

BAA AIRPORTS MARKET INVESTIGATION

Provisional decision on remedies

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The Competition Commission has excluded from this published version of the provisional finding report information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by ✂.

BAA Airports Market Investigation

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Introduction

1. On 29 March 2007, the Office of Fair Trading (OFT) referred the supply of airport services by BAA in the UK to the Competition Commission (CC) for investigation. In our provisional findings, published on 20 August 2008, we provisionally found that there are features of the markets for the supply of airport services by BAA Limited (BAA) that result in an adverse effect on competition (AEC¹) within the meaning of section 134(2) of the Enterprise Act 2002 (the Enterprise Act).
2. Where the CC finds that there is an AEC, it has a duty, under the Enterprise Act, to decide whether action should be taken by the CC, or recommended for others, to remedy, mitigate or prevent the AEC and any detrimental effects on customers resulting from it. The CC must also decide what action should be taken and what is to be remedied, mitigated or prevented. In taking this decision, the CC, as required by the Enterprise Act, will seek to achieve as comprehensive a solution as is reasonable and practicable.
3. We published a notice of possible remedies (Remedies Notice) on 20 August 2008 which set out a number of measures that we considered could address the AEC and its resulting detrimental effects and invited comments from all interested parties. We received a number of responses to our Remedies Notice and have held a number of hearings and meetings with relevant parties to discuss remedies. Having given careful consideration to all evidence we have gathered to date on remedies, this document sets out our provisional decision on remedies and serves as a basis for further consultation.

¹AEC refers to one or more adverse effects on competition.

4. It is important to note that this provisional decision proposes remedies that address features of the market and AEC as set out in our provisional findings. We have received a number of submissions in response to our provisional findings and have had discussions with various parties concerning these submissions, though these discussions are not yet completed. These findings are currently being reviewed and updated, where necessary, in the light of new evidence. If as the result of any such changes, or for any other reason, the CC group undertaking this investigation (the group) materially revise our provisional decision on remedies, we will consult further on any significant changes.
5. This document begins by setting out the framework we have used for consideration of remedies. It then moves on to summarize the AEC set out in our provisional findings and summarizes the package of remedies we now intend to pursue to address this AEC and its resulting detrimental effects. We then consider aspects of the package of remedies in detail.
6. BAA and any other interested persons should provide any views on the analysis and conclusions in this provisional decision in writing no later than 9 January 2009.
7. A number of significant consultations and reviews into the airports sector are being conducted by others. They include:
 - (a) The Civil Aviation Authority's (the CAA's) review of airport charges at Stansted, with a final decision expected in March 2009. The CAA's proposals were published for consultation on 9 December 2008 but due to their timing, we have not been able to take them into account in this provisional decision on remedies.
 - (b) The work carried out by the independent panel on airport regulation (the Independent Panel), appointed in early 2008 to provide advice to the Department for Transport (DfT) and due to report in early 2009. The Independent Panel

issued its emerging thinking on 12 November 2008. We refer to this document in the section on regulation.

- (c) The consultation carried out by the DfT in late 2007/early 2008 on ways in which Heathrow Airport (Heathrow) could be developed over the next 20 years. The decision of the Secretary of State for Transport (the Secretary of State) on this issue is awaited.

Framework for the assessment of remedies

8. Having identified in our provisional findings a number of features of the markets for airport services in the UK as exist in connection with the supply of airport services by BAA that result in an AEC, we are required to decide the following additional questions under section 134(4) of the Enterprise Act:
- (a) whether action should be taken by us for the purpose of remedying, mitigating or preventing the AEC concerned or any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the AEC;
- (b) whether we should recommend the taking of action by others for the purpose outlined in (a) above; and
- (c) in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.
9. In choosing appropriate remedial action, the CC has a statutory obligation to achieve as comprehensive a solution as is reasonable and practicable to the AEC and any detrimental effect on customers so far as resulting from the AEC.²

²Section 134(6) of the Enterprise Act.

10. As noted in its guidance (CC3, paragraph 4.9), the CC will consider the effectiveness of different remedies and their associated costs and will have regard to the principle of proportionality when deciding on appropriate remedies.
11. In deciding what remedy or remedies would be appropriate, the CC will first look for a remedy that would be effective in dealing at source with the AEC arising from the relevant features of the market rather than seeking to deal with the detrimental effects on customers arising from the AEC (CC3 paragraph 4.22). Our guidance considers that one-off remedies that change the structure of the market (so-called structural remedies) have advantages compared with remedies that impinge upon the behaviour or conduct of firms (so-called behavioural remedies) in that 'they address the competition concern directly and will require comparatively little, if any, monitoring or enforcement of compliance' (CC3 paragraph 4.15).
12. The CC has made several general observations in its guidance about factors relevant to its consideration of effectiveness (CC3 paragraph 4.13 and following). First, an effective remedy will make clear the persons to whom it is directed and any other persons who might be interested in it. Second, in considering its effectiveness, the CC will consider the prospects of a particular remedy being implemented and complied with. The effectiveness of any remedy may be reduced if elaborate, and possibly costly, monitoring and compliance programmes are required. A third relevant consideration is the period within which the remedy will take effect. Other factors may also be relevant to the CC's consideration of effectiveness, depending on the facts of the case.
13. In considering whether a remedy is reasonable and practicable, the CC will consider the relevant costs associated with implementing the remedy. If it is choosing between two remedies or packages of remedies which it considers would be equally effective,

it will choose that which imposes the least cost or that is the least restrictive (CC3, paragraph 4.10). The CC will also seek to implement remedies or a package of remedies which are not disproportionate in relation to the AEC and any resulting detrimental effect on customers. (CC3, paragraph 4.10).

14. The CC will endeavour to minimize any ongoing compliance costs to the parties, provided that the effectiveness of the remedy is not reduced (CC3, paragraph 4.12).
15. The CC will also have regard to the effects of any remedial action on any relevant customer benefits within the meaning of section 134(8) of the Enterprise Act arising from the adverse feature or features of the market concerned. Such benefits comprise lower prices, higher quality or greater choice of goods or services or greater innovation in relation to such goods and services. To qualify within the meaning of section 134(8), the CC must believe that the benefit would be unlikely to accrue without the relevant feature or features giving rise to the AEC.

The adverse effects on competition

16. Our current view, as set out in our provisional findings published on 20 August 2008, is that a number of features each give rise to an AEC:
 - (a) As regards common ownership:
 - (i) Common ownership of Edinburgh Airport (Edinburgh) and Glasgow Airport (Glasgow) is a feature of the market which prevents competition between them.
 - (ii) Common ownership of the three BAA London airports is a feature of the market which prevents competition between them; the effectiveness of competition between them absent common ownership is likely to increase in the longer term, with the increased incentive to invest, although we also see

some scope for competition between them in the short term despite existing capacity constraints.

- (iii) Common ownership of Southampton Airport (Southampton) and both Heathrow and Gatwick Airport (Gatwick) is a feature of the market which prevents competition between them, as shown in particular by the lack of responsiveness of BAA to developing Southampton to satisfy the requirements of its airline customers.
 - (iv) Common ownership of the BAA London airports further restricts competition between airports through its effects on capacity constraints; and exacerbates the inadequacies of the regulatory system, reducing the benefit of regulation, distorting competition between airlines.
- (b) Heathrow's position as the only significant hub airport in the South-East and indeed the UK is a feature which restricts competition between airports for some airlines.
 - (c) Aberdeen Airport's (Aberdeen's) comparatively isolated geographical position and other factors that make it unattractive to serve a catchment of Aberdeen's size with more than one airport are features preventing competition to Aberdeen.
 - (d) Aspects of planning restrictions are features which restrict competition by contributing to the current capacity constraints at the BAA London airports.
 - (e) Aspects of government policy restrict or distort competition by contributing to the current capacity constraints at the BAA London airports.
 - (f) The current system of regulation of airports is a feature which distorts competition between airlines.
 - (g) The current London air traffic distribution rules which prevent the operation of new cargo services from Heathrow and Gatwick at peak times are a feature which restricts competition between airports and cargo airlines.

Provisional decision on remedies: summary

17. To remedy the above AEC and its detrimental effects on customers as comprehensively as is reasonable and practicable, we have provisionally decided, following careful consideration of the evidence and for reasons set out in the text of this decision document, that the following package of remedies is required:
- (a) structural remedies, comprising:
- (i) the divestiture of both Gatwick and Stansted to different purchasers. In relation to Stansted, we are seeking views on the timing of divestiture which is most likely to support the development of competition, although our preference is to initiate it as soon as possible;
 - (ii) the divestiture of Edinburgh rather than Glasgow. However, we remain open to further views on this issue;
 - (iii) the appointment of a monitoring trustee to monitor the progress of the above divestitures and otherwise assist in managing divestiture risks. The CC will retain the option to require the appointment of a divestiture trustee at any time in specified circumstances;
- (b) behavioural remedies, comprising:
- (i) in relation to Aberdeen, rebates on charges linked with investment incentives and required consultation on capital expenditure;
 - (ii) in relation to Heathrow, and possibly Gatwick and/or Stansted, requirements strengthening the consultation processes, provisions on non-discrimination and provisions on quality of service;
- (c) in relation to the economic regulation of airports, recommendations to the DfT that:
- (i) the Government should adopt a licence-based regime of economic regulation;
 - (ii) the regulator's primary objective should include a duty to promote effective competition between airports and in assessing the interests of consumers, the regulator should have due regard to the view of airlines;

- (iii) the role of the CC should be changed to that of an appellate body and the right of appeal should be extended to airlines and parties whose interests are materially affected by the airport regulator's decisions; rights of appeal should apply to the airport regulator's determinations on whether an airport holds Significant Market Power (SMP) and associated licence obligations;
 - (iv) the licence should impose a set of duties on the operator of Heathrow. The licence should also give the regulator adequate information gathering powers;
 - (v) the regulator should be under a statutory duty not to set price caps or impose related licence obligations or to retain them unless its market analysis shows that there is a material risk of the relevant airport charges being set at an excessively high level with adverse consequences for end users; and
 - (vi) the legislation should be amended to allow for terminals to be developed or re-developed and operated separately from runway facilities;
- (d) in relation to air transport policy, recommendations to the DfT that:
- (i) it should, in the context of the development of the aviation National Policy Statement (NPS) consider the impact of the White Paper on the aviation market in the South-East, in the light of the divestiture of Gatwick and should ensure that the aviation NPS does not unduly constrain this market;
 - (ii) in developing the aviation NPS, the DfT should give due consideration to the ambitions of the new owner of Gatwick, including the possibility of a second runway at Gatwick after 2019; and
 - (iii) the DfT should request a review, under section 31 of the Airports Act, of the current air traffic distribution rules relating to cargo traffic at Gatwick.

18. We consider that the above measures provide a comprehensive solution to the various aspects of the AEC outlined in paragraph 16. Items (a) and (b) are measures that lie within the CC's powers of implementation. Items (c) and (d) are

recommendations to be considered for action by the DfT. The elements of the proposed remedies package are considered in detail in the following sections.

Assessment of divestiture remedies

Introduction

19. Common ownership of the BAA airports is identified in our provisional findings as a feature that may prevent, restrict or distort competition as it prevents rivalry between airports that could potentially compete with one another. A divestiture remedy seeks to act directly and structurally upon the AEC resulting from this feature as it replaces common ownership with separate ownership where each separate owner has incentives to compete to gain the business of customers.

20. In this section we first consider the effectiveness of divestiture as compared with alternative remedy options, then proceed to consider the appropriate choice of airports for divestiture and issues of proportionality.

Effectiveness of divestiture

21. In its response to our Remedies Notice, BAA considered that we had failed to demonstrate any consideration of remedies other than divestiture for the supposed AEC caused by common ownership.³ It also considered that we had disregarded the possibility that remedies other than divestiture might be equally effective in addressing the AEC attributed to common ownership, both with respect to London and Scotland.⁴ But a number of airlines have commented that divestiture remedies would be more effective than behavioural remedies.

³See Paragraph 15.

⁴See Paragraph 17.

22. We consider that to create effective rivalry between airports that have the potential to compete, divestiture needs to dispose of a viable, competitive business to a suitable purchaser through an effective divestiture process. We review the risks attaching to each of these three critical elements of divestiture in detail in paragraphs 86 to 141 of this document. Although the proposed divestitures are not without risk, there is no significant evidence from the submissions we have received from BAA and other parties to suggest that these risks are not manageable or are likely to render divestiture ineffective. We therefore consider that divestiture is likely to be effective in addressing the AEC that we have identified that result from common ownership.
23. The AEC resulting from common ownership by BAA is analogous in many ways to the result of an accretion of market power in a completed merger situation that would result in a CC finding of a substantial lessening of competition (SLC). Our provisional findings note that 'BAA accounts for about two-thirds of airport passengers in the UK, about 90 per cent in south-east England and almost 85 per cent in Scotland. These are very substantial shares: it is unlikely that a merger resulting in shares of such size would be allowed on the basis of actual or potential competition particularly given the high barriers to entry which may exist'.⁵ Divestiture or prohibition has been required in the vast majority (over 80 per cent) of merger cases under the Enterprise Act in which the CC has found an SLC and in virtually all cases where divestiture (or prohibition) has been feasible.
24. In our Remedies Notice we invited submissions on any practical alternatives to the possible remedies outlined in the notice that would appropriately address the AEC or resulting detrimental effects on customers identified in our provisional findings.⁶

⁵Provisional findings paragraph 2.134.

⁶See paragraph 48.

