

MANCHESTER AIRPORT INQUIRY

Issues Statement

MANCHESTER AIRPORT INQUIRY: ISSUES FOR DISCUSSION

1. As part of its regulatory inquiry into Manchester Airport plc (MA) the Competition Commission (CC) is putting a list of issues to MA and to the CAA. The CC has already received evidence from third parties; it is publishing this summary of the main issues to give all the parties involved or interested the opportunity to comment on any matter that they may not yet have addressed. (Comments should be sent to the Commission at New Court, 48 Carey Street, London WC2A 2JT, addressed to the Reference Secretary, Manchester Airport inquiry, or Email: manchesterairport@Competition-Commission.gsi.gov.uk). The background to many of these issues, in particular the CAA's recommendations, is available on the CAA website (www.caa.co.uk). The evidence to the CC from the CAA, MA and a number of third parties is also available on the CC website (www.competition-commission.org.uk/inquiries/manchester).
2. The CC are required to investigate and report on:
 - (a) the maximum level of airport charges (ie charges to aircraft for landing and parking) that can be levied by MA, for the five years beginning 1 April 2003 (the fourth quinquennial period—Q4) conventionally expressed in the formula RPI-X; and
 - (b) whether MA or any of its associated companies has pursued any course of conduct which has operated or might be expected to operate against the public interest in relation to the activities specified in the reference in the period from 10 December 1996 to 28 February 2002.

Background to the issues

3. To date, airport charges have been set at levels that allowed MA to earn a reasonable rate of return on its regulatory asset base i.e. the investments it has made in the construction and operation of the airport.
4. The airport charges have been set in the following way:
 - (a) the CAA, following a CC review, devising a formula for the maximum revenue from airport charges, in terms of £ per passenger, covering the next five years;
 - (b) the formula has, until now, been based on a 'single till', whereby the maximum level of airport charges was set to cover the operating costs and rate of return of all the airport's assets, commercial as well as aeronautical. The effect of using a single "till" is that airport charges are lower than if they were set on the basis of aeronautical assets only (sometimes called the "dual" till) because the commercial activities make significant profits;

- (c) the maximum allowable charge took account of costs for the five year period of capital investment, operating expenditure, the cost of capital and passenger forecasts, as well as the initial asset base used for regulatory purposes; and
 - (d) new security requirements introduced during the course of the charging period were not included in the price cap but passed through to the airlines, at 95 per cent of their estimated level (the 'S' factor).
5. The rest of this statement discusses the issues that the CC has so far identified under the two areas, (a) and (b) in paragraph 2, which the CC has been asked to investigate.

A. Issues relating to the maximum amounts that can be levied by way of airport charges for the five years beginning on 1 April 2003.

(a) The formula for charges

6. The CAA believes that a change to a "dual till", in which commercial activities are excluded from the regulatory asset base, would be advantageous in providing clearer incentives to invest in aeronautical and in commercial assets. However the CAA acknowledges that the case for a dual till at Manchester is weaker than at more congested airports. MA has supported the CAA's general preference for the dual till, while differing on some major points of implementation. It is widely accepted that Manchester is already well invested in aeronautical assets compared with competitor airports, particularly since the opening of its second runway in February 2001. This has made congestion at Manchester more limited than at some other airports. Airlines are strongly opposed to the dual till, on the grounds that e.g. it would increase the charges they pay to airports at a time when airline finances are under severe pressure but without leading to significantly improved facilities for them.
7. Issues arising include:
- (a) whether the retention of the single till would, as MA argues, be likely to result in a level of under investment in aeronautical assets such as to lead to Manchester Airport becoming congested or to cause the level of service provided to users to deteriorate significantly;
 - (b) as investment in commercial activities is considerably more profitable than investing in aeronautical facilities, commercial investment would become even more attractive under the dual till. How could it be ensured that these stronger incentives did not lead to inadequate investment in aeronautical facilities or to a distortion of priorities between the aeronautical and commercial in a way which caused facilities for passengers (eg more shops, less seating) to be worsened;
 - (c) how can surface access costs, such as the Ground Transport Interchange and car parking facilities, be separated under aeronautical and non-aeronautical headings, as under the single till such costs

are largely included within the regulatory asset base but would under the CAA recommendations be largely excluded by a dual till ;

- (d) whether surface access costs should in fact be excluded from the regulatory assets till under a dual till;
- (e) what effect the higher landing charges under the dual till might have on airlines' fares and on usage of the airport;
- (f) whether adopting the dual till at an uncongested airport would be consistent with the guidelines of the International Civil Aviation Organization (ICAO), which "recognize that circumstances differ between airports and that a range of approaches may be appropriate"; and
- (g) whether applying a dual till would result in frequent disputes between MA and airlines about the balance of future investment between the aeronautical and the commercial activities.

