planning to develop a Masterplan later this year. GAL is understood to be reviewing options including use of its northern (standby) runway or a new runway⁷.
- 1.15 Wider developments could also impact on Gatwick airport in the short and longer term. Heathrow is continuing to develop its plans for capacity expansion, there is uncertainty about the implications of Brexit and there continues to be press speculation that GAL's largest shareholder, Global Infrastructure Partners, may be considering the sale of its shares.

⁶ This excludes 2010, when average on-time performance at all UK airports was affected by the closure of airspace due to volcanic ash.

⁷ This is reported in the minutes of the 9 November 2017 meeting of the Gatwick Airport Consultative Committee.

Chapter 2

The process and timetable for replacing the current commitments

Introduction

- 2.1 As we are at the start of this review and because the commitments are a new form of regulation it is appropriate to consult on the best process and timetable for the review of the commitments. We describe our current thinking in the rest of this chapter, but we are also open to alternative proposals from stakeholders.
- 2.2 Our current thinking is based on two important considerations:
- we assume that our regulation of GAL from April 2021 will be based on a framework that is broadly similar to the current commitments framework. While there may be opportunities to refine the current framework, we are not aware of any desire among Gatwick stakeholders for a return to the previous form of regulation, which tended to be less flexible and have less focus on encouraging the airport and airlines to enter into tailored commercial arrangements; and
 - we hope that there will be the maximum opportunity for the review process to be both designed and implemented by agreement between GAL and the airlines that use Gatwick, so that all parties can explore and develop arrangements consistent with their commercial and service needs, and with appropriate protections for the interests of consumers.
- 2.3 Our primary focus will be to protect the interests of consumers, as discussed further in Chapter 3. We do not intend to stand in the way of a commercial approach where this can deliver outcomes that are in consumers' interests. We will be looking to encourage commercially-negotiated outcomes and to protect consumers' interests.

Possible process

- 2.4 We set out below some broad principles that might help shape the process of replacing the current commitments. They are quite high level at present, as we wish to leave scope for the process to reflect GAL and airlines' views.
- 2.5 To the extent practicable the negotiations on changes to the commitments should be driven by GAL and airlines. Furthermore, we would also welcome active involvement from both GAL and airlines in designing the review process and timetable.

- 2.6 There is an opportunity for GAL and airlines to take ownership of the process and timetable. While much of the process could be based on negotiations between GAL and airlines, there may also be scope for co-operation on other activities in support of the review. This might include, for example, commissioning primary research into specific aspects of consumers' preferences, or working together to develop potential approaches to meeting key challenges.
- 2.7 We will need to remain involved in the process in order to ensure that consumers' interests are protected. If the process is led by negotiations between GAL and airlines, then we will need to review any proposals agreed between the parties. When considering the timetable, we consider it would be prudent to allow for at least two such reviews. Even if we raise concerns following our first review, this will still give stakeholders an opportunity to propose their own solutions that we can consider during the second review, rather than having to impose our own solutions.
- 2.8 When carrying out any review of proposals agreed between GAL and airlines, our focus will be on protecting consumers' interests. Our approach to such reviews will be guided by our duties (see Appendix A). Among other things, we will look to protect the interests of all consumers, including both current and future consumers, consumers of different types of airline and route, and passengers with needs for specific services at the airport. We might be concerned, for example, if we think a set of proposals could lead to service quality outcomes that do not meet consumers' expectations, or to airport charges (and therefore fares) that do not represent value for money.
- 2.9 We may highlight issues and invite stakeholders to discuss possible solutions, or in some cases we could offer our own suggestions. And we are ready to play a more active role in the review, for example if stakeholders are unable to reach agreement on key issues. But our role will be to protect the interests of consumers rather than the commercial interests of individual airlines that are unwilling to enter into meaningful negotiations with GAL or choose to agree poor commercial terms.
- 2.10 If negotiations between GAL and airlines have been carried out effectively, we would hope that any changes we proposed would build on, rather than replace, the terms of the agreed proposal. This is most likely to happen if any proposal from GAL and airlines is based on a good understanding of consumer interests (for example, informed by specific research) and can be shown to represent a good deal for consumers.
- 2.11 Our current view is that negotiations between GAL and airlines might be more likely to generate proposals in consumers' interests (and less likely to require amendment by us) if:

- they are underpinned by meaningful evidence, including primary research, about what is best for consumers. We encourage GAL to come forward with a compelling, evidence-based proposition that both responds to airlines' input about the outcomes and outputs that it should deliver and demonstrably promotes consumers' interests;
- airlines representing the full range of services operating from Gatwick (now or in future) are represented and have clearly articulated their views about the future airport facilities and services that best meet the needs of their passengers;
- all parties participate in negotiations in good faith, sharing evidence where possible in order to explain and expand on their negotiating positions; and
- the timetable allows sufficient time for consideration of possible refinements to the commitments framework, and also for any material differences between the parties to be investigated and resolved (including for example carrying out further analysis or developing alternative mechanisms). This will help to avoid the risk of 'take it or leave it' deadlines, or stakeholders feeling pressurised into giving their agreement, and should also allow sufficient time for us to consider issues if they cannot be resolved by agreement between GAL and airlines.