25. BAA argued that peak-pricing could be used as an alternative to divestiture of either Gatwick or Stansted to address the asserted scope for encouraging greater use of capacity in off-peak periods. This, BAA argued, could be implemented either by way of regulatory requirement or by increasing the incentives for airports to attract airlines to use spare capacity. We disagree. We do not view peak-pricing and/or making maximum use of existing runway capacity as an end in itself (particularly if it results in poor service quality). Rather we view spare runway capacity, the size of which depends on the efficiency of runway utilization, as a factor which may facilitate competition between airports and, in so doing, ensure the best possible outcomes for customers in terms of pricing, service and innovation.
26. BAA suggested that the benefits which we have identified resulting from the proposed divestitures to investment in new capacity could be achieved by a stable regulatory framework that provided increased incentives to invest in such projects. For example, it suggested that the regulator could set returns on incremental outputs delivered by new runways at a higher level than for existing outputs. Alternatively, if this was not fully effective, trigger mechanisms could be introduced to provide greater assurance over the delivery of new capacity.
27. BAA itself recognized in proposing this alternative remedy that it would require the regulator to take a substantive view of the appropriate basis for expansion, with user perspectives properly accommodated in this process through enhanced consultation arrangements. We have documented extensively in our recent quinquennial price control reports how challenging this process can be.
28. We recognize that reforms to the regulatory system may be helpful in encouraging capacity development, compared to current regulatory arrangements. However, we

consider that a regulatory system with further refinements will remain an imperfect and uncertain mimic of competitive rivalry.

29. BAA considered that the scope for improvements arising from new management strategies (that we believed would result from divestiture) could be addressed through the introduction of management and/or financial separation of the airports.
30. We consider that the incentives for innovation and rivalry generated by such separation will be relatively weak unless there is full separation of ownership. Enforcement of such separation may also be an onerous regulatory requirement. We note that BAA has, in any case, not worked up this possibility into a detailed proposal for implementation.
31. In general we note, with reference to BAA's proposals of alternatives to divestiture, that although these proposals may provide advantages in alleviating certain areas of detriment in the short term, they are ineffective in providing the comprehensive long-term solution that we are required to seek. The proposals also require ongoing monitoring and enforcement which may constrain their effectiveness and increase the costs of implementation on a continuing basis.
32. Separate terminal operation and development (STOD) or terminal competition has been put to us as a remedy that may, in certain circumstances, be more effective than divestiture in introducing market disciplines into airport investment and/or operations. Similar proposals (terminal development tendering (TDT)) were also raised with us in the context of the development of a second terminal at Stansted and we consider this concept in greater detail in Appendix 7.

33. We consider that STOD might address some detriments, such as poor responsiveness of capital programmes and service levels in terminals set up for such competition, but it would not deal with these detriments in respect of common areas or infrastructure services. The proposal might also suffer from the following shortcomings:
- (a) *Regulatory involvement.* STOD might require significant on-going regulatory involvement regarding the interface between the terminal and the rest of the airport operations.
 - (b) *Potential for exclusionary behaviour.* Safeguards would be needed to ensure that new entrant airlines were not excluded from terminal facilities by incumbent airlines.
 - (c) *Operational interface.* Unlike overseas examples of separate ownership of terminals where core airport infrastructure is generally publicly owned, the implementation of STOD at BAA's airports would involve a terminal competing with the remaining privately owned and integrated operations and terminals provided by BAA. There is therefore the potential for the separately operated terminal to be disadvantaged by a number of 'soft biases' by BAA in favour of its own terminal clients.
 - (d) *Operational flexibility.* The separate operation of the terminal would have the potential to increase the complexity and reduce the flexibility of airport operations.
 - (e) *Legal issues.* The implementation of STOD would require legislative reform.
34. In view of the above issues we consider that STOD is unlikely to be as effective as divestiture in addressing the detriments we have identified where airports have the potential of competing. However, where divestiture is not viable or is unable to address anti-competitive features then this proposal may have a role. We return to this possibility in considering recommendations for regulatory reform as we consider

that it would be advantageous for the regulatory system to be able to facilitate terminal competition where the need arises in future.

35. In this section we have considered the effectiveness of divestiture alongside other suggested alternatives. We conclude that these alternatives to divestiture are unlikely to be effective in providing the comprehensive long-term solution that we are required to seek. In the next section we consider the appropriate selection of airports for divestiture and then consider the proportionality of divestiture in the context of the likely costs and benefits of divestiture.

Choice of airports for divestiture

36. In the Remedies Notice, we sought views on our proposals that divestiture of two of Heathrow, Gatwick and Stansted was required to achieve separate ownership of each of Heathrow, Gatwick and Stansted to address effectively the AEC resulting from the common ownership of these airports. We also considered that if Heathrow or Gatwick was under separate ownership, this would effectively address the AEC resulting from common ownership of Southampton with the London airports owned by BAA. In addition, we sought views on which of Edinburgh and Glasgow would be the most effective divestiture business to remedy the AEC resulting from common ownership of BAA's Scottish airports. We further consider the choice of airports to divest in the following paragraphs.

BAA's London Airports

37. In the Remedies Notice we stated that, in choosing between divestiture businesses that are equally effective in addressing the AEC, the CC would choose those which imposed the least cost or least restriction. On this basis we were unlikely to require the divestiture of Heathrow unless divestiture of Gatwick or Stansted was likely to be ineffective or impractical.

38. BAA stated in its response to the Remedies Notice that it was ‘not aware of any issues or obstacles associated with the divestment of Gatwick or Stansted that would provide grounds for preferring Heathrow as the divestiture business. In such circumstances, BAA considered that Heathrow could be ruled out for any potential divestiture’.
39. We have received no significant evidence to suggest that there is likely to be an obstacle to divesting Gatwick or Stansted and therefore, on this basis, we propose that Heathrow is not divested as the AEC we have provisionally found with respect to BAA’s London airports may be effectively remedied by the divestiture of Gatwick and Stansted. In the event that either Gatwick or Stansted could not be sold, it would be necessary for us to consider the divestiture of Heathrow to address the AEC.
40. In our Remedies Notice we considered that existing capacity constraints in BAA’s London airports might restrict the extent of competition in the short term following divestiture and that this implied regulation in some form might need to continue at Gatwick and Stansted until more capacity became available. In the case of Heathrow, we also noted that its hub status might limit the degree to which it could be constrained in the long term by rival airports (for some airlines) and therefore suggested that Heathrow might warrant longer-term regulation. We return to the issue of the form of regulation in the later section on ‘Recommendations on airport regulation’. We note that since the publication of the Remedies Notice, further expansion has been approved⁷ at Stansted which will add a further 10 million passengers per annum (mppa) of capacity and also that current utilization of existing capacity has fallen due to the impact of recession on the demand for air travel. These

⁷This is currently being appealed.

factors will tend to lessen capacity constraints in the short to medium term and increase the scope for competition following divestiture.

41. Since publication of our Remedies Notice BAA has started the process of selling Gatwick. BAA has also argued that our proposal to remedy the AEC associated with common ownership by divesting two of its London airports has not been supported by a proper analysis of potential remedies. BAA argued that it is incumbent upon us to consider whether the divestiture of one airport would be sufficient to address our concerns and to set out our views to facilitate effective consultation. We set out our consideration of this issue in detail in Appendix 1 but note particular points in the following paragraphs.

42. BAA has argued that the scope for competition between Heathrow and Stansted is limited because the substitutability between Heathrow and Stansted is weak. This, it argued, implies that the AEC associated with common ownership of both airports is small and the resulting rationale for the divestiture of Stansted is correspondingly weak. In particular, BAA claimed that:
 - (a) Heathrow's hub characteristics limit the scope for competition with Gatwick and Stansted;
 - (b) the majority of airlines serving Heathrow would not consider the other London airports to be close or effective substitutes, or even alternatives at all given Heathrow's unrivalled network of long-haul and short-haul connections;
 - (c) the vast majority of Heathrow's transfer passengers would not consider Gatwick or Stansted as close or effective substitutes, or even alternatives for Heathrow at all;
 - (d) a large proportion of non-transfer passengers using Heathrow would not consider the other London airports to be close or effective substitutes given the significant

differences in location, network coverage and frequency between these airports;
and

(e) the degree of excess demand at Heathrow is particularly large and the likelihood of deregulation at Heathrow is less than at the other airports, which means that there is particularly strong reason to doubt that there is any scope for static (ie short term) competition between Heathrow and the other airports.

43. In our view the evidence does not support BAA's view. The survey results and analysis we have collated (summarized in Appendix 1) indicate that, although some airlines may not view Heathrow and Stansted as substitutes, many of their non-transfer passengers do. Evidence from British Airways Plc (BA) corroborates this view: it told us that competition from low cost carriers (LCCs) at Stansted had affected the profitability of a number of its short-haul routes that they operated from Heathrow.⁸ We recognize that approximately one-third of the passengers using Heathrow are transfer passengers and most are unlikely to view Stansted as a substitute. However, non-transfer and transfer passengers travel on the same flights and there are important complementarities between the two sources of demand. This implies that the behaviour of non-transfer passengers will influence the strategic choices the operators of Heathrow and Stansted make. This view is also supported by BAA's own modelling which shows how passenger numbers and profitability at Stansted may be influenced by prospective capacity expansion (mixed mode and runway 3) at Heathrow.

44. We therefore expect Heathrow and Stansted to compete under separate ownership. At first, we anticipate that they will be confined to competing for passengers with one

⁸BA gave us a number of examples of competition at Stansted affecting its services from Heathrow. In one case, entry at Stansted by an LCC increased the overall market size of a particular route, but also increased price competition at Heathrow, with a reduction in yield of about one-third in economy class. BA moved its services to Gatwick, and then discontinued the route. Loss of passengers as a result of growing competition from LCCs at both Luton Airport (Luton) and Stansted more generally caused BA to change the commercial proposition for short-haul services, as a result of which it competed more effectively with the LCC sector.

another within the confines of economic regulation and existing runway constraints and that the impact of this competition may be marginal. However, as capacity increases and regulation is relaxed we expect competition between Heathrow and Stansted to become more intense.

45. In addition, we consider that divestiture of Stansted would bring other important benefits in the 'short term' through the following means:
 - (a) the creation of another independently operated airport enabling regulators and investors to benchmark airport performance better; and
 - (b) the introduction of another new management team active in the south-east airport market which may employ new approaches to airport operation offering passengers higher quality, greater innovation and increased choice.

46. It should be noted that the conceptual distinction between the 'short term' and the 'long term' is likely to be less than clear-cut in practice. Decisions regarding the form and amount of significant additional capacity come into effect in the 'long term'. However, the decisions themselves may take place in the 'short term' and would be influenced by the pressures of rivalry following divestiture. Thus the benefits of dynamic competition on the form and amount of capacity expansion are likely to begin to accrue in the 'short term' as decisions begin to reflect competitive pressures.

47. The full range of benefits of the sale of Stansted cannot be predicted with precision, given BAA's joint-ownership of the three largest airports in the South-East, which has prevented the development of competition to date but over time we would expect the divestiture of Stansted to have significant benefits in terms of the additional rivalry that this would exert, for example on the competition for capacity expansion, on the subsequent roll-out of capacity and on the level of competition observed between airports once capacity expansion has been completed.

48. By increasing the degree of inter-airport rivalry in the South-East, the divestment of Stansted also increases the likelihood of de-regulation at Gatwick and Stansted (and perhaps in the longer-term Heathrow), and the transition towards competition.
49. In view of the above we consider that divestiture of Stansted in addition to Gatwick is justified to remedy effectively the AEC we have identified arising from BAA's ownership of London airports.

Southampton

50. In our Remedies Notice we stated it was currently our view that if Heathrow or Gatwick were under separate ownership from Southampton, this would effectively address the AEC resulting from their common ownership.
51. Flybe Group Limited (Flybe), which accounts for over 90 per cent of passengers at Southampton, commented that the separation of ownership of Gatwick and Southampton would not address all the AEC we identified. In particular, Flybe argued that Southampton had the potential to provide domestic and European services which would be competitive with those from Heathrow; that the benefits of this competition were unlikely to be achieved if Southampton remained in common ownership with Heathrow; and that Southampton would consequently stagnate. Flybe referred to our statements in our provisional findings about BAA's lack of engagement with users and lack of ambition at Southampton. Flybe suggested that BAA should be required to divest Southampton.
52. We consider the issue of the potential divestiture of Southampton in more detail in Appendix 2. In summary, however, Southampton is a small airport and, as indicated in our provisional findings is a very weak substitute for Heathrow. Divestiture of Southampton would not therefore result in any significant additional constraint on Heathrow. Southampton is already subject to competition from Bournemouth Airport,

which is not currently constrained by capacity limits, and the divestiture of Gatwick by BAA will significantly increase the competitive constraints on Southampton.

Separation of Southampton's ownership from Heathrow as well as Gatwick could increase the competitive constraints on Southampton. In the short term this might provide an incentive for a separate owner to reduce passenger charges at Southampton, albeit any such incentive seems likely to be quite weak.

53. Flybe also argued that divestiture of Southampton would have a greater competitive benefit than divestiture of Stansted. Our quantitative evidence does not support this view: Stansted is the second closest substitute to Heathrow after Gatwick and Southampton is quite a long way behind reflecting its much smaller size.
54. On balance, we consider that the divestiture of Southampton is not justified as it is unlikely to generate sufficient incremental benefit to competition over and above the divestiture of Gatwick.

Scotland

55. In our Remedies Notice we sought views on which of Edinburgh and Glasgow would be the most effective divestiture business to remedy the AEC resulting from common ownership of BAA's Scottish airports.
56. BAA considered that there was no basis in terms of the AEC to suggest that either Edinburgh or Glasgow would be a more effective divestiture business. BAA was also not aware of any specific issue or obstacle that would impact the saleability of either airport.
57. In response to our Remedies Notice, a number of third parties have argued that Edinburgh would constitute a more effective divestiture package than Glasgow:

- (a) easyJet plc (easyJet) argued that, if Glasgow was retained by BAA, it would be under competitive pressure from both Edinburgh and Prestwick Airport (Prestwick). This was also Ryanair Limited's (Ryanair) view.
- (b) Flybe argued that Edinburgh had the better prospects for development and would benefit more than Glasgow from having an owner other than BAA.
- (c) Flybe also argued that different ownership of Edinburgh and Heathrow would bring benefits, as a separate owner of Edinburgh would have a stronger incentive to cut airport charges and encourage new route development, rather than have passengers continue to travel via Heathrow.
- (d) The MSP for Clydebank and Milngavie commented that if Glasgow were sold, BAA would still have the two major airports in the east of Scotland and possible competition between Edinburgh and Aberdeen for passengers from areas such as Perth and Dundee would be ruled out. (A similar argument was put to us by an airline.)