(b) *The RPI-X charging formula*

8. The CC is unlikely, subject to further arguments, to recommend departing from the general RPI-X approach and third parties have not suggested that it should.

(c) *The possibility of a Q factor in the price cap*

9. The CC wishes to consider the arguments for and against including a "Q" term or another form of service quality regulation, if necessary, in the price cap. The relevant considerations are set out under the "quality of service" heading in Part B of this document.

(d) *The S factor*

10. Airlines generally support the CAA proposal to drop the S factor, though MA has argued that this would be unreasonable. An option suggested by some third parties is to retain the S factor but to pass through 75 per cent only of any increase instead of 95 per cent as at present, as this would encourage MA to implement security measures as cost-effectively as possible.

(e) *The size of X*

11. For the current review period, X was set by the CAA at -5 in the RPI-X formula. The CAA proposals would in effect set X at 0 from 1 April next, resulting in higher charges to MA users-though the CAA also argues that MA would be unlikely to price up the maximum level allowed by the regulatory "cap". The CC wishes to consider what the right level of X should be e.g. should it be less than proposed by the CAA? A lower, and tighter, cap would arguably give more incentive to MA to drive down its costs. Among specific issues arising in considering X are the following.

(i) Level and balance of charges at Manchester Airport.

12. An issue raised with the CC is the relationship between the costs of providing non-regulated services and the charges for them, in particular:

- whether existing non-regulated charges and increases made during the current review period (Q3) simply reflect MA's costs or, even where balanced by MA pricing below the cap for regulated services, have the effect that airlines pay more overall for services provided to them;
- whether new and possibly unjustified non-regulated charges have been introduced during Q3;
- whether MA plans to introduce any further non-regulated charges, or significantly increase existing charges, in the next review period (Q4) and if so why.

13. The CC has not found much support from users in particular for peak pricing or off-peak discounts by MA. Relevant considerations are: whether MA sees scope beyond discounts available already for non-discriminatory price differentiation to encourage off-peak usage; whether that would be effective in encouraging a more balanced pattern of aircraft movements during the day; and, in that event, whether it could be done transparently and without distorting competition between airlines.

(ii) Cost of capital

14. There is a difference of views between MA and the CAA on the appropriate cost of capital though both might be regarded as being on the high side. The CC is still considering this matter.

(iii) Financing of investment

15. Though the borrowing controls applying to airports in local authority ownership, such as Manchester, have been lifted, the CC needs to consider whether MA's ability to finance a capital programme consistent with the level of charges that it may recommend for Q.4 might be constrained in any way. Two considerations could be relevant. Although MA's stated policy is to pay out around a third of its earnings in dividends, it has often paid out more in recent years. MA also has relatively high gearing (around 66 per cent) which might have implications for its ability to borrow.

(iv) Operational efficiency

16. Published studies show that Manchester's airport charges are about 25-30 per cent higher than its competitors. Relevant issues include whether efficiency improvements being undertaken or planned by MA are sufficient to improve its competitiveness significantly or whether more radical reductions in operating costs are necessary. If so, how could they be achieved?

(v) Capital investment

17. Detailed consideration has not yet been possible as MA's revised capital expenditure programme is not yet available. Related issues include the methodology and procedures used in MA's capital programmes and the extent to which service quality to users may have been adversely affected by inadequate or inappropriate investment in operating assets such as baggage systems.

(vi) Traffic Growth

18. The CAA has a higher estimate for Q4 passenger numbers than MA. Considerations include the reasons for this difference and whether the regulatory system has a tendency for forecasts to be understated, in a way which may increase the total revenue that can be raised from airport services charges.

(vii) Commercial activities

19. Income from commercial activities has fallen from 50 to 47 per cent of MAs total revenue between 1998-99 and 2000-01. Were the CC minded to recommend that the single till be retained, then it would need to take account of how much commercial income MA might be able to earn during Q4 in recommending what the amount of the regulatory till, to which RPI-X would be applied, should be. A related issue for the CC to consider is the extent to which, as argued by the CAA, the high profitability of airports' commercial activities is due to locational rather than monopoly advantages, and whether any excess market power can sensibly be dealt with by the provisions of the Competition Act 1998.