Possible timetable

- 2.12 As with the process, we would welcome stakeholders' views on the overall timetable. Especially if the process is based on negotiations between GAL and airlines, then it may not be necessary to establish a very detailed timetable, but instead allow negotiations at different stages or on different issues to run their course. If negotiations go well, then there is scope for the new arrangements to be agreed and the necessary licence modifications implemented well before the current commitments expire.
- 2.13 Nevertheless, it will be important to have a shared view on the latest times by which certain key stages of the review should be completed. As well as establishing the relative importance of different stages of the process (including, for example, how much progress towards a detailed final agreement the parties should have made by the time of our first substantive review), this will also allow us and other stakeholders to monitor progress and to consider whether any action needs to be taken to ensure that the new arrangements can be put in place by April 2021.

- 2.14 The new regulatory arrangements will need to be implemented through a modification to GAL's licence.⁸ In practice, this means that we will need to reach a final decision on the new arrangements by the end of 2020. By this time, we will need to have carried out our own review(s) and be content with the proposal, and we will also need to have consulted stakeholders on the final proposal. The formal process after this point includes a notice of the proposed modification, allowing respondents a reasonable time for representations, and then a final notice confirming the modification.⁹
- 2.15 A possible high-level timetable for a process led by negotiations between GAL and airlines is shown below. This assumes that GAL and airlines carry out negotiations, and undertake any necessary analysis or research, during early to mid-2019, leading to an initial proposal for us to review in late 2019.
- 2.16 The process after our first review might then depend on whether there are any outstanding issues where GAL and airlines were not able to reach agreement, and whether we have any material concerns about consumers' interests. One possibility is a further round of negotiations, for example to address outstanding issues or any consumer interest issues that we identified, leading to a revised proposition for us to review in summer 2020. This would leave time to make any final changes before consulting on final proposals in autumn 2020 and reaching a final decision by the end of 2020.

Figure 2: A possible timetable for a process led by airline-GAL negotiations



⁸ The formal licence modification provisions are set out in section 22 of CAA12. Although some aspects of the commitments can be amended by agreement between GAL and sufficient airlines, this does not apply to the term of the commitments.

⁹ The final notice needs to be issued a minimum of six weeks before the modification takes effect. And it can only be issued if there is no significant difference from the proposed modification set out in the previous notice (hence the need to have consulted stakeholders on the final proposals before starting the formal modification process).

- 2.17 If negotiations go well, and if the agreed proposals do not raise any material consumer interest issues, then there is scope for the process to be completed much sooner than shown above. But there would be only limited scope for the process to be delayed and still allow the new arrangements to be implemented by April 2021.
- 2.18 To the extent that material areas of disagreement remain, or an agreed proposal is not possible, we might need to put forward our own proposals for stakeholders to review and comment on. Even if GAL and airlines are unable to agree a new set of arrangements, the process of negotiation could generate an evidence base from which we could develop our own analysis and proposals.
- 2.19 If we need to play a more active role in the process, the timetable for this could still be similar to that shown above. In this case, we could put forward initial proposals in late 2019, and final proposals in summer 2020. This would allow for substantive input from stakeholders before our final decision in late 2020. We encourage stakeholders to take note of these constraints when making suggestions with respect to the timetable for reviewing the commitments, and for GAL and airlines to make timely progress in negotiating new arrangements.

Views invited

- 2.20 We would welcome comments on any aspects of the timetable and process for the review of the commitments regime and in particular our initial views that:
- the review should provide the maximum opportunity for the process and timetable to be both designed and implemented by agreement between GAL and the airlines that use Gatwick, so that parties can explore and develop arrangements both consistent with their commercial and service needs and with appropriate protections for the interests of consumers; and
 - our role should focus on protecting consumers and that unnecessary regulatory interventions will be best avoided if proposals from stakeholders for new arrangements are underpinned by meaningful evidence about what is best for consumers, involve agreement with a full range of airlines, and are provided on a timely basis.
- 2.21 We would also welcome comments on the most appropriate timetable for reviewing the commitments framework, including how to allow sufficient time for agreements between GAL and airlines, and for us to have sufficient time for us to consider issues that cannot be resolved by agreement, protect consumers and reach a final decision on the arrangements to take forward as proposed licence modifications by the end of 2020.