58. [REDACTED] considered that a new owner of either airport would be likely to drive investment in infrastructure and route development to recoup its investment in acquiring the business. However, at present, Edinburgh was perceived to have the greater potential for growth and route development. Glasgow continued to be an attractive location but was perceived to be more mature, had less growth potential and had adequate capacity for the foreseeable future.

59. We have considered carefully all the arguments for a divestiture of Edinburgh in preference to Glasgow. Taking the arguments in turn:

- (a) While we agree that Prestwick exerts a greater competitive constraint on Glasgow than on Edinburgh, effective divestiture of either Glasgow or Edinburgh will result in the same long-term competitive outcome of three separately owned airports in central Scotland and thus address our AEC of common ownership.

- (b) We accept that Edinburgh's development and growth prospects are probably better than those of Glasgow. However, that does not in itself suggest that there will be stronger competition as a result of divesting Edinburgh. In the absence of common ownership with Glasgow, we would expect that any owner, including BAA, would have incentives to develop Edinburgh. However, we believe it is plausible to consider that the sale of Edinburgh would result in more rapid development than if it were retained by BAA, given the impact of new management. Divestiture of Edinburgh, as the airport with greatest potential for development, rather than Glasgow, may therefore lead to a more rapid realization of the benefits of addressing the AEC.
- (c) We have not provisionally found any AEC from BAA's common ownership of Heathrow and Edinburgh. We have not seen evidence that BAA is reluctant to expand its other airports because of a wish to maintain transfer traffic through Heathrow.
- (d) We have not provisionally found any AEC from BAA's common ownership of Edinburgh and Aberdeen given the small level of overlap of catchment areas of the two airports.

60. Another reason why we might consider the divestiture of one of the two airports to be preferable would be if there was doubt about the saleability of the other one. There appears to be a clear consensus among respondents other than BAA that Edinburgh is a more attractive airport for sale than Glasgow. Although divestiture of Glasgow appears to be feasible and there does not appear to be a substantial risk that Glasgow will not secure a suitable buyer, there appears to be materially less risk that Edinburgh will fail to secure a suitable buyer than Glasgow. This may be particularly relevant if, as BAA has predicted latterly in connection with the sale of Gatwick, conditions for sale of infrastructure assets deteriorate during the course of 2009.

61. We recognize that some of the arguments put to us, as outlined above, do not appear to justify divestiture of Edinburgh rather than Glasgow in terms of remedying the AEC. However, we consider that divestiture of Edinburgh is likely to realize the benefits of addressing the AEC more rapidly than divestiture of Glasgow and may be less subject to purchaser risk. Our provisional decision is that on balance, BAA should be required to divest Edinburgh rather than Glasgow. However, we remain open to further views on this issue.

Proportionality of divestiture remedies

62. Having considered alternatives to divestiture and then the appropriate choice of divestiture airports which is the least intrusive that is consistent with effectively addressing the AEC we have identified, we now move on to consider whether the proposed divestitures are proportionate in relation to the AEC and any resulting detrimental effect on customers.

Costs of remedies

63. Part of the CC's consideration of proportionality includes an assessment of the costs of implementing and complying with a remedy. However, the CC must also consider the wider picture. An AEC is likely to result in a cost or disadvantage to the UK economy in general and customers in particular. Where significant, these costs might usually be expected to outweigh the costs incurred by any person on whom remedies are imposed.⁹

64. BAA has provided estimates of the cost of separating Gatwick, Stansted and Glasgow from the remainder of the BAA group. Included in these costs is a pension cost of £[X] to cover pension scheme liabilities arising on divestiture [X].

⁹CC3, paragraphs 4.10 and 4.11.

65. We note that the agreement does not change the overall pension fund liability to pension fund members but crystallizes a cash contribution on a conservative basis from BAA in place of potential ongoing contributions from BAA. We note therefore that the total liability represents a rephasing of cash flow (with some associated financing costs) rather than a true overall cost of divestiture. Furthermore, to the extent that the liability exceeds the likely present value of future contributions that would otherwise be required from BAA, this would improve the overall funding of the pension fund and should be reflected in a higher value to be received from the airport sale.

66. [REDACTED]

67. In view of the above considerations we do not consider that the pension liability should be considered to be a relevant cost of the divestiture remedy. The remaining costs of separation are summarized below and are set out and considered in detail in Appendix 4.

TABLE 1 **Analysis of the cost of separation**

	<i>£ million</i>			
	<i>Gatwick</i>	<i>Stansted</i>	<i>Glasgow</i>	<i>Total</i>
Total—excluding pension costs	44.5	44.8	16.8	106.1
CC adjusted total	27.6	23.0	12.2	62.8

Source: BAA, CC analysis.

68. BAA considered that the total cost of separation for the three airports excluding pension costs would be £106 million.

69. The costs are reviewed in detail in Appendix 4. We consider that many of these costs are overstated and lack substantiation. After removing unrealistic elements we

consider that a more appropriate estimate for the relevant costs of divestiture is approximately £63 million for the three airports.

70. We note that the above estimate of relevant costs is a relatively small sum in relation to the total market value of these airports, estimated by some commentators to exceed £4 billion,¹⁰ and also in relation to the turnover of the airports.
71. In any event, we also note, as we commented in the Remedies Notice, that the Ferrovial consortium, Airport Development and Investment Ltd (ADI) which acquired BAA in 2006, chose to complete the acquisition of BAA after the OFT had announced a market study of BAA in which continuing common ownership of BAA's airports was flagged as an issue. In deciding to proceed with the acquisition of BAA, ADI took on the regulatory risk of potential divestiture and we are therefore not minded to place any significant weight on the one-off costs of divestiture in deciding upon the appropriateness of divestiture remedies.

Relevant customer benefits

72. In selecting appropriate remedies, the CC will have regard to any relevant customer benefits within the meaning of section 134(8) of the Enterprise Act arising from the feature or features giving rise to the AEC. To be regarded as relevant customer benefits, the benefits should be unlikely to accrue in the absence of the feature or features and should be expected to be reflected in lower prices, higher quality or greater choice of goods or services or greater innovation in relation to such goods or services.

¹⁰We have no firm evidence on their actual current value, but even if it were substantially less than this figure, the estimated costs would still be a very small proportion.

73. BAA submitted that the economies of scale associated with operating the relevant airports under the feature of common ownership were in the region of £100 million a year. Economies of scale accrue in the first instance to BAA and could represent a relevant customer benefit if passed on to customers. We would expect the benefits of economies of scale to be passed on if there is effective competition. However, we have provisionally found this is absent due to BAA's common ownership. In the case of BAA's London airports, any economies of scale might also be passed through to customers as a result of regulation, though the inevitably imperfect nature of regulation could limit the extent of pass through. BAA's submission on economies of scale is reviewed in detail in Appendix 4. We consider that the figures are overestimated, unsubstantiated and in some cases double-counted. After removing unrealistic elements we consider that a maximum estimate for these benefits is approximately £29 million a year for the three airports.
74. BAA has also pointed to a number of unquantified benefits of common ownership such as delivering new runway capacity and favourable access to capital markets. These claims are also reviewed in Appendix 4 and we conclude that there appear to be no significant miscellaneous benefits arising from common ownership. We note in particular that in the context of current capital market conditions and its recent refinancing, BAA does not appear to have better access to capital markets than others and that it has not developed new runway capacity since its privatization in 1987 and therefore does not have particular advantages in this regard.
75. We also observe that BAA's submissions are predicated on the assumption that the airports will be stand-alone entities after any divestiture. It is highly likely, given the value of the airports under consideration, the CC requirements for expertise in airport operation in any suitable purchaser and the record of acquisitions of airports in recent years, that the airports may be acquired by existing large companies or financial

institutions, with existing airport operations and expertise in planning and developing airport facilities. In such circumstances the new business would potentially have the ability to deliver much of what BAA considers to be the benefits of common ownership. In effect, much of these benefits would not be relevant customer benefits as they could plausibly be generated in the absence of the relevant features.

76. As noted in Appendix 4, a number of airlines have submitted that there may in fact be negative economies arising from BAA's common ownership of airports. In the CC's regulatory reviews of Gatwick, Heathrow and Stansted, we have also found significant scope for efficiency savings in BAA's capital and operating expenditure.
77. On balance, we consider that any relevant customer benefits arising from BAA's common ownership are likely to be negligible.

Benefits of competition

78. In our guidance (CC3) we note the advantages of competitive rivalry:
- Rivalry has numerous beneficial effects: prices and costs are driven down, and innovation and productivity increase, so increasing the quality and, more generally, the diversity of choice available to customers. Further, markets that are competitive generate feedback from customers to firms who, in consequence, direct their resources to customers' priorities. In addition firms are encouraged to meet the existing and future needs of customers as effectively and efficiently as possible. It is where this process is hampered or otherwise hindered, by features of the market that competition may be adversely affected.¹¹

¹¹CC3 paragraph 1.17.

In our provisional findings we observe these advantages of rivalry in our case studies of competing airports (see paragraphs 4.7 to 4.13). In our observations of BAA in our provisional findings, we note many of the disadvantages of a lack of rivalry, notably in the absence of responsiveness to customers, quality of service deficiencies and a failure to ensure operating excellence.

79. In our judgement, the benefits of divestiture in terms of addressing the detrimental effects of the AEC are likely to be substantial in total and in comparison with the relatively low relevant costs of divestiture.
80. Calculation of the quantum of divestiture benefits is inevitably complex and subject to uncertainty. Competition is a dynamic and inherently uncertain process, and it is therefore difficult to anticipate precisely how competition between the airports will benefit customers following divestiture. The uncertainty is exacerbated in this case by the current absence of competition between BAA airports and the shortage of direct comparators from which to extrapolate the size of benefits that could be expected to result from competition between BAA's airports in the South-East and between Edinburgh and Glasgow.
81. Even so, for Glasgow and Edinburgh we have attempted to make some estimates of benefit based on relative price trends over the past 15 years (our detailed analysis is in Appendix 3). Based on our assumptions, we would expect discounts on existing services at Edinburgh to increase to the level already present at Glasgow, generating a present value of benefits to customers of at least £40 million. Additional to that, we would expect further benefits from each of the two airports responding to competition from the other; from new services being launched at both airports; and in the longer term from capacity developments and service levels at both airports being more closely aligned with customer interests.

82. Estimation of benefits for the divested London airports is subject to greater uncertainty given the more complex interactions and the existing regulatory regime. However, we estimate that on average the net benefits of competition for the London airports would only need to exceed between 2p and 9p per passenger at Stansted or between 2p and 7p per passenger at Gatwick on average over the next 30 years to exceed our estimate of the maximum relevant costs of divestiture. These calculations are based on one-off costs of divestiture of approximately £28 million at Gatwick and approximately £23 million at Stansted, and the benefits are shown net of any relevant customer benefits that would arise from continuing common ownership (the calculations are set out in Appendix 4).
83. In the course of our recent review of airport charges at Stansted, we have also identified examples of potential savings, resulting from improved capital efficiency, the design of differentiated terminal facilities and better control of staff costs:
- (a) our cost consultants, Gleeds, considered that a saving of £500m on the development of a second runway and associated facilities at Stansted could potentially be achieved through capital efficiency. This represented a 19 per cent saving on the costs put forward by BAA. The adoption of different parameters for the terminal building and airfield could result in further savings;
 - (b) similarly, Currie & Brown's analysis of the capital projects costs of BAA's original Stansted Generation 1 capex programme showed that BAA's project costs included high risk allowances and considered that a leaner approach to cost estimation could have resulted in savings of 10 to 16 per cent, equivalent to £25 to £40 million¹² over Q5;¹³

¹²These savings relate to BAA's chosen programme for the development of Stansted to 35 mppa. Under pressure from the airlines, key projects were removed from the programme. C&B's analysis of this much reduced programme resulted in the identification of 6 to 7 per cent efficiency savings.

¹³Five years from 2009/10 to 2013/14.

(c) in relation to operating expenditure, based on analysis carried out by IDS and further CC work, we concluded that it was reasonable to assume that Stansted could eventually reduce relative pay costs by at least 20 per cent. There was also scope for reducing absenteeism.

84. We consider that the above example savings would be delivered more quickly and to a much fuller extent in a competitive environment and that airports under separate ownership would have stronger incentives to deliver differentiated facilities to meet the needs of their customers and to manage their project costs more efficiently. These examples support our view that the net benefits of competition are likely to be substantial and considerably to exceed the relevant costs of divestiture.

85. We therefore conclude that the relevant costs of divestiture are relatively minor and that divestiture of each of Gatwick, Stansted and Edinburgh is proportionate in relation to the AEC and the detriments to customers it may address.

Implementation issues

86. To be effective in fostering rivalry between BAA's airports, the divestiture remedy should involve the sale of an appropriate divestiture package to a suitable purchaser through an effective divestiture process. Each of these areas may give rise to risks that could compromise the onset of competition. *Composition risks* may arise if the scope of the divestiture business is too constrained or not configured to attract a suitable purchaser or does not allow a purchaser to operate as an effective competitor. *Purchaser risks* may arise if a suitable purchaser is not available or BAA disposes to a weak purchaser. *Asset risks* may arise if the competitive capability of a divestiture is allowed to deteriorate during the course of the process.

87. It appears that the main potential risks that we should seek to control in this case are:

- (a) the separate sale of key airport assets;
- (b) the inadequate planning of separation of central services (notably IT) or continuing supply of central services in a form that would compromise competition from the purchaser;
- (c) the sale to a purchaser with inadequate financial facilities to develop the airport in question;
- (d) the unwarranted exclusion of potentially strong competitors from the sale process;
- (e) the sale to a purchaser with inadequate operating expertise; and
- (f) in relation to Stansted, the risk of prejudicing the outcome of the Stansted Generation 2 (SG2) planning inquiry.