(viii) Cross-subsidisation of non-regulated activities

20. Users of Manchester Airport have expressed concern that revenues deriving ultimately from the regulated services (or scarce management resources) might be diverted to other purposes such as subsidising MA's regional airport subsidiaries (Humberside, East Midlands and Bournemouth Airports), or that the financing needs of these subsidiaries could constrain MA's ability to borrow for its needs at Manchester Airport. The CC will wish to consider what practical steps MA has taken or proposes to take to ensure that such cross-subsidisation does not occur.

B. Issues in respect of conduct contrary to the public interest

21. Issues at present arising include the following:

(a) The structure and transparency of airport charges.

22. One issue is whether lower landing charges for cargo aircraft as opposed to passenger aircraft are justified, as some users believe, because any differential would not reflect differences in costs incurred by the airport.
23. A further issue concerns the nature and extent of individual contractual arrangements between MA and users, particularly airlines, such as joint marketing or promotional schemes. If MA contributes to such schemes by discounts to an individual airline or promotional expenditure to benefit an airline, could that constitute unreasonable discrimination between airlines? And how would MA justify this as in the public interest (or compatible with the UK's international obligations)? Also relevant is the extent to which such individual treatment of airlines might be made transparent.
24. In the previous review, the CC recommended as a public interest concern that MA be required to provide annually to users full information on the revenue from, and costs of, supplying utilities to users. That recommendation was adopted. Many users still consider the information they receive insufficient for them to understand the revenues and costs involved and the reasonableness or otherwise of the charges they pay to MA. The CC welcomes views on whether this is indeed the case and, if so, what is needed to remedy it.
25. Similar concerns have been expressed about the information that users receive from MA on increases in charges for certain unregulated services and the extent to which they may be more than necessary to cover the costs incurred in providing them. There is at present in force a public interest condition arising from the last review on the provision of information on costs and charges for specified services and facilities (e.g. check-in desks, baggage systems, car parking charges). An issue will be why there is still such dissatisfaction, how justified it is and whether there are grounds for the CC to make a further public interest finding on these matters, or extend the existing public interest condition to other services and facilities.
26. A further issue under this head is the complaint to the CC by some users about MA's continuing practice of "bundling" the charge for air traffic control services within aeronautical charges instead of showing them separately as is done at other major airports.

(b) Quality of service

27. The CC will wish to consider whether the arrangements at Manchester Airport for ensuring adequate service quality may be expected to operate against the public interest, in the light of concern from users. Existing Service Level Agreements (SLAs) applying to such matters as People Movers and Security

Queuing Standards were drawn up by MA and users but have largely fallen into abeyance. Relevant considerations include the need for improved monitoring of service quality and how the observance of any new arrangements is enforced, whether by financial compensation for failure to meet agreed standards, or by other methods such as including in the price cap a formula for adjusting the cap downwards if agreed standards were not met - on the lines of the CAA proposals for BAA airports. The CC may also wish to consider whether a public interest finding could help to bring about improved and sustained arrangements for the service provided to users.

28. Some users have complained that the Terms and Conditions of Use in MA's Fees and Charges booklet of fees are unreasonable, in e.g. containing too many exclusion clauses and no clear statement of MA's obligations to users. The CC would welcome views on this.

(c) Arrangements for consultation

29. The CC made a public interest finding in the last report that modified procedures for consultation of user interests, to be approved by the CAA, be put in place by MA. User interests generally say that the changes made to MA's consultation procedures have been an improvement, though not in respect of capital expenditure decisions. But users remain concerned, e.g. that although more meetings are being held and papers circulated they feel their views on operational decisions are in effect disregarded by MA.

30. MA in its response to preliminary proposals from the CAA recognised that there remains dissatisfaction with its consultative arrangements on capital investment decisions and argues that developments such as organisational restructuring within MA will enable users to participate more fully in decisions. Capital expenditure apart, the CC will wish to consider generally how MA can best continue to develop, in close consultation with users, its consultative mechanisms and whether that process would be facilitated were the CC minded to make a further public interest finding.

(d) The role of ground handlers

31. The CC has been told that ground handlers are unfairly disadvantaged by unilaterally imposed charges for unregulated services such as check-in desks or sorting baggage, that the allocation of such facilities is arranged mainly between the airline users and MA- yet the ultimate liability for meeting these charges falls on the ground handlers in the event of airlines failing to meet their obligations to the handlers.

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