Chapter 3

Protecting consumers' interests

Introduction

- 3.1 As noted in Chapter 1 we introduced the commitments regime to encourage bilateral contracts that could be better tailored to the needs of individual airlines and their passengers. We hoped that this would promote more targeted service offers by GAL and incentivise volume growth, and GAL would also have greater flexibility to tailor its investment to the needs of airlines. During our short and focused health check on the operation of the commitments framework in 2016, stakeholders did not suggest that we return to our previous form of regulation for GAL.
- 3.2 Our assumption is that stakeholders will want to build on the successes of the commitments regime and consider whether there is scope to refine and improve the framework.
- 3.3 This chapter sets out our initial views on the issues we should focus on in protecting the interests of consumers, in line with our primary duty under CAA12.

Identifying consumers' interests

- 3.4 To ensure consumers' interests are protected from 2021 onwards, we expect a renewed commitments framework to be informed by consumer views and preferences of what they want from their airport experience. Therefore, a robust evidence base capturing consumer interests needs to be developed, including relevant primary research.
- 3.5 GAL has already launched a review of service quality standards and rebates. This review is a timely opportunity to test if the current approach is fit for purpose, as well as being good practice for the airport and airlines to reconsider service quality provision from time to time. We welcome GAL's review, and encourage airlines and passenger representatives to fully engage with this review.
- 3.6 We consider that, for consumer interests to be meaningfully reflected in a renewed commitments framework, evidence of consumer views, including their views on issues beyond the current provision of service quality standards, should be developed. A robust evidence base would include taking a fresh look at what aspects of airport performance are most important to consumers, so that a shared understanding of the key outcomes consumers want from their airport experience can be developed and understood. Such outcomes could reflect how

consumer needs vary across different passenger types, and could consider longer terms strategic issues, such as how best to develop the airport to deliver on consumer expectations for the future of the airport.

- 3.7 In particular, we consider that a robust consumer evidence base would include an understanding of consumer views on the resilience of the airport's operation, and how consumer needs can be best served in an increasingly congested airport.
- 3.8 In terms of undertaking consumer engagement, in the first instance we consider GAL as the operator of the airport is best placed to develop its understanding of the aspects of airport services that consumers value. Since airlines have significant knowledge and insight into consumer views, it is in GAL's interest to work closely with airlines in developing this understanding.
- 3.9 During the current regulatory period, there have been cases where airlines and GAL have disagreed about the measures needed to deliver services in consumers' interests. For example, airlines have argued that GAL should provide more airfield capacity in order to reduce congestion and improve on-time performance, whereas GAL has argued that airlines should build more resilience into their schedules. There have also been disagreements over the need for and timing of investment in new piers and stands.
- 3.10 Once a robust evidence base is in place, we encourage GAL and airlines to collaborate to consider how best to develop the airport in future to meet the expectations of consumers. We consider this dialogue could provide a stronger underpinning for a future set of commitments.
- 3.11 We recognise there is inevitably some uncertainty around GAL's future plans for the airport, particularly in relation to capacity expansion and plans to accommodate future traffic growth. GAL and airlines will want to consider how the commitments framework should deal with this uncertainty and provide confidence that consumers interests will continue to be protected.

Reflecting consumers' interests in the commitments

- 3.12 As noted in Chapter 2, we expect to review any proposals agreed between GAL and airlines to ensure they are in consumers' interests. We welcome any proposals from GAL and airlines on how to ensure future regulatory arrangements are closely aligned with consumers' interests. But we will also consider further intervention if we believe that a set of proposals agreed between GAL and airlines does not adequately reflect consumers' interests.
- 3.13 How best to reflect consumers' interests in a new set of commitments is likely to vary between different elements of the commitments. If research reveals new information about consumers' expectations around specific aspects of service quality, and these are largely or wholly within GAL's control, then it may be

relatively easy to reflect this in a revised set of service quality targets and rebates.

- 3.14 Other cases may be less straightforward, for example when there may be uncertainty about the specific services or infrastructure required to meet consumers' expectations, or where parties other than GAL play an important role in delivering certain outcomes for consumers. Nevertheless, we encourage GAL and airlines to consider how best to describe the services that GAL is expected to provide in return for airport charges consistent with the commitments.
- 3.15 Such arrangements may be more likely to be effective if they are enforceable and flexible. GAL's current investment commitment, for example, requires it to maintain and develop the airport infrastructure to enable it to meet its service quality targets, and also to invest a minimum of £700 million over the term of the commitments. As we found in 2016, however, airlines were frustrated by GAL's postponement of airfield investment projects, despite stronger than expected traffic growth.
- 3.16 We would welcome proposals from GAL and airlines for improving how GAL's obligations to develop the airport and protect consumers can be better reflected in the commitments, taking account of uncertainties about the future. Ideally, this would be based on a shared understanding between GAL and airlines of how the airport should be developed in the interests of consumers, and how this can be captured in the commitments through a set of outcomes and outputs that GAL will be expected to deliver. Similarly, we hope that stakeholders can reach a shared understanding of how best to respond to the challenges associated with maintaining or improving resilience, including on-time performance at Gatwick.
- 3.17 We will also be interested in the value for money incorporated in any new set of commitments. As noted in Chapter 1 and Appendix C, traffic growth at Gatwick has been very much higher than expected. GAL has held its airport charges below our fair price benchmark, which we welcome. However, this is a voluntary decision and not necessarily something we could rely on in future.
- 3.18 Stakeholders might therefore consider how risks are best shared or uncertainty allowed for in future regulatory arrangements in order best to promote consumers' interests.¹⁰ And we will look to GAL to provide compelling evidence to airlines that any proposal represents a good deal for consumers, and that this will continue to be the case under a range of plausible developments during the next commitments period.