88. We discuss each source of potential divestiture risk and the process for managing these risks in the paragraphs below. Asset risks appear to be relatively low and are not discussed further. We note, however, some airlines' concerns that quality of service might degrade and investments might be deferred prior to divestiture.

Viability divestiture package and composition risks

89. The business or package of assets to be divested should contain all that is necessary for a suitable purchaser to compete effectively with the divesting business. Airports are relatively self contained businesses and therefore the definition of the divestiture is relatively straightforward for complete airports compared with other cases of divestiture. Composition risks in this case therefore appear to be low.

90. The main issue raised by the airlines (eg BA, Virgin Atlantic Airways Limited (Virgin)) is that BAA should not be allowed to sell off profitable assets separately from within the single till that may be regarded as an important facility by prospective purchasers (eg land, parking rights). Another concern (also expressed by Virgin) was that

sharing of the use of IT facilities between the new owner of Gatwick and BAA would be complex and risky, and could undermine the effectiveness of the remedy.

91. Another potential issue relates to the licence to operate the airport. However, in this case each airport company (ie Heathrow Airport Limited (HAL), Gatwick Airport Limited (GAL) and Stansted Airport Limited (STAL)) holds the CAA licence¹⁴ which allows it to operate under UK airport safety regulations. Provided that the sale process involves a transfer of shares, with no change to the management structure, the airport will be able to continue to operate. If changes were made to the management structure, however, these would be dealt with as part of the normal licensing process. There could clearly be complications before the licences were allowed to continue or before new licences were issued.

92. Key separation issues will concern IT systems, for which a transitional contract between the new owner and BAA will be needed. BAA's IT service provision is centralized and integrated. Issues identified by BAA include:
 - (a) the integrated nature of the IT infrastructure which provides the required resilience for the group as a whole;
 - (b) data classification and separation, eg shared document separation; and
 - (c) common external data interfaces.

93. BAA estimated that to achieve the separation of IT systems and infrastructure would take 12 to 18 months, but this time line could be reduced to six to nine months if a transitional arrangement could be made a condition of any divestiture. BAA estimated that such transitional arrangements would need to be in place for 12 to 18 months

¹⁴Issued by the CAA's Safety Regulation Group.

following the sale depending on the new owners IT capability and future service requirements.

94. Pan-airport contracts, from which the divested airport would need to be extricated, could in theory raise practical difficulties. However, in this case the majority of supplier contracts are undertaken at an airport level and should therefore not pose significant problems. We consider that given their nature, contractual issues are primarily a concern in so far as they may affect the cost of divestiture, rather than the ability of any BAA airport to operate as a stand-alone business.
95. Care will also be needed to ensure that the divestiture is not encumbered by continuing long-term contracts with BAA or assets owned by BAA that could restrict future competition. Divesting rights to develop and operate terminals is dealt with under the separate remedies option of STOD, which is discussed in detail in Appendix 7.

Suitable purchaser and purchaser risks

96. In controlling purchaser risk we need to apply criteria that prevent BAA from divesting to purchasers that will be compromised from competing effectively. However, we also seek to be reasonable in applying the criteria to avoid introducing constraints that result in no realistic purchasers being available.
97. In the Remedies Notice we considered that a suitable purchaser should be independent of BAA, should have appropriate expertise and financial resources to operate and develop the divestiture business as an effective competitor and should not create further competitive concerns as a result of divestiture. These are effectively the standard criteria that we use in merger inquiries.

98. We consider below the extent to which the specificities of this case require different or additional requirements. We also provide greater detail on how we would apply the criteria specified in the Remedies Notice referred to in paragraph 97 above.

Parties' views

99. BAA argued that there was no basis for additional criteria to be applied in this case, since our provisional findings made it clear that separate ownership alone would be sufficient to drive the competitive process, rather than competition being dependent in some way on the particular attributes of the separate owners or additional safeguards. BAA was also concerned that additional criteria would also create risks for the divestiture process by unduly narrowing the field of potential purchasers.
100. The CAA noted that its Safety Regulation Group would need to satisfy itself as to the competence of airport management from a safety perspective.
101. The DfT was concerned with the financial robustness of prospective purchasers, and in particular the ability of the purchaser of Gatwick to fund the Q5 capex programme. The DfT also argued that potential purchasers should demonstrate both their resilience to financial shocks and their ability to raise capital to pursue appropriate investment consistent with the Government's policy objectives for airports. The DfT was itself the regulator for airport security and would require that any purchaser would not itself create security concerns and could show that it understood the need for compliance with DfT directions in this area.
102. Virgin told us that involvement of airlines in purchasing consortia would be beneficial in aligning the operations of airports with the requirements of customers. Virgin cited the example of National Air Traffic Services Limited (NATS) as a helpful parallel of airline involvement. Other airlines (BA, easyJet and Ryanair), however, expressed

varying degrees of concern that airline ownership of airports could result in discriminatory practices. Similarly, some airlines (Flybe, Ryanair) did not consider NATS to be a particularly effective model for consortium ownership.

Proposed purchaser criteria

103. Based on our analysis and submissions to date we propose the following application of purchaser criteria:

(a) *Independence from BAA and ADI/Ferrovial*—A purchaser's independence from BAA should not be impaired by major operational dependencies (eg IT) other than in a transitional form. Existence of significant economic relationships with the Ferrovial consortium or any of its members would be a major area of concern but would be subject to assessment on a case by case basis regarding the extent of influence.

(b) *Appropriate expertise*—If a purchaser operates other well-regarded comparable airports then prima facie, we will interpret this as providing strong evidence that the purchaser possesses appropriate expertise. If a purchaser does not operate such other airports with a similar reputation, then we will need to be provided with persuasive evidence regarding its access to expertise and ability to provide a management team with comprehensive experience of operating airports. Where the existing BAA airport management team will be employed by the purchaser, this should in any event be supplemented with management with appropriate strategic, regulatory and financial skills to fulfil the functions currently resourced at a group level. The purchaser will also need to satisfy the CAA's Safety Regulation Group regarding management proficiency and will also need to satisfy the DfT regarding security regulations. For each purchaser we would expect to see a comprehensive business plan that feeds into long-term financial projections with accompanying sensitivity analysis. For all purchasers, but particularly

consortia, we would expect to see clearly defined governance arrangements setting out management processes, voting rights, reserved matters, etc.

(c) *Appropriate financial resources*—A purchaser should have access to sufficient financial resources to acquire, develop and operate the airport concerned. This should be evidenced by robust long-term financial projections and sufficient head room in finance facilities or capacity to raise capital to cope with significant adverse sensitivities.¹⁵ In the case of Stansted we would expect a purchaser to have the capability to fund the development of SG2.

(d) *Absence of further competitive concerns*—A purchaser should not have significant horizontal overlaps with the airport to be acquired. Vertical issues, such as the involvement of airlines in purchaser consortia, will be reviewed on a case by case basis. In principle, we welcome any structure that would deliver a customer-focused approach to the management of the airport. However, we would be concerned if an airline's economic involvement in a consortium could result in exclusionary behaviour towards its competitors, although we recognize that such issues would be limited if the airlines had limited ownership and voting rights *and* there were appropriate controls in place. We note that, in any event, the divestiture will be subject to normal merger control procedures.

Key aspects of the process for assessing the suitability of purchasers

104. In general, we will seek to evaluate whether purchasers fulfil the criteria before any purchaser is granted exclusivity, in order to avoid situations where a prospective purchaser undertakes lengthy due diligence on an exclusive basis but is then found not to satisfy our criteria.

¹⁵This general statement applies to all airports. There may be additional requirements in relation to Stansted, as set out in paragraph 128(c).

105. Our evaluation of bidders during the sales process will entail several stages at which potential purchasers and their plans will be subject to increasing scrutiny. In the first stage when submitting indicative bids, we would expect potential purchasers to be able to satisfy us that they are independent of BAA and Ferrovial and do not give rise to further competitive concerns. We would also expect them to provide us with preliminary evidence with regard to the other purchaser criteria. In subsequent stages, when purchasers have access to more detailed BAA information we would expect to review purchaser plans, projections and management expertise in detail to assess expertise and financial resources. In the final stages of the divestiture process, we would seek to ensure that the contractual arrangements did not create obstacles to future competitive rivalry.
106. In this particular case, the assessment will also involve other interested parties: the DfT and the CAA. We envisage requiring bidders to provide plans and projections directly to us on how they meet the various criteria and, where appropriate, we will seek to share this information with the DfT and the CAA's Safety Regulation Group to avoid the duplication of processes.
107. Given the importance of capacity development for competition between airports in the South-East, a significant aspect of the assessment of the suitability of purchasers will be the review of their airport development plans. In this respect, we note that if purchasers wish to pursue, with customer support, a different capital investment programme for the acquired airport from the one approved by the CAA for Q5 then this may have implications for the level of the price cap for Gatwick and Stansted following divestiture.
108. In addition, we will seek to limit the possibility of a suitable purchaser transferring control of the recently acquired airport to another purchaser who does not fulfil the

criteria set out above. It is envisaged that one condition of our approval of the purchaser will be an undertaking from the purchaser preventing the onward sale of the airport within a given period (eg five years) unless the CC is satisfied that the same criteria required on the initial divestiture are fulfilled by the new purchaser. In our view, this should not materially affect the attractiveness of the airport to prospective bona fide purchasers with an interest in the long-term development of the relevant airport.

Effective divestiture process

109. The divestiture process needs to be structured to enable canvassing of suitable purchasers and to protect the competitive capability of the divestiture package. We note, in considering the design of the divestiture process that BAA as vendor will have an interest in maximizing divestiture proceeds but it will also have an interest in selling to less competitive purchasers.

Timing issues

General considerations on timing

110. We noted in the Remedies Notice that 'an effective divestiture process should ensure that divestiture of an appropriate divestiture business to a suitable purchaser takes place within a reasonable time period. It should also ensure that the divestiture business does not degrade prior to divestiture'.
111. In determining an appropriate divestiture period, the CC generally seeks to find an appropriate balance between factors that would favour rapid disposal and factors that favour slower divestiture. The former include addressing the AEC promptly and avoiding deterioration of the business. The latter include providing sufficient time to attract and retain suitable purchasers to the divestiture. In the particular case of

Stansted, it will also include ensuring a commitment to the development of new runway and terminal capacity.

112. BAA, in responding to our Remedies Notice, considered that it should be allowed to take longer than the standard period of six months to complete the divestiture process as, among other factors, separating airports from group linkages would take time and there was no need to stipulate a short divestiture period to mitigate the risk of degradation to assets. BAA noted that 'specifying a shorter divestiture period than twelve months at the outset, or requiring the divestments to be carried out concurrently, would create risks for the divestment process that could have a significant impact on the value achieved from the disposals'. However, BAA has itself now decided to accelerate the divestiture of Gatwick so that it should now take significantly less than 12 months to divest if this goes according to plan. BAA indicated to us that this had been prompted by [✂].
113. The CAA did not comment specifically on divestiture periods other than to note that there were some significant limits to the extent that airports were likely to degrade during a divestiture period, given the nature of airports and their main operating assets, together with the CAA's regime of safety regulation.
114. BA did not see any reason for the BAA divestitures to depart from the standard divestiture period of six months.
115. We accept the view that airports are unlikely to degrade as fast as other businesses over a divestiture period. We also accept that the persistence of adverse conditions in financial markets will entail a degree of difficulty for financing airport acquisitions. On this basis, we consider that a 'standard' divestiture period for BAA airports of nine

months on a stand-alone basis, including the preliminary period of two to three months prior to the issue of an information memorandum, would be appropriate.

116. In principle, the divestiture process should be required to start immediately after the acceptance of undertakings or publication of an order to divest by the CC, in order to enable competition to the benefit of customers as soon as possible. However, in this case, there may be two particular reasons for considering whether to delay the divestiture of some of BAA's airports:

(a) the potential interaction between the divestiture of Stansted and the SG2 planning inquiry, and

(b) issues relating to the simultaneous sale of more than one airport in the UK.

Timing of the Stansted divestiture

117. BAA has argued that the risk of disruption to the SG2 planning inquiry would be minimized if divestiture took place after the publication of the decision on the planning application by Ministers. In support of this view, BAA has presented a number of arguments, which we set out in detail in Appendix 5 alongside the views of the DfT and of the Planning Inspectorate and advice we have received from counsel on this issue.

118. The choice of Stansted as the first location for a new runway in the South-East has been driven by the Government following a complex analysis of economic and environmental considerations. Following the announcement of the Government's support for a second runway at Stansted in December 2003, BAA immediately

proceeded with the development of its scheme and submitted its applications¹⁶ on 11 March 2008. The Planning Inquiry is scheduled to commence on 15 April 2009.

119. Investment in new runway and related capacity in the South-East of England is critical to the long-term development of competition for airport services. We recognize, therefore, that a decision on the timing of the divestiture of Stansted should be taken against the background of how best to ensure that investment takes place and to incentivize potential purchasers accordingly.
120. Determining the optimum timing for the divestiture of Stansted involves weighing a number of factors with different implications, including:
 - (a) the degree of flexibility which has been built into the planning application and the extent to which a new owner of Stansted may feel constrained by the terms of any consequent planning consent;
 - (b) the extent to which the planning application and its associated capital and operating costs can be taken into account in the purchase price; and
 - (c) the risk that an early divestiture might prejudice the development of capacity at Stansted.
121. From the point of view of the purchaser of Stansted, there may be both potential drawbacks and benefits from adopting BAA's planning application. The main drawback is that a new owner wishing to proceed with expansion without delay will, by necessity, be constrained in what it builds by the key features of BAA's planning application. In particular, under the terms of any consequent planning consent, the locations of the runway and terminal building are likely to be fixed; similarly some high level parameters will constrain the size of buildings. In other respects, however,

¹⁶The SG2 application is made up of several applications. Hereinafter in this document, the application (singular) refers to the body of applications which together are needed for the SG2 development.

there appears to be significant scope for the new owner to shape the development of Stansted in line with its own views of market requirements, as explained in more detail in Appendix 5 paragraphs 4 to 7. For example, the detailed design of the terminal building has not yet been determined and the new owner should be able to build it and other aspects of the scheme at a different pace from what is outlined in the planning applications. The degree of such flexibility within the planning consent will, however, be constrained by any condition imposed by the Secretaries of State when taking their decision.

122. A key consideration, therefore, in reaching an eventual view on the impact of the planning application on the prospects for new investment, at least in terms of timing, is the extent to which any potential purchaser feels constrained by the terms of the current planning application (within which there is likely to be considerable but far from total scope for partial modification) or alternatively is prepared to suffer the expense, delays and potential risks of submitting a new planning application.
123. Considerations for potential purchasers in reaching a view on such matters are likely to include the commercial implications of the current application in terms of capital and operating costs and the extent to which this may be taken into account in the purchase price. An associated factor is the attitude of Stansted's principal carriers, Ryanair and easyJet, which account for 83 per cent of the passenger throughput, both of which currently object to BAA's plans for the airport.
124. If BAA was required to divest Stansted as soon as possible after the publication of our report, given the timescale of the divestiture and of the planning inquiry, in practice, the new owner of Stansted would gain control of the airport towards the end of the planning inquiry. [✂] It is unclear whether the new owner of Stansted would see benefits in being involved in the planning inquiry.

125. One of the possible risks of an early divestiture prejudicing the development of capacity at Stansted relates to the airport operator's Compulsory Purchase Order (CPO) applications, as discussed in more detail in Appendix 5. It appears to us that this risk would be best mitigated via the sales process and we are considering whether a number of obligations should be placed on the purchaser of Stansted as part of the sale process. The intention of doing so would be to provide a sufficient degree of certainty during the divestiture process to allow the planning inquiry to proceed.¹⁷
126. In reaching our provisional decision on the timing of divestiture, we have been mindful of a number of risks:
- (a) that during the planning inquiry, if in control of the process, BAA may make commitments which would constrain the ability of the new owner to compete effectively with Heathrow;
 - (b) that BAA's handling of the planning inquiry could delay the outcome or result in refusal, as its incentives to win the planning application may be eroded by the prospect of divestiture, even though a planning consent for a second runway should in principle be reflected in the valuation of the airport;
 - (c) that BAA may withdraw its planning application, before the publication of our final report;¹⁸
 - (d) of disruption to the planning inquiry, for whatever reason, resulting in delays and possibly a refusal, if the divestiture takes place during the planning inquiry; and
 - (e) of the planning inquiry and subsequent decision by the SoS being delayed for reasons independent of our investigation.

¹⁷For the avoidance of doubt, we fully acknowledge that the decision whether or not to confirm Stansted Airport's CPOs entirely lies with the relevant Secretary of State.

¹⁸At the point at which the CC assumes formal powers it could and may be minded to require the planning application to be pursued.

127. On balance, however, and recognising the difficulties in evaluating these uncertainties, many of which are contradictory, our current preference is to initiate the divestiture of Stansted as soon as possible, provided, following responses to this document that first, progress on the current planning application is unlikely to be unreasonably compromised and second, the overall objective of developing new runway capacity is not jeopardized.
128. We are therefore now seeking views from all interested parties on all of the factors set out above, including but not limited to:
- (a) the weight that should be attached to the various risks identified in paragraph 126;
 - (b) whether or not it should be a condition of sale that the new owner of Stansted should be required to undertake to continue to pursue BAA's SG2 applications; and
 - (c) whether or not as part of the evaluation of potential purchasers of Stansted they should be required to demonstrate that they have the financial resources necessary to justify making CPOs¹⁹ for the purposes of the development of a second runway at Stansted.
129. If BAA decides to withdraw its planning application in the meantime, we consider that there will be no case for deferring the divestiture of Stansted.

Simultaneous sale of BAA airports

130. BAA is particularly concerned [X]. Manchester Airport Group (MAG) considered that a sequential divestiture process would be preferable to the concurrent sale of several

¹⁹Further guidance on the justification for making Compulsory Purchase Order can be found in Ministerial Circular No 06/2004, D-1212.

BAA airports, as bidders would have a limited ability to mount effective bids simultaneously. [✂]

131. We recognize that the simultaneous sale of BAA airports might, in current market conditions, constrain the opportunity to sell to a suitable purchaser and restrict prospective proceeds. We are therefore seeking additional views, particularly from interested purchasers of BAA airports, on this issue.

Monitoring arrangements and hold separate provisions

132. In most divestiture cases, we put in place hold separate management and appoint monitoring trustees in order to control divestiture risks. In addition, we would normally retain the option to appoint a divestiture trustee if the divesting party did not achieve an effective divestiture within a given period.
133. In our Remedies Notice in this case, we invited views on whether a divestiture trustee should be appointed from the outset of divestiture. Some airlines (eg Virgin and Flybe) supported the appointment of a divestiture trustee but the reasons they gave for this preference (eg scale and complexity of divestiture, BAA's conduct on constructive engagement, risk of underinvestment and deterioration of service quality prior to divestiture) generally seemed to justify close monitoring of the sale process rather than justifying appointment of a divestiture trustee. Adequate reasons would be needed to justify the appointment of a divestiture trustee from the outset of the divestiture process. We have not received or formulated such reasons to date. We will, however, retain the option of appointing a divestiture trustee, if at any point before the completion of the divestiture of any of the relevant airports we have reasonable grounds to believe that a divestiture process managed by BAA will not achieve an effective divestiture in a reasonable timescale.

134. The size and complexity of the divestiture would justify the deployment of commensurate monitoring trustee resources.
135. We propose that each of the divestiture airports should be separated effectively from BAA group management and services as soon as possible and that the provision of such services after completion of divestiture will be subject to appropriate transitional service agreements. We consider that hold separate provisions should otherwise be restricted to limitations on the transfer of key management and staff during the period leading up to divestiture.

Arrangements for the sale of Gatwick

136. Under the provisions of the Enterprise Act with regard to market inquiries, we are unable to require the appointment of a monitoring trustee prior to the publication of our final report. With the stated intention of facilitating the sale process and our requirements, BAA appointed a 'shadow' monitoring trustee for the sale of Gatwick on 25 November 2008. The shadow trustee will function with the same authority as a normal monitoring trustee. The trustee will carry out his functions under direction from us rather than BAA and will monitor various aspects of the divestiture of Gatwick on our behalf. BAA's intention is that this appointment will facilitate the transition to any formal arrangements required after we publish our final report.
137. We recognize the clear advantages of this approach and have been consulted by BAA on the terms of the appointment, which we consider to be suitable. However, we consider that issues of continuity will be dependent upon the effective operation of this arrangement and will retain the discretion to satisfy ourselves as to the continuing suitability of the monitoring trustee and terms of appointment following the publication of our final report.

138. For the avoidance of doubt, the appointment of the shadow monitoring trustee by BAA will not prejudice the appointment of a divestiture trustee if we believe we have reasonable grounds to require such an appointment.

Interim measures relating to Stansted

139. We consider that although BAA has an incentive to obtain planning consent for SG2 in so far as it believes this will be reflected in a higher valuation for the airport, it also has an incentive to weaken the ability of the purchaser of Stansted to compete effectively with its remaining airports and potentially would have an ability to do so through its handling of the planning application. In addition, depending on the timing of the divestiture of Stansted, BAA may have an added incentive to delay the outcome of the planning inquiry.
140. For these reasons, we consider that interim measures will need to be put in place following the publication of our report to ensure:
- (a) the safeguarding and incentivizing of the team involved in the planning inquiry to achieve the best possible outcome from the planning inquiry;
 - (b) that at the inquiry BAA does not accept or agree to unreasonable constraints being placed on the airport (eg via agreement to inappropriate conditions or s106 agreements);
 - (c) that BAA does not unduly delay the outcome of the planning inquiry;
 - (d) that BAA does not increase the risk of refusal of its planning application;
 - (e) that the new owner would be able to rely on BAA's reasonable assistance in relation to the planning application/consent during and after the divestiture to ensure continuity; and
 - (f) the independence of the airport from BAA up to the time of the divestiture, through any additional measures that may be necessary.

141. BAA did not believe that the risk of its undermining or delaying the application would warrant the type of interim measures set out above. However, BAA considered that there were measures that could be implemented which would enable the CC to satisfy itself that BAA's conduct during the SG2 planning inquiry would be in the interests of any new owner of Stansted.

Behavioural remedies

142. In this section, we consider behavioural remedies in relation to Aberdeen, where we do not regard divestiture as appropriate to remedy the AEC and consequent adverse effects on customers we have identified. We also consider behavioural remedies to supplement the divestiture remedies put forward above for the London airports, pending the full emergence of competition following divestiture and changes to the regulatory regime, in order fully to remedy the AEC and adverse effects on customers we have identified.²⁰

143. The rationale for these proposals was set out in the Remedies Notice (see paragraph 41):

To overcome potential delay due to the likely need for legislation in implementing certain measures of regulatory reform, such as licence conditions, the CC is considering whether to require implementation of such measures through undertakings or orders pending formal amendment to the regulatory framework. Our intention is that such undertakings would be cancelled once the requisite legislation was in operation. We consider that such measures may need to apply to Aberdeen as well as to the London airports. We welcome views on

²⁰We also considered whether ringfencing arrangements with regard to Heathrow should be included in undertakings but concluded that imposing ring fencing undertakings on an existing complex financial structure that already had its own ringfencing provisions was likely to be highly complex and risked unintended consequences. We therefore decided not to pursue this remedy option further for behavioural undertakings. However, we consider that ringfencing and the capacity to appoint a special administrator may be a suitable option within a revised regulatory framework.

appropriate measures to be included in such interim action and the implementation of this approach.

Aberdeen

144. In our provisional findings we considered that Aberdeen had the characteristics of a natural monopoly, deriving from its comparatively isolated geographical location relative to other centres of population, combined with other general factors that made it unattractive to serve a catchment of Aberdeen's size with more than one airport and so deterred entry (see paragraph 4.137). We sought views regarding the need for, and form of, measures to address the AEC and added that these measures might involve behavioural undertakings or, alternatively, some degree of regulation. We consider this issue in detail in Appendix 6 but summarise our considerations in the following paragraphs.
145. Our analysis of capital expenditure relative to EBITDA at Aberdeen over the 20 years to 2006/07 compared with that of other BAA airports suggested a significant lack of development. Projections for capital expenditure for the next ten years for Aberdeen were also comparatively modest. Aeronautical revenue per passenger and levels of profitability were high relative to other BAA airports. We also compared prices at Aberdeen with those in force at airports where we were able to observe competition. This comparison showed that in 2006 and 2007, Aberdeen's average net revenue per passenger was higher than that of virtually all non-BAA airports we looked at and also that it was higher than all BAA airports except Heathrow and Southampton.

Consideration of parties' views

146. This section presents a high level summary of the representations we have received on the desirability of behavioural remedies in relation to Aberdeen. A fuller description of these representations and our responses can be found in Appendix 6.

147. The focus of BAA's response was on disputing the AEC: BAA claimed that our assessment of pricing and profit levels had been inadequate and disputed our analysis of profitability, citing in particular the profitability of the Belfast airports to dispute our view that Aberdeen's profits were high. BAA also considered that regulatory intervention could be supported only if it could be shown that profits were excessive. BAA conceded that Aberdeen's airport charges were perhaps above average but were not out of the normal range. BAA claimed that costs of serving Aberdeen's customers were likely to be higher than the cost of serving, for example, LCCs, and also disputed our concerns regarding route development.
148. In response to BAA's criticisms, we carried out further analysis, which is set out in Appendix 6, paragraphs 11 to 13. This analysis confirmed our view that Aberdeen's local market power was reflected in relatively high levels of prices and profitability.
149. Notwithstanding its views on the AEC, BAA considered that the CC's concerns regarding investment could be met by improving its consultation processes in respect of Aberdeen's capital investment plans. This would involve the provision of information on the airport masterplan, the annual capital plan and individual key projects to the airlines and other interested parties and the creation of a forum for the proposals to be discussed.
150. We consider that BAA's proposal would not be sufficient to address our concerns, in particular as it would not address issues relating to prices and would not address concerns regarding the level of capital investment. However, we consider that appropriate consultation of key stakeholders, including airlines operating from Aberdeen, would be a necessary element of any behavioural remedy.

151. The CAA did not consider that the CC's provisional findings on Aberdeen's market power adversely affecting competition were well-founded, and thus argued that there was no case for putting in place behavioural measures at Aberdeen, for four main reasons:

- (a) the CC's competition analysis omitted competitive pressures affecting Aberdeen from airlines switching operations between airports across Europe rather than just between neighbouring airports, which would lead to a finding that Aberdeen's market power may not be as strong as identified by the CC;
- (b) the measures applied to Aberdeen might be disproportionate as comparable airports are free of such measures and Aberdeen fell even below the threshold likely to be set in the planned EU Airport Charges Directive (5 mppa);
- (c) there had been no complaint to the CAA under section 41 of the Airports Act about Aberdeen's behaviour; and
- (d) BAA had observed a pricing policy of RPI-1 for a number of years.

152. In our view, the CAA's arguments do not diminish the provisional AEC or the need for remedial action, given the size and complexity of Aberdeen relative to other isolated airports cited by the CAA, and the caution that should be exercised in relying on the absence of complaints and BAA's pricing policy as reliable indicators that there is no adverse effect on customers.

153. A number of themes emerged from responses we received from representatives of Aberdeen's local community:

- (a) Capital investment had been inadequate in the past but had improved in recent years.
- (b) It was not clear that the improvement in recent years had enabled Aberdeen to catch up to where it ought to be in serving its customers.

- (c) There was concern that BAA had not committed to a significant forward investment programme.
- (d) There was concern that inflexible regulatory/behavioural measures might imperil future investment.

154. The key issue to emerge from these local responses was that any remedy should not provide a significant disincentive to future investment.

Remedy options

155. In this case, it is not practicable to remedy the AEC directly through measures such as divestiture, that introduce competition but it appears feasible to address the detrimental effects on customers through the combination of a price control, which we discuss further below, and behavioural undertakings on consultation, as proposed by BAA.