¹⁰ Dealing with uncertainty does not automatically mean that higher (or lower) than expected traffic growth should lead to lower (or higher) charges. Consumers' interests will be affected by other factors, such as whether capacity-related investment might be brought forward in response to higher than expected traffic growth.

Views invited

- 3.19 We would welcome views on any aspect of how we should best protect consumers' interests and in particular on:
- the emphasis we have given to GAL and airlines gathering and then using evidence of consumers' views and preferences as part of the process for reviewing and renegotiating the commitments; and
 - our initial views on issues that are likely to be most important to consumers in the future, and how these can be best reflected in the commitments regime. Some potential issues include:
 - quality of service and consumer outcomes,
 - how GAL's obligations to develop the airport can be best captured in consumer-focused outcomes,
 - resilience and on-time performance, and
 - risk allocation and value for money.

Appendix A

Our duties

- A1 The CAA is an independent economic regulator. Our duties in relation to the economic regulation of airport operation services (AOS) are set out in the Civil Aviation Act 2012 (CAA12).
- A2 CAA12 gives the CAA a general (“primary”) duty, to carry out its functions under CAA12 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 AOS.
- A3 CAA12 defines users of air transport services as present and future passengers and those with a right in property carried by the service (i.e. cargo owners). We often refer to these users by using the shorthand of “consumers”.
- A4 The CAA must also carry out its functions, where appropriate, in a manner that will promote competition in the provision of AOS.
- A5 In discharging this primary duty, the CAA must also have regard to a range of other matters specified in the CAA12. These include:
- the need to secure that each licensee is able to finance its licensed activities;
 - the need to secure that all reasonable demands for AOS are met;
 - the need to promote economy and efficiency on the part of licensees in the provision of AOS;
 - the need to secure that the licensee is able to take reasonable measures to reduce, control and/or mitigate adverse environmental effects;
 - any guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and
 - the Better Regulation principles.
- A6 CAA12 also sets out the circumstances in which we can regulate airport operators through an economic licence. In particular, airport operators must be subject to economic regulation where they fulfil the Market Power Test as set out in CAA12. Airport operators that do not fulfil the Test are not subject to economic regulation. As a result of the market power determinations we completed in 2014 the airport operators of both Heathrow and Gatwick airports are subject to economic regulation.

- A7 We are only required to update these determinations if we are requested to do so and we consider there has been a material change in circumstances since the most recent determination. We may also undertake a market power determination whenever we consider it appropriate to do so.

Appendix B

Overview of our current economic regulation of GAL

B1 The commitments comprise a set of conditions, schedules and annexes from GAL's Conditions of Use. The main provisions include:¹¹

- a price commitment – in summary this is based on price paths of the Retail Price Index (RPI) +0% for the blended price (which takes accounts of discounts agreed in bilateral contracts) and RPI+1% for the published price.¹² GAL can trade-off under or over-recoveries in individual years, subject to any cumulative over-recovery of published prices not exceeding £10 million in any intermediate year (and zero by the end of the seven years), and the average published price not increasing by more than RPI+10% in any of the first six years;
- a service standards commitment – similar to the service quality rebates included in GAL's Q5 price control, there is a system of rebates payable if GAL misses certain service quality targets. The targets cover passenger satisfaction measures, security queues, passenger operational measures, airline operational measures and an aerodrome congestion term. GAL's performance is assessed monthly, and separately for each terminal. The maximum amount of revenue at risk is 6.75 per cent (South Terminal) or 7.25 per cent (North Terminal);¹³

¹¹ Various administrative clauses also form part of the commitments, including applicability and enforceability; variation; and dispute resolution procedure.

¹² In each case, the "price" refers to the average revenue per passenger from services and facilities connected with the landing, parking or taking off of aircraft and from selected ancillary services. There is also provision for a pass through of changes in security costs.

¹³ The Conditions of Use also detail Airline Service Standards for check-in queues and arrival bag performance. Airlines that do not meet these standards may have any service quality rebates they would otherwise have received reduced by up to 1.5 per cent of GAL's revenues. These airline standards are not treated as conditions of GAL's licence.