156. We considered four approaches to the development of the price control:

- (a) the formalization, in an undertaking, of the current informal price cap of RPI-1, or a similar price cap, but at a different level, eg RPI-2 or RPI-3. In addition, or as an alternative, an initial price reduction could be used to address perceived overcharging;
- (b) a formalized cap, as above, with some form of commitment or incentives regarding a forward investment programme over a given period;
- (c) a price cap on a rate of return on capital basis in which a proportion of the return achieved above a threshold linked to the likely weighted average cost of capital (WACC) at Aberdeen would be rebated to customers; and
- (d) a price cap based on the weighed average charges set in airports that are subject to competition, for example Scottish lowland airports following the divestiture of Edinburgh or Glasgow.

157. Having weighed up the advantages and drawbacks of each option, we considered that option described in 156(b) performed best against the following objectives:
- (a) to address Aberdeen's relatively high charges;
 - (b) not to avoid disincentivizing investment; and
 - (c) to be less onerous than a full RAB based price cap.

Proposed price cap

158. In summary we propose a relatively straightforward price cap which consists of the following elements:
- (a) Increases in traffic charges are restricted to RPI-1 a year (as under BAA's current pricing policy).
 - (b) The above charges are subject to a level of rebate to customers which, as we will discuss further below, we propose to set initially at 15 per cent.
 - (c) The level of rebate would be reduced by 12 per cent of the cumulative excess of capital expenditure over depreciation from the date of application of this measure. This incentive would apply only if the overall capital expenditure programme was subject to an adequate degree of consultation with airlines and local stakeholders.

The intention is to reduce charges to a more comparable level with other airports while providing incentives for new investment.

159. Paragraphs 31 to 39 of Appendix 6 set out our assessment of the possible methodologies for the calculation of the two elements of the proposed price cap: the rebate in the traffic charges and the reduction in this rebate for capital expenditure in excess of depreciation.
160. We considered that the charges should be subject to a rebate which starts at 15 per cent but the total value of the rebate could be reduced by 12 per cent of the

cumulative excess of investment over depreciation following implementation of this cap. The latter investment incentive would apply only if the overall investment programme was subject to an adequate degree of consultation with airlines and local stakeholders.

161. The allowance of 12 per cent on the excess of capex over depreciation is intended to represent a high-end estimate of nominal WACC. The objective is to provide a relatively generous incentive for investment in excess of a conservative allowance for maintenance expenditure.

162. The rebate of 15 per cent results in a reduction of approximately £1 per passenger in charges. This would reduce charges to a more appropriate level relative to comparable airports and would reduce Aberdeen's pre tax income by over £3 million a year. However, this level of rebate could be eliminated in due course if Aberdeen's investment were to exceed depreciation by £25 million cumulatively in future years. This would represent a significant step up in Aberdeen's investment plans as the latest investment projections forecast expenditure of approximately £40 million over the next ten years compared with depreciation of £39 million in the ten years ended 2007 (and the last three years have been a period of above average investment at Aberdeen).

Airline consultation, non-discrimination and quality of service

163. We commented at length in our provisional findings on the detrimental effects on customers of the AEC we had found. In particular, we found that at the south-east airports, BAA showed a lack of responsiveness to the interests of airlines and passengers. This was evidenced by BAA's approach to planning capital expenditure, including weaknesses in consultation and lack of responsiveness to the differing needs of its airline customers, and hence passengers, and the consequences for the

quantity, quality, location and timing of investment. Quality of service deficiencies in the London airports were also indicative of lack of responsiveness to customers.

164. We also commented on the deficiencies of the current regulatory regime in remedying the detrimental effects of common ownership on customers. Recognizing the need for a reform of the regulatory regime, the DfT launched a review of the economic regulation of UK airports in April 2008.²¹
165. As a direct result of the development of competition between the south-east airports, supported by a more flexible regulatory regime, we anticipate that the responsiveness of the operators of Heathrow, Gatwick and Stansted to the interests of airlines and passengers will improve.
166. However, as a hub airport, Heathrow will continue to be able to exercise significant market power over a proportion of its customers. The reformed regulatory regime proposed by the DfT will therefore be a key remedy to the detrimental effects of Heathrow's position as the only significant hub airport in the South-East. Due to the likely need for primary legislation, it could, however, be some years before changes to the current regime are implemented. We therefore see a need for interim behavioural undertakings to deal with the more significant detrimental effects on customers of BAA's market power in the South-East that remain following divestiture. These are undertakings given to the CC under the Enterprise Act which in due course will be rolled into the new regulatory regime (see paragraph 235). These measures would provide a continuing focus for addressing responsiveness of investment and quality of service during a period of transition.

²¹We comment on this review further in paragraphs 195 to 258.

167. The case for putting in place one or more of such undertakings at Gatwick and Stansted is less clear cut, given that the market power of these airports derives from common ownership and that we have provisionally decided to address this AEC through the divestiture of these two airports. However, we also recognize that in the short term, even under separate ownership, both airports may retain significant market power.

Parties' comments

168. BAA was of the view that seeking such remedies undermined our claims that separation of ownership would give rise to a material degree of competition between the airports.

169. The CAA did not undertake detailed analysis of the scope for interim regulatory requirements, but was not persuaded that there was a strong case for imposing interim regulatory requirements on BAA's airports. It observed that the DFT was reviewing the broader regulatory framework of UK airports, and that any potential remedies should be consistent with the future regulatory framework. Furthermore, the CAA also considered that the current system, despite its general inflexibility, already provided some scope for behavioural regulation.

170. Airlines have been generally supportive of our proposals. More specifically, BA commented that there had been improvements in BAA's consultation over capex, but was concerned that this might be a temporary response to the high level of scrutiny to which BAA was currently exposed. It also pointed out that in any case, airlines still did not have access to some of the information needed, notably on commercial revenues and on airport opex associated with a project. BA suggested that we should, inter alia, take the following remedial action in relation to capex issues, pending the new regulatory regime:

- (a) the scope of Constructive Engagement should be widened, in particular information on new projects should include an analysis of the impact on airport opex costs and projected retail revenues;
- (b) information should be provided on asset disposals; and
- (c) we should set a clear policy on the treatment of capex underspend.

171. We have now developed our thinking further and are proposing three complementary sets of behavioural measures on which we are seeking views:

- (a) measures to supplement the existing provisions for consultation on capex (these are set out in Annex G to the CAA's 2008 decision on the economic regulation of Heathrow and Gatwick, 2008–2013) with certain additional measures recommended by us to the CAA in the context of the Q5 price control review at Stansted;
- (b) measures seeking to address the impact of agreements between BAA and certain airlines on the competitive position of other airlines operating at its regulated airports; and
- (c) measures relating to service quality.

Supplementing Annex G

172. In our provisional findings, we commented on the deficiencies in the Annex 4 of the CAA's February 2003 decision on airport charges and the more recent Annex G on enhanced information disclosure and consultation, which was published with the March 2008 CAA decision on airport charges at Heathrow and Gatwick, following a process of consultation that had started with its November 2007 proposals.

173. Commenting on these proposals, BAA included a draft update of the Annex 4 agreement in its January 2008 submission to the CAA. BAA's update was described as representing the outputs from a concerted effort by both BAA and the airlines to

build upon and enhance the Annex 4 agreement, and said that all parties agreed that the majority of the document had achieved this objective; although described as 'BAA's proposals', much of the document had been written by airline representatives.

Five areas of difference were recorded:

- (a) the definition of 'long-term land use plan';
- (b) asset disposal;
- (c) options for the development of the airports;
- (d) the outputs expected of individual projects, in particular inclusion of commercial revenues; and
- (e) updating of BAA's Gateway process.

174. The CAA in its final decision on airport charges at Heathrow and Gatwick in March 2008 made changes to all but the first of these points, to which BAA agreed, although provision of information on commercial revenues remained subject to BAA's discretion if it believed disclosure would jeopardize its interests or that of a third party.

175. BA said that there were still serious weaknesses in Annex G. It suggested to us that the role of the CAA was uncertain in the event of disagreement between the airlines and BAA; as was the status of the appendices setting out the detail of the consultation processes but not reproduced in the CAA decision document. Consultation on long-term plans and strategic issues was also limited, and there was no requirement to consult on disposals of assets not in the RAB. The CAA told us that it did not include the detail of the consultation process in its decision document as these were not central to the specification of what BAA should deliver through the Annex G process. It also noted the reference to the long-term use plan in Annex G and drew attention to the requirement to consult on assets included in the RAB; but

regarded disposals of assets not included in the RAB as not relevant to the regulated business.

176. Under Annex G, there would be three aspects to the consultation on airport development plans: the airport masterplan and long-term use plan;²² the Capital Investment Plan (to include principal business drivers; forecast demand; development options; planned capacities; cost of the investment plan; cost estimates and efficiencies of major projects; and the expected outputs of individual projects) and consultation on individual projects. The latter would be structured to support the key decision points on BAA's Gateway process. There would also be consultation on changes to the plans and an explanation of changes whether to individual projects or at a higher level (see paragraph 2.34).
177. In our view, the revised agreement in Annex G was, in effect, therefore tailored to what BAA was willing or able to provide: there was, for example, no requirement to provide information on commercial revenues if BAA considered at its discretion that disclosure could jeopardize its interests or those of a third party (see paragraph 2.41).
178. In our recommendations to the CAA on Stansted airport charges for Q5, we specified in some detail the information that would need to be provided and suggested improvements to the consultation process. In framing these recommendations in late October 2008, we drew on our direct experience of the consultation process on capex at Stansted and on the responses to our provisional findings more generally. There are many similarities between Annex G and our recommendations, but we have identified the following key gaps:

²²The CAA noted that this was expressly included to provide a better longer-term context for airlines when considering options for medium-term development and capital investment.

- (a) there is no explicit reference in Annex G to the *timeliness* of the information flow, or the *transparency/auditability* of the process;
- (b) there is no requirement in Annex G to provide or consult on a *strategic business plan*. Airlines at Heathrow and Gatwick have not complained about this specifically, but BA has commented on the inadequacies of the current information on long-term business plans and strategic thinking;
- (c) there is no explicit reference in Annex G to the requirement for *cost benefit analysis*, although benefits in terms of capacity, service levels or statutory compliance etc) and quantified outputs are referred to;
- (d) there is no reference in Annex G to either *opex costs and commercial revenues* associated with each project;
- (e) there is no mention in Annex G of a *maintenance plan*, although this has not been required by the airlines at Heathrow and Gatwick. At Stansted, the purpose of this requirement was to provide more understanding and control over the spend on small projects (which are generally related to maintenance). This may be less appropriate for the greater scale of Heathrow capex; and
- (f) there is no provision for a *facilitator* in Annex G.

179. Our recommendations to the CAA in relation to Stansted's airport charges for Q5 did not cover all aspects of Annex G, reflecting the different circumstances of Heathrow and its customers and were limited to the terms of reference of the Stansted review.

For example:

- (a) There is much less emphasis on the 'Gateway processes' about which bmi/Star Alliance had been particularly concerned at Heathrow—G13 and G14 of Annex G.
- (b) There is much less in Annex 1 of the Stansted recommendations on consultative structures than in the Annexes to the BAA January response documents,

possibly reflecting the greater number of operators and scale of the capex programme at Heathrow.

180. The provisions of Annex G covering Heathrow and Gatwick and our recommendations to the CAA at Stansted arose from the quinquennial reviews of airport charges, undertaken under the Airports Act 1986. Here we are concerned with the remedies to the AEC we have provisionally found under the Enterprise Act. In particular, in proposing behavioural remedies at BAA's regulated airports, we are seeking to address the consequences of BAA's lack of responsiveness to the interests of airlines and passengers (as noted in paragraph 163). In doing so, however, we are drawing on the evidence from quinquennial reviews. In reaching our provisional decisions, we have also sought to introduce remedies which build on mechanisms which are already in place or in contemplation and are therefore practical and proportionate.

181. For these reasons, we consider that, instead of replacing Annex G with a new set of requirements on consultation, we should seek to address through undertakings to the CC the main lacunae identified by us and the airlines. In particular, we will seek to require BAA:

- (a) to incorporate provisions on the *timeliness/transparency and auditability* of the provision of information;
- (b) to provide the airlines with a *strategic business plan*;
- (c) to provide the airlines with *detailed project information*, including: a statement of the need for the project with quantified benefits; timescale for implementation; drawings and plans; an assessment of the project capex and firmness of capex

estimates and the analysis of each project's impact on opex and projected retail revenues;²³

(d) to provide the airlines with a *maintenance plan*; and

(e) to provide for the appointment of a *facilitator*.

All such information must be provided on a timely basis.

182. On 9 December which was very shortly before this document was finalized, the CAA published its consultation document on airport charges at Stansted. In the time available, we have been unable to take into account the CAA's response to our recommendations on consultation. We will review our position on the need for these measures at Stansted in the light of the CAA's price control proposals and any further submissions we may receive on this issue.

183. We have provisionally decided that these measures should apply to Heathrow until the reform of the regulatory regime, and we anticipate that these measures will be rolled forward into the new regulatory regime (see paragraph 235). We are seeking views on the list of requirements set out in paragraph 181 above, and whether additional requirements should be added. We are also seeking views on whether these undertakings should apply to Gatwick and/or Stansted, and if so, whether they should be in place until divestiture, until the reform of the regulatory regime or until competitive rivalry removes the need for regulating Gatwick and/or Stansted.

²³BA suggested such information include:

Statement of the need for the project and quantified benefits including:

(a) Runway, stand, terminal capacity increase.

(b) Service Quality improvements (punctuality improvements, shorter queues, less towing, quicker minimum connecting times).

(c) Operating cost savings.

(d) Environmental/Planning Conditions to be met.

(e) Commercial Revenue increases.

Timescales for implementation, drawings, plans etc, assessment of project's capex (total over the life of project, and annualized). Assessment of firmness of capex estimates. Assessment of the decrease/increase in airport opex. Assessment of the increase/decrease in airport commercial revenues. This could well need a confidentiality agreement between airport and airlines involved in the negotiation, but that should not be a barrier.

With this data an impact on prices could be assessed (using, say the current cost of capital).

Non-discrimination

184. We described, in paragraphs 2.50 to 2.56 of our provisional findings, the consequences of the allocation of Heathrow's Terminal 5 (T5) to BA on competition between BA and other airlines at Heathrow, particularly the Star Alliance; the belated consultation of the airlines on Terminal 2A (formerly referred to as Heathrow East Terminal), the aim of which was to provide competitive equivalence across the Heathrow campus, and the adverse consequences of the operational difficulties experienced by BA since the opening of T5 on other airlines. We noted that the delay in the transfer of services into T5, on which other airlines had not been consulted, would be at the expense of other airlines, which would have to occupy poorer facilities for much longer. We also noted that BAA had not offered any compensation to airlines.
185. BAA's behaviour here could be tantamount to discrimination in relation to a trade practice or a pricing policy and, in principle at least, the CAA may be able to intervene under section 41 of the Airports Act. Similarly, this conduct might constitute an infringement of the Competition Act 1998 (Competition Act), which could in principle be investigated by the OFT under section 25 of the Competition Act, although it has very rarely used these powers. The knock on effects on other airlines of the operational difficulties experienced at the opening of T5 and the several changes to the scope and timing of the development of Terminal 2A are illustrative of the lack of responsiveness of BAA to the interests of airlines and their passengers. A remedy to this customer detriment is therefore required as part of our inquiry under the Enterprise Act and we do not consider it sufficient to rely on potential actions by others under other legislation.
186. We have therefore provisionally decided to put in place undertakings to supplement existing legislation by addressing the specific issues we have found at Heathrow in a

more flexible way than might be possible under existing legislation. Specifically, we have provisionally decided that BAA should undertake not to make any agreement or embark upon any practice in relation to the provision of specific airport facilities and/or services with one customer that may have a significant impact on the competitive position of other customers at the airport for a significant period of time unless BAA has taken a number of steps prior to the agreement being made or the practice commenced. These steps are set out in Appendix 9 for consultation.

187. It is intended that these undertakings would apply only to events which can be reasonably be expected to have a significant impact on the competitive position of other airlines for a significant length of time, and would apply only to: any proposed move of airlines within and between airport facilities and the provision of large scale new facilities (to be defined) to airlines. We are seeking views from the airlines, BAA and any other interested parties, including the CAA on the practical aspects of this remedy and in particular the materiality test that should be applied.
188. It is currently our view that the conditions that have given rise to the requirement for this remedy should apply only to Heathrow, but depending on the responses to this document, we will consider further whether the remedy may also be appropriate for Gatwick and Stansted, and, if so, whether it should remain in place until divestiture, until the reform of the regulatory regime or until competitive rivalry removes the need for regulating these airports.

Quality of service

189. In our provisional findings we considered that the detrimental effects resulting from common ownership of the BAA London airports and the market position of Heathrow included adverse standards of customer service. These standards were also reflected in our adverse public interest findings on quality of service in our recent

regulatory reports on Heathrow, Gatwick and Stansted. In each case the CAA has adopted or proposes to adopt a service quality rebate (SQR) scheme to provide appropriate incentives to deliver acceptable customer service.

190. We consider that the SQR regime is an important means of incentivizing customer service where there is a lack of adequate competitive rivalry to ensure satisfactory service provision. We are not seeking to introduce a new SQR, but are considering whether there are further measures that are appropriate to reinforce the SQR regime to address the detrimental effects on service resulting from the AECs that we have found.
191. These remedies could be implemented at Heathrow, as well as Gatwick and/or Stansted as temporary measures pending divestiture, further regulatory reform and/or developing competitive rivalry following divestiture that will remove the need for regulation. These measures would focus on improving the robustness and scope of the SQR regime. For example, the measures may include BAA, and possibly the acquirer of Gatwick and Stansted, funding appropriate audit and testing of SQR data or funding further customer research for the CAA, possibly through its Consumer Protection Group regarding relevant indicators of customer service/passenger experience. We invite views on the form and scope of appropriate measures to fulfil these requirements.

Monitoring and compliance issues

192. The means of monitoring and enforcing behavioural measures are key elements in considering the practicality of such measures. The OFT has the responsibility for monitoring and enforcing undertakings or orders under the Enterprise Act. However, the OFT has limited resources to devote to this role.

193. In some past merger cases involving behavioural measures we have sought to bolster the OFT's resources through merged parties paying for monitoring resources and in some cases for adjudicators, who were paid for by the merged parties and responsible to the OFT but provided with advice and guidance by the sector regulator where appropriate.
194. We have provisionally decided that a similar approach should be adopted in the present case and that such arrangements should include the appointment of a compliance officer/adjudicator, who would monitor compliance with the undertakings and would intervene when agreements between airlines and airports could not be reached following the consultation processes set out in paragraphs 181 and 186. We will discuss further with the OFT, the CAA and BAA the practical aspects of these arrangements but are also seeking the views of any other interested parties including the airlines.

Recommendations on airport regulation

Introduction

195. We have provisionally concluded that the current system of regulation of the designated airports (Heathrow, Gatwick and Stansted) is a feature that distorts competition for the following reasons:
- (a) the absence of statutory duties and economic licence provisions on BAA;
 - (b) the limited scope for the regulator to act between quinquennial reviews, including by means of agreed changes to licence provisions;
 - (c) the narrow focus of the CAA's statutory duties in economic regulation (which is to set maximum airport charges at designated airports every five years) and the way in which the CAA has given effect to its four statutory objectives in fulfilling those duties. Notably, limiting its activities unduly in relation to the first three objectives and emphasizing the fourth (which is to impose the minimum restrictions

consistent with achieving its other objectives) has adversely affected competition through the impact on airlines and passengers of inadequate investment and service standards.

196. We also stated in our provisional findings that, in a well functioning system of regulation, we would expect processes and procedures to be in place for all relevant information to be made available by the airport operator to airlines and the regulator and on a timely basis to enable:
- (a) airlines to engage in constructive dialogue with the airport operator on investment (overall and on a project by project basis), on levels and quality of service and on other areas of mutual interest; and
 - (b) the regulator to ‘monitor what is going on’ and act as arbitrator when necessary, though within an established protocol/framework.
197. We also posited that, as effective competition developed between separately owned London airports, alternative approaches to regulation could be appropriate and said that we should consider this in the context of our consideration of remedies.
198. In our Remedies Notice we outlined the aspects of the system of regulation which we considered might need to be reformed to address the AEC and detriments to customers we have provisionally found. We also identified that there would be regulatory impediments to the development of terminal competition, if such a remedy was pursued.
199. In this section, our focus is on making a number of recommendations to the DfT:
- (a) to remedy the AEC stemming from the impact on airlines and passengers of the current system of regulation, through a reform of the statutory duties of the CAA; a more flexible regime, allowing the CAA to intervene in the market more easily

when needed; a reform of the statutory duties of the CAA and changes to the role of the CC, resulting in more accountability for the CAA; and increased accountability of the operator of Heathrow, via its statutory duties and licence obligations; and

(b) to mitigate the reduction in the effectiveness of the proposed divestiture remedy in the South-East due to continued regulation. In doing so, we consider how the regulatory regime should evolve to support the development of competition following the divestiture of Gatwick and Stansted; what role terminal competition could play in a competitive market; and the extent to which competition between a price-capped Heathrow and a de-designated Gatwick and Stansted could lead to significant distortion of investment decisions with adverse effects on consumers.

200. On 12 November 2008 the Independent Panel, appointed by the Secretary of State to provide advice to the DfT on the reform of airport regulation in the UK, published its emerging thinking. Many of the proposed changes to the regulatory framework for airports currently favoured by the panel would contribute to the reforms that we consider necessary to address the AEC we have provisionally found and are therefore the starting point for our discussions in this section.

201. The Independent Panel is considering some other changes, aspects of which we comment upon, where appropriate. In particular, it sets out its emerging thinking on regulating to improve the passenger experience. Ultimately, the aim of our remedies, both structural and behavioural, is to deliver a better outcome for customers. However, we are limited in what we can do by our terms of reference, which relate specifically to the supply of airport services by BAA. We recognize that there are wider influences on the quality of customer experience at BAA's airports, which are beyond the remit of our inquiry. We sketch out in paragraphs 259 to 263 how the

work undertaken by others, in particular the CAA and the DfT, complements our investigations by addressing the issues impacting on passenger experience more broadly.

202. In addition, we draw on knowledge gained in the course of this market inquiry and our other recent reviews of airport charges at BAA's three London airports to make observations intended to assist the Independent Panel in developing its thinking on the regulation of financial structures and of performance. We note that the Independent Panel indicated in its emerging thinking that it currently favours provision being made for a small number of key airports to be subject to special administration regimes and ring fenced from their parent companies.

Recommendations to remedy the adverse effects on competition through its impact on airlines and passengers of the current system of regulation

203. The DfT's review of the economic regulation of the UK airport system, supported by the Independent Panel, seeks to answer three questions:
- (a) What should be the objectives of effective economic regulation of airports?
 - (b) What are the weaknesses in the current systems of regulation? and
 - (c) What lessons can be learned from alternative regulatory systems?
204. The DfT's review is due to report during the course of 2009, but the Independent Panel's emerging thinking indicates that among the institutional features of the regulatory regime it currently favours, are the following:
- (a) regulation by licence with airports of different size and market power having different licence obligations;
 - (b) a statutory provision requiring the regulator to owe a duty in the first place to consumers;
 - (c) secondary duties for the regulator including:

- (i) a duty to ensure the financeability of airport services for which demand is established; and
 - (ii) a duty to follow the principles of better regulation, which include proportionality and the avoidance of over-regulation;
- (d) a duty for airports to consult airlines and take account of their views;
- (e) powers to determine whether an airport has significant market power (SMP);
- (f) powers to impose licence obligations on airports with SMP including price controls and conditions to establish:
- (i) the outputs to be delivered by the airport;
 - (ii) a requirement for effective consultation with both airlines and end users; and
- (g) powers to impose licence conditions on airports found to exercise a degree of market power, less than dominance, which require them to consult airport users and issue reports on the outcome of such consultations.

205. We fully support a licensing regime of the kind favoured by the Independent Panel with different licence obligations for airports of different sizes and market power, as it would introduce more flexibility to the regulation of airports. In particular, the operation of licensing regimes in other sectors demonstrates that under such a regime, regulators are able to relax the intensity of regulatory scrutiny, where they see opportunities for increased competition or increase it, where they identify increased risks resulting from the exercise of market power.

206. We explore below how three aspects of this regime should be shaped to remedy the adverse effects between airlines of the current system of regulation:

- (a) the airport regulator's principal objectives;
- (b) rights of appeal; and
- (c) aspects of the full regulatory model as applied to Heathrow.

Airport regulator's principal objective

207. Currently four objectives are imposed on the CAA in performing its functions as economic regulator of airports: furthering the reasonable interests of users; promoting the efficient, economic and profitable operation of airports; encouraging investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports; and imposing the minimum restrictions that are consistent with the performance of its functions. Whilst it is the duty of the CAA to perform its functions in the manner which it considers is best calculated to achieve these objectives, the objectives themselves are potentially conflicting. It is up to the CAA as to how it balances the objectives against each other but this weakens accountability and is likely to exacerbate conflict between airport and airlines as each is likely to have a different view of how the CAA should balance these conflicting objectives.
208. Until recently, it was common for the main objectives of sectoral regulators in the UK to be accorded equal importance in the relevant statutes. These objectives then had to be balanced by the regulators when exercising their functions. However, reforms to the economic regulation of electricity, gas and telecommunications since 2000 mean that the relevant regulators (Ofgem and Ofcom) each have a principal objective (or duty) that is unambiguously focused on advancing the interests of consumers (present and future), where appropriate by promoting effective competition.²⁴ Likewise, the regulator of postal services in the UK (Postcomm) has a principal objective, in this case unambiguously focused on ensuring the provision of a universal postal service.²⁵ As noted above, the Independent Panel currently considers that the regulator's primary duty should be to consumers. Adopting this approach for airports would have benefits in improving accountability and reducing

²⁴In the case of Ofcom, its principal duty is (a) to further the interests of citizens in relation to communications matters; and (b) to further the interests of consumers in relevant markets, where appropriate by promoting competition'. The reference to citizens reflects that there are communications-specific matters that are not paralleled in airports.

²⁵Postcomm also has an objective which mirrors the principal objectives of Ofgem and Ofcom, of furthering the interests of users of postal services, wherever appropriate by promoting effective competition between postal operators. This ranks second in priority only to the universal service objective.

conflict but this does raise the issue of whether the definition of ‘consumers’ needs to be clarified.

209. The Independent Panel has not yet determined the wording of the regulator’s principal objective that it will recommend. However, its emerging thinking is that a duty ‘to promote the interests of consumers of passenger and freight services at UK airports, using competition where possible’ is an example of the type of duty that should replace the CAA’s existing objectives. BAA, MAG and the CAA have argued that consumers should be identified with passengers and air cargo shippers. However, either definition of ‘consumers’ would risk exacerbating the CAA’s tendency (that we have provisionally found) to give insufficient weight to airline users of the airports and be non-responsive to airline concerns. As we noted in our provisional findings, for most purposes competition between airlines is likely to imply a commonality of interests between airlines and final consumers, hence the regulator is unlikely to be in as good a position to judge the interests of end users as airlines. A second more minor issue is the greater difficulty of covering the interests of consumers of freight services—air cargo shippers are not themselves final consumers and there seems no reason to give their interests primacy over those of airlines.
210. On these grounds, the airlines have argued that the regulator’s principal objective should be to further the interests of all users (not just consumers).²⁶ However, as we also noted in our provisional findings, on some issues existing airlines’ interests are likely to diverge from those of final consumers. A formulation that simply refers to

²⁶International Air Transport Association/British Air Transport Association (IATA/BATA) put forward seven principles for future regulation of which the sixth states ‘key aspects of the current regime should be retained, including....statutory objectives towards all users (not just consumers)....’. It is not entirely clear from this whether IATA/BATA consider this should be the primary duty but Cambridge Economic Policy Associates (CEPA), in their report for BA, suggest that the regulator’s revised primary duty should be ‘protecting existing and future users’. Similarly Ryanair stated in its submission to DfT ‘the key objective of regulation should, therefore, be to ensure that the airport is incentivized to offer efficient services to its airline customers at the lowest possible cost’.

users leaves it unclear how the regulator is to resolve any conflicts between airlines and final consumers. Moreover, to the extent that the interests of intermediate customers (such as airlines) and final consumers are the same, it is actually unnecessary to refer to both.