- continuity of service plan, operational and financial resilience – an obligation to prepare and maintain plans on continuity of service and operational resilience. The continuity of service plan must be provided to us and amended in line with our reasonable requirements, and GAL must consult stakeholders (including us) annually on the operational resilience plan. It is required to have regard to any guidance that we issue on the operational resilience plan. In addition, GAL must provide an annual confirmation of adequate resources and obtain our approval before making certain changes to its finance documents;
- an investment and consultation commitment – GAL will maintain the airport to comply with safety/environmental requirements and develop the infrastructure to allow it to meet service quality standards. To achieve this, it will invest at least £700 million during the seven years of the commitments. It will also consult airlines and passenger representatives on its investment programme; and
- a financial information commitment – GAL will ensure that it provides either statutory accounts or an equivalent audited statement so that airlines can understand whether charges are reasonable. Each year it will provide its assessment of the value of its asset base.

B2 GAL's licence identifies the parts of GAL's Conditions of Use that make up the commitments, and states that:

- the commitments are conditions of the licence (which means, among other things, that they are enforceable by us);
- however, any obligations placed on third parties in the commitments shall not be treated as conditions of the licence;
- in complying with the commitments, GAL 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;
- GAL can only modify the commitments in accordance with specific provisions of the Conditions of Use – in summary the price path for the blended price and the service standards and rebates can be modified if this is agreed by airlines carrying at least 67 per cent of passengers or representing at least 50 per cent of airlines;
- if CAA modifies the licence,¹⁴ GAL will make any necessary consequential changes to its Conditions of Use; and

¹⁴ The process for this is set out in section 22 of the Act.

- GAL's automatic recovery of second runway costs will be limited to £10 million per year.¹⁵

Our reasons for accepting GAL's commitments

B3 Our reasons for accepting GAL's commitments included:¹⁶

- by the time of our final proposals, the price caps included in GAL's commitments were close to our view (developed during the Q6 price control review) of a fair price;
- the commitments would provide a better framework to diversify the service offering and incentivise volume growth, as they would encourage bilateral contracts that could be better tailored to the needs of individual airlines and their passengers;
- the commitments should promote competition by facilitating innovation and diversity of offer;
- the commitments would lock in lower future charges for longer (i.e. seven rather than five years), providing greater certainty to airlines and their passengers;
- the longer time period would provide GAL with greater incentives to reduce operating expenditure and outperform commercial revenue assumptions; and
- the commitments would facilitate efficient investment, as GAL would have flexibility to tailor investment to the needs of airlines.

Monitoring the commitments

B4 We stated that we would implement a monitoring framework to review a number of areas. This would help ensure that GAL promotes passengers' interests and that any problems arising could be more easily addressed. We monitor a small number of areas on an ongoing basis. These include:

- the level of charges – rather than monitoring GAL's compliance with its commitments (RPI+1% and RPI+0% respectively for the published and blended prices), we said we would monitor prices against our fair price benchmark. Specifically, we will compare the outturn blended price with our view of a fair price (RPI-1.6%);

¹⁵ Higher amounts can be recovered with the agreement of airlines or through a licence modification proposed by us.

¹⁶ See CAP 1102, Economic regulation at Gatwick from April 2014: final proposals. Available at www.caa.co.uk/cap1102.

- service quality – if GAL misses a particular target for six months in a financial year then no further rebates are payable for that target during the rest of that year, thus reducing GAL's liability for repeated service failures. We said that we would undertake sufficient monitoring to enable us to identify an individual metric failing for more than six months; and
- operational resilience – GAL is required to consult on and publish its operational resilience plan by 1 October 2014, and then to review the plan annually.

B5 GAL publishes annual performance reports, which are available on GAL's website and include information on traffic growth, service quality and on-time performance.¹⁷

¹⁷ Available at <https://www.gatwickairport.com/business-community/about-gatwick/company-information/how-we-are-regulated/>.

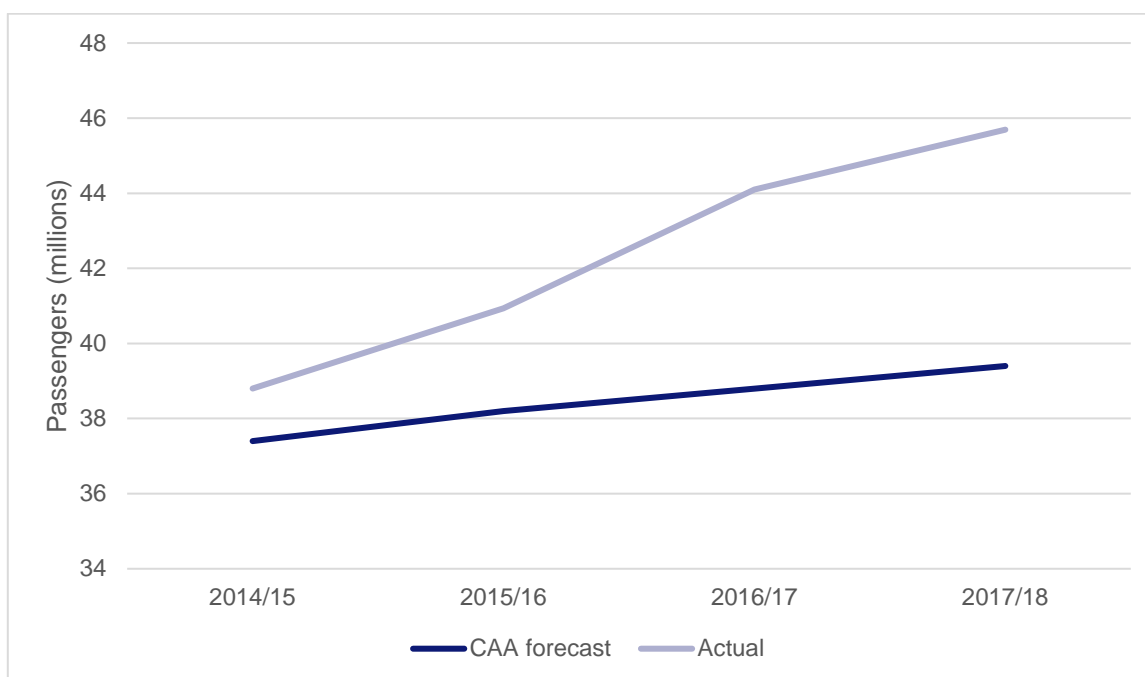
Appendix C

Summary of recent developments

Traffic growth

- C1 When calculating our fair price benchmark during the Q6 review we adopted traffic forecasts that showed what have turned out to be quite modest growth rates of between 2.0 per cent and 1.4 per cent a year in passenger volumes between 2015/16 and 2018/19. In contrast, as shown in Figure 3, traffic growth has remained healthy, averaging 6.2 per cent a year during the first four years of the commitments period.¹⁸
- C2 This growth reflects a combination of factors. While GAL was already capacity constrained at peak times, from summer 2014 it increased the peak capacity of its runway from 53 to 55 movements an hour. Apart from this change, traffic growth has mainly been achieved through a combination of greater use of off-peak slots, an increase in average aircraft size (some of which is due to an increasing share of long-haul traffic) and also higher average load factors. There is potential for these trends to continue in future, including through the addition of further long-haul routes and the use of larger aircraft (such as the A321neo) on short-haul routes, as well as further increases in the utilisation of off-peak slots.

¹⁸ Note that traffic growth in 2017/18 was affected by the loss of Monarch Airlines services from October 2017.