211. Thus we recommend the adoption of a principal objective focussed on the interests of final consumers linked to a duty on the regulator to have regard to the views of airlines, in its consideration of the interests of consumers, for instance with a formulation such as the following:

The regulator's principal objective is to further the interests of (present and future) consumers, where appropriate by promoting effective competition between airports. In assessing the interests of consumers, the regulator should have due regard to the views of airlines.

212. We expect the regulator would also have a number of secondary duties. We consider these should include a duty that licence holders are able to finance the activities authorized or required by their licences, as is the case for other regulators. We note that the Independent Panel believes that a duty of this kind should be included in the regulator's secondary duties.

Rights of appeal

Reasons for extending the rights of appeal beyond airport operators

213. In our Remedies Notice we stated that:

We consider that the current regulatory process in which designated airports are automatically referred to the CC prior to the CAA arriving at its quinquennial determination is cumbersome and blurs responsibility for regulatory outcomes. We concur with Sir Joseph Pilling's strategic review of the CAA which recommended a similar process to that

employed in other regulated sectors. This would require the CAA to determine the outcome of the quinquennial review without prior reference to the CC but the CC would consider appeals on the merits of the CAA decisions. We welcome views on the appropriate form of this process and, in particular, whether airlines and other airport users should, individually or collectively, be granted rights of appeal as well as airport operators.

214. In other sectors in which regulated firms are subject to economic regulation through licences (electricity and gas, postal services, rail, water and sewerage services and air traffic services), price caps are implemented as licence conditions. The relevant statutes give the regulator powers to enforce licence conditions and to modify them. Licence modifications to which the licence holder does not agree cannot proceed without a reference to the CC which then carries out its own analysis and reaches its own conclusions, drawing on evidence from the regulator, the regulated company and others. Thus, in the case of licence modification, the licence holder has the right to appeal to the CC against decisions by the regulator on the merits of the case. This 'traditional' model does not give any right of appeal on the merits of the case either to the licence holder's immediate customers or to any body representing the interests of final consumers.
215. The view underlying the traditional model, going back to the original privatizations, is that the regulator engages, on behalf of consumers, in a negotiation with the regulated company. At the time of the privatizations it was not envisaged that regulators would engage in lengthy and complex rate determinations (there was a strong desire to avoid this feature of the US system). On this view, the regulator's incentive is to negotiate a tough deal, but any potential for unfairness to the regulated company is mitigated by the ability of the company to refer the outcome to the CC for

a full analysis. It was considered that there was no need for consumers to have appeal rights since it was assumed that the regulator represented consumers' views. However, the original wish to avoid lengthy and complex determinations has not been fulfilled—regulators' periodic reviews have become very long and complex processes. Moreover, regulated companies have in recent years found little in regulators' decisions that merits appeal to the CC. In the period 1993 to 2000 the CC published eight reviews relating to electricity, gas and water price caps²⁷ while in the subsequent eight years there have not been any.²⁸

216. The Independent Panel says in its emerging thinking that it will reach a view on whether airlines should have a right of appeal in relation to regulatory decisions that crucially affect them. In that regard, it is relevant to note that, in relation to telecommunications networks and services, the traditional model has been replaced by a right of appeal for all affected persons. Under the Communications Act 2003, any person affected by a decision by the regulator (OFCOM) relating to networks and services can appeal on the merits to the Competition Appeal Tribunal (CAT). In the case of decisions imposing price control conditions, the CAT then refers any price control matters raised by the appeal to the CC for determination.
217. Similarly, certain decisions by the regulator (Ofgem) on modifications to designated electricity and gas network codes can be appealed to the CC by any person 'materially affected' by the decision and by bodies representing persons so 'materially affected' (such as Consumer Focus).²⁹ A party to a code can seek its modification by putting forward a code modification for consideration within the industry and by a code panel. Where modifications are suggested, the code panel

²⁷In some cases, companies appealed against more than one proposed licence condition.

²⁸There have been no references to the CC in the rail and postal sectors. There have been a number of telecommunications references: while none were straightforward price cap cases, two—in 1999 and 2003—covered mobile termination rates (the CC is currently considering further mobile termination rate cases, but this is under a different process under the Communications Act 2003).

²⁹From 1 October 2008 Consumer Focus has taken on the functions of energywatch and Postwatch.

makes a recommendation to Ofgem, which then decides whether the proposal should be accepted or rejected. Broadly speaking, appeals against such decisions can be made only where Ofgem rejects a majority recommendation of a particular modification by the industry's own code panel. This appeals mechanism, established by the Energy Act 2004, currently applies to three codes in each of the electricity and gas industries. It was designed to improve the accountability of the process by which the detailed rules that govern activities in the gas and electricity markets as set out in the various industry codes are amended. Previously market participants' only means of redress had been to initiate a judicial review.³⁰

218. In its comments on our provisional findings and Remedies Notice, the CAA said that it was unclear how we would envisage a quinquennial review process operating alongside (or indeed within) a licensing arrangement where airport users, as well as airports, have rights of appeal.³¹ However, the process would seem relatively straightforward to us:
- (a) the airport regulator would carry out a periodic review and then give notice of the licence modifications that it proposed to make, allowing those likely to be affected to make representations about the proposals which were to be considered before modifications could be made, in the same way as regulators in other sectors do at present; and
 - (b) a decision by the regulator to implement the proposal (with or without changes) would be given effect by publication of a notice setting out the modifications and it would then be up to the airport and other parties with the right of appeal whether or not to dispute the decision.

³⁰See paragraph 335 of the Explanatory Note to the Energy Act 2004.

³¹In its February 2008 submission on economic regulation of UK airports (paragraph 5.52) the CAA itself suggested that 'there might also be a case to extend the right of appeal to other affected parties (airlines)'.

219. Airlines favour extending the right of appeal to the CC beyond just airport operators. IATA/BATA argued that natural justice demands that an appeal to the CC is possible by both sides and that, unlike other regulated sectors where there are thousands or millions of direct customers, there are relatively few direct airline customers of airports. On this latter point, we note that other regulated companies such as electricity and gas distribution and transmission companies do have large direct customers.

220. In a report commissioned by BA, Cambridge Economic Policy Associates (CEPA) gave some further reasons for extending the rights of appeal:

- (a) the existing role of the CC and so the significantly greater access that users and other stakeholders already have in the airport sector and their consequent concern if that existing right were to be removed. This is particularly relevant in the context of significant and widespread concern among airlines about the approach the CAA has taken to regulation (ie excessively 'light touch');
- (b) broader concerns about the way in which existing appeals work in other sectors and whether there is a need to extend the right to appeal to customers or their representative bodies; and
- (c) the unusual position that airport users are in relative to other regulated industries in terms of the degree of pre-funding of investment that is undertaken.

The first two at least seem to be reasons for preferring a two-sided appeals process, given the importance of resolving conflicts between airports and airlines.

221. It follows from our provisional finding that the current system of airport regulation distorts competition between airlines, that the regulator should be more accountable to airlines. Whilst we consider this to be the main reason for extending the right of appeal to airline users, it seems to us that there are two additional reasons:

- (a) the difficulty of encapsulating in the commercial terms between the airport operator and its airline customers or Service Level Agreements, quality of service requirements relating to airport facilities, even though the quality of the passenger experience at an airport impacts on each airline's competitive position. This issue is particularly acute at a constrained airport undergoing significant redevelopment; and
- (b) the difficulty for the regulator of assessing capital investment programmes, elements of which may need to be tailored to the needs of individual airlines.

222. Taking all of the above factors into account, we therefore recommend that the rights to appeal should be extended beyond the airport operator itself to other parties with a sufficient interest in the level of the price cap. We consider that this would significantly improve regulatory accountability; help to generate the change in regulatory culture that we think is needed; and hence improve the quality of regulatory decision-making and provide greater customer focus.

Managing the risk of excessive appeals

223. The CAA suggested that:

Thought needs to be given to the incentives bearing on the different parties. Whereas an airport operator in appealing needs to balance any potential advantage against the costs (both direct and in terms of management focus) no such consideration applies to users since such costs would mostly fall on the operator. This could lead to an exaggerated incentive on users to appeal.

However, we note that every party with a sufficient interest in appealing faces some costs in doing so—including the opportunity cost of the time its management spends on the appeal, any advisers' costs incurred, and the risk that the decision reached by the appellate body may result in a worse outcome for the appellant.

224. Another suggestion was that, if there were symmetric rights of appeal, the ‘loser’ would always appeal to the CC, leading to the CC becoming the real regulator. However, this assumes there is a clear ‘winner’ and ‘loser’ and it is not obvious this would always, or even usually, be the case. Also, it would not necessarily follow as there are costs to all parties in appealing.
225. CEPA suggested that appeals should not be undertaken lightly and suggested several options for discouraging excessive appeals:
- (a) explicit provision that appeals will not be allowed if they appear to be frivolous or vexatious;
 - (b) alternative dispute resolution to be undertaken prior to a full appeal;
 - (c) a financial risk to be borne by the appealing party—for example, the potential for reasonable costs of all parties involved in the appeal to be awarded against the appellant if the appeal is lost; or
 - (d) airlines accounting for a minimum percentage of passengers at an airport to support the appeal as an indication of importance of the issue.
226. The first two of these would seem desirable in themselves—indeed we would see the resolution of disputes as an important part of the regulator’s function. But we accept there may be a case for additional measures to discourage excessive appeals.
227. As to the third point, the code modifications process appears to provide a model for dealing with costs when there are symmetric rights: the CC makes a determination about who should pay its own costs and any reasonable costs incurred by the successful party or parties. Under this process, if the regulator loses the appeal, it may have to contribute to the costs of the appellant or appellants as well as pay its own costs. This may not be too much of a problem since, as well as costs under code modification appeals, regulators (including the CAA in relation to en-route air

navigation) are liable for costs when appeals are made to the CAT against their Competition Act decisions.

228. Nevertheless, regulators are public bodies and additional costs must either result in the regulator carrying out its functions less well or be passed through to the regulated sector. In the latter case, costs could be passed to the airport concerned or spread across all regulated airports, all airports or the whole aviation sector. There seems little reason to spread the costs beyond the regulated airport, but as long as the CC's determination before costs is sufficient to cover the airport's cost of capital it follows that any additional costs need to be added to the price cap.³² Airlines might need to recognize this is a logical consequence of a symmetric appeals process.³³ As long as regulated airports are large, the costs per passenger will be small: total costs of £5 million for a 30 million passenger airport would add less than 5p per passenger to a five year price cap (if spread over the five years). Also, it would not represent much of a change from the current Airports Act regime, where airports know in advance that there will be a CC inquiry and include the expected cost of the inquiry in the expenditure on which the price cap is based.

229. As regards CEPA's fourth option, in principle a minimum passenger percentage requirement could be instead of, or as well as, awarding costs. However, awarding costs would in itself represent a considerable deterrent to small airlines by themselves making an appeal, so it would not seem necessary additionally to require appealing airlines to account for a minimum percentage of passengers. As an alternative to awarding costs, a minimum passenger percentage would seem to have some disadvantages: first, it is difficult to determine a suitable percentage; second, it

³²We note that section 54 of the Water Act 2003 gives the CC discretion to decide whether to include the costs associated with an undertaker's appeal against a determination made by Ofwat on price controls in its calculations, having regard to the extent to which it is likely to support the undertaker's claim against Ofwat.

³³If only airports have the right to appeal, it is unlikely to be necessary for costs to be awarded against the unsuccessful party. In these circumstances it is not unreasonable for the regulated company to pay its own costs and those of the regulator and the CC as it can take this into account when it decides whether to appeal.

might be seen to advantage larger airlines at the expense of smaller ones; third, if airlines can appeal without themselves incurring significant costs, it might not deter excessive appeals.

230. There are two further issues in relation to appeals against licence changes:
- (a) Whether symmetric appealing applies to all licence changes or just price cap conditions. The issues would appear similar although the likelihood of excessive appeals might be greater and consequently the arguments for a costs award stronger for other licence conditions.³⁴ We have noted that the Independent Panel provisionally holds the view that the regulator should be the body which, subject to appeal, determines whether an airport has SMP. The Independent Panel envisages that, in cases where it is determined that an airport has SMP, the regulator would have powers to impose certain licence obligations in addition to price controls. In that case it would seem appropriate that symmetric appealing should apply to SMP determinations and to all such SMP conditions.
 - (b) Which parties have the right to appeal: it would seem logical that any party with a sufficient interest in the regulator's price cap determination should have the right to appeal. It would be up to the appellate body to decide if a party had sufficient interest.
231. The CAA's view is that appealing to the CC would be significantly more burdensome to the airport operator than to other appellants. It is not immediately clear why this should be: first, airport operators have a lengthy engagement (around two years) with the regulator through the periodic review anyway—an appeal means only about a six-month extension to this; second, under the current system BAA already has to face a CC inquiry into airport charges at its regulated airports every five years; third,

³⁴The discussion above in regard to costs when the appeal goes against the regulator would not necessarily apply to non-price cap-appeals.

it is not immediately obvious why attending, say, three hearings should be a major distraction for top management—unless perhaps an airport operator has engaged in extensive gaming, for example inflating operating expenditure and waiting until after the price cap is settled to cut its costs. Furthermore, costs to airline appellants could be large—for example if the appellate body