Figure 3: CAA traffic forecast vs actual traffic

Source: CAA (CAP 1152), GAL monthly traffic reports

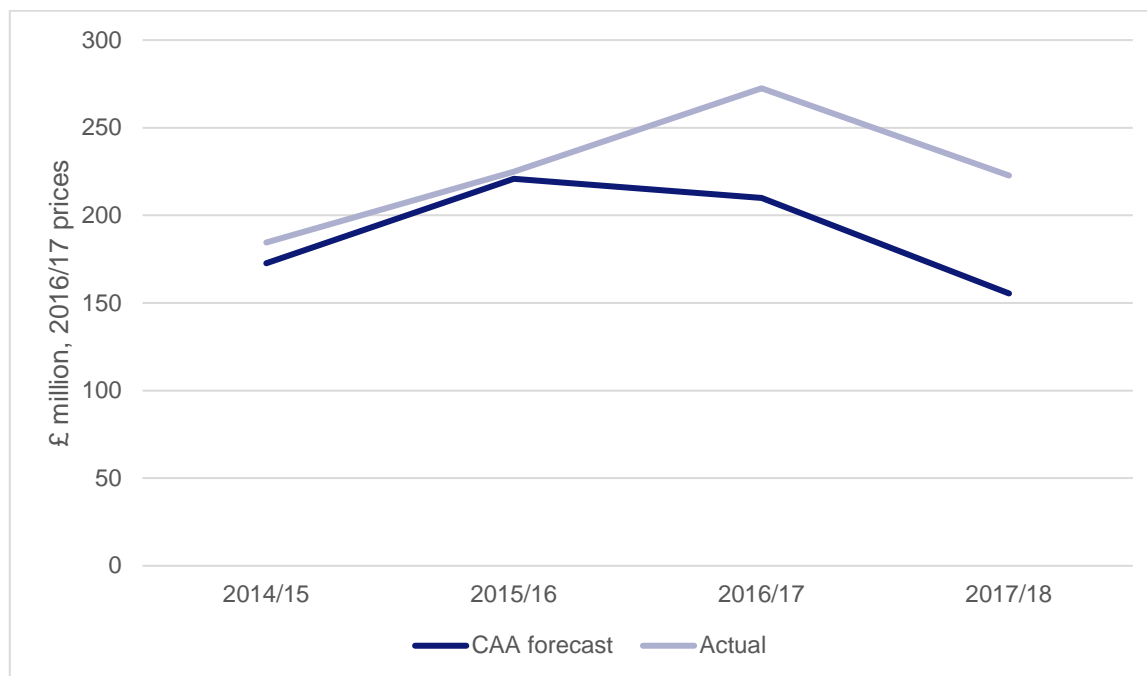
Investment

- C3** GAL's total investment during the first four years of the commitments period, which is shown in Figure 4, exceeded both the forecasts that underpinned our fair price calculation and the minimum investment of £700 million set out in the commitments. As noted in our 2016 review there were significant differences between the investment programme that underpinned our calculation and the projects that GAL has implemented.
- C4** One of the largest changes (by value) was the postponement of the Pier 6 southern extension project, which was included in our investment forecasts but had been delayed, initially because easyJet's consolidation in the North Terminal was expected to delay the need for new pier capacity. Our 2016 review has a more detailed description of GAL's planning of this important project.¹⁹
- C5** GAL's 2018 Capital Investment Programme states that GAL plans to invest a further £726 million (in 2017/18 prices) over the remaining three years of the commitments period. This includes £127 million for the Pier 6 extension project (with a further £37 million in the following two years) and £23 million on another

¹⁹ See Chapter 3 of CAP 1502, Economic regulation: A review of Gatwick Airport Limited's commitments framework – Findings and conclusions. Available at www.caa.co.uk/cap1502.

important project to accommodate passengers arriving to the South Terminal from the Common Travel Area.

Figure 4: CAA forecast core capital expenditure vs actual capital expenditure



Source: CAA (CAP 1152), GAL economic regulation monitoring reports, GAL 2018 CIP

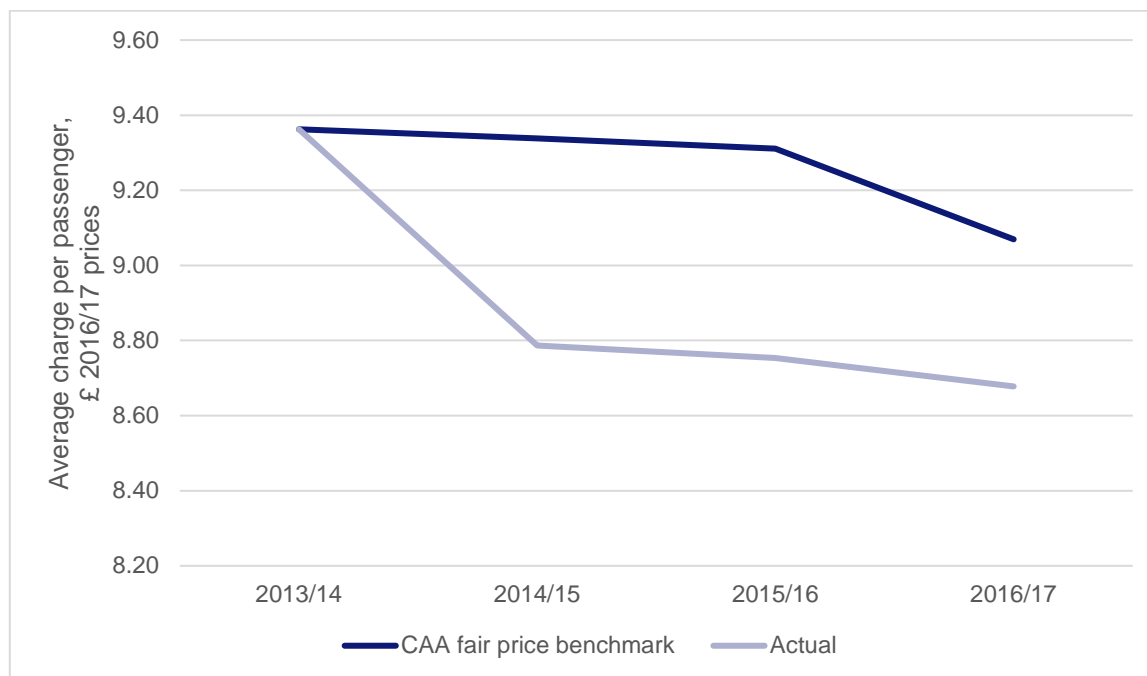
Airport charges

- C6 As shown in Figure 5, during the first three years of the commitments period GAL has held its charges below our fair price benchmark,²⁰ and even further below the average price path implied by its commitments. Despite this, the impact of higher than expected passenger volumes means that GAL's total revenues from regulated charges over the first three years of the period have been above the forecast that underpinned our fair price calculation.
- C7 In November 2016 GAL offered (non-binding) 'enhanced pricing guidance' stating that it intends to price to a level no higher than our fair price benchmark over the seven years of the commitments period.
- C8 Nonetheless, the fact that GAL has charged below our fair price benchmark in the first three years of the commitments period (and expects to have done so again in 2017/18) means that, in principle, it would have scope to increase its charges during the remaining three years of the period without breaching its pricing guidance. At the time it issued the guidance, GAL stated that a price

²⁰ The fair price benchmark shown in Figure 5 is modelled as a formal price cap of RPI-1.6%, calculated using the change in the RPI over the 12 months to the previous August, rather than a simple real reduction of 1.6% each year. This mirrors the approach we used in GAL's previous price caps, and also the way that compliance with GAL's commitments is assessed.

path of RPI+2.0% was one possible profile that would not be inconsistent with its guidance.

Figure 5: Real terms comparison of airport charges



Source: CAA analysis, GAL economic regulation monitoring reports

Service quality

- C9** GAL's service quality commitments include a set of rebates that are payable if it misses certain service quality targets.²¹ In our 2016 review we reported that GAL had missed only 45 of the 1240 targets measured during the period from April 2014 to October 2016. Since then, GAL has continued to perform well in these aspects of service quality and has not missed any further targets.²²
- C10** On-time performance is not included in the service quality targets in GAL's commitments. One reason for this is that it is affected by the actions of a number of different parties, including GAL, airlines, ground handlers and air traffic control. As shown in Figure 6, on-time performance in the peak summer periods declined during the first three years of the commitments period. This was due to factors including air traffic control strikes, weather-related disruption,

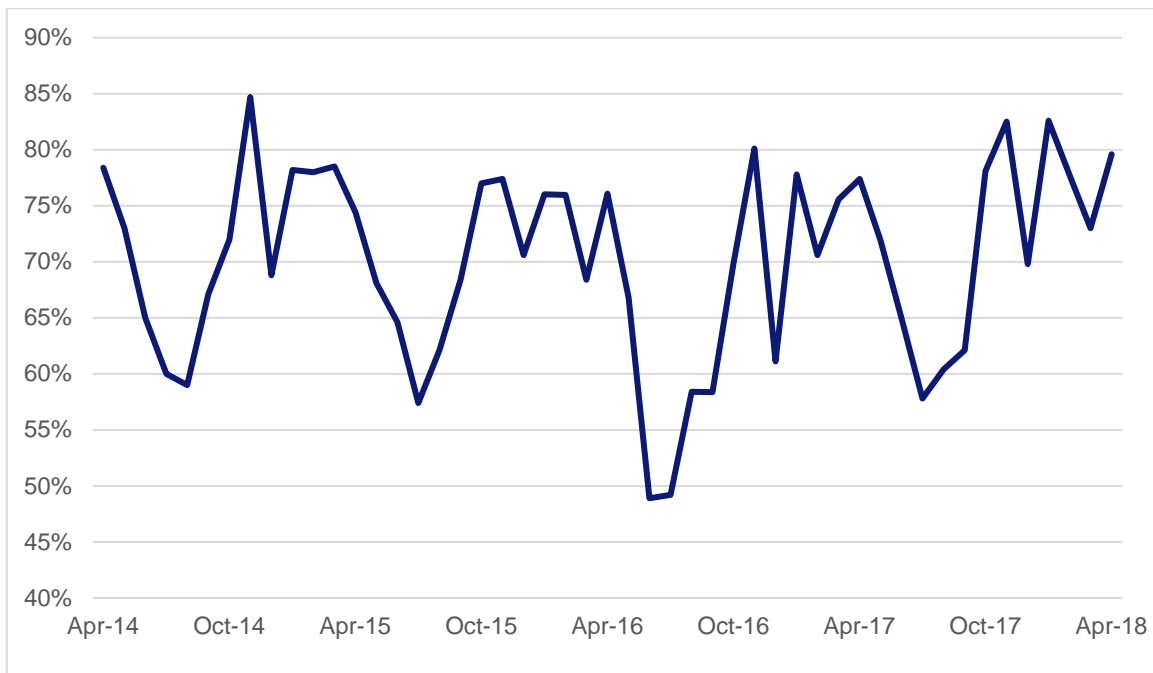
²¹ These targets cover passenger satisfaction measures, security queues, passenger operational measures, airline operational measures and an aerodrome congestion term. GAL's performance is assessed monthly, and separately for each terminal. The maximum amount of revenue at risk is 6.75 per cent (South Terminal) and 7.25 per cent (North Terminal). GAL's performance is documented in monthly reports that are published on its website and displayed at the airport.

²² GAL paid rebates to airlines for a baggage system fault in May 2017 that resulted in poor service for airlines and passengers but was not reflected in the automated performance measurement.

and staffing problems experienced by certain ground handlers in each of the first two summers.

C11 On-time performance in summer 2017 showed some improvement over summer 2016, and was similar to the level experienced in summer 2015. This improvement has been sustained into the first few months of 2018. GAL has continued to work with airlines and ground handlers to identify operational measures that could help to improve punctuality, especially during the peak summer months.

Figure 6: Departure punctuality (% of flights departing within 16 minutes of scheduled time)



Source: GAL monthly performance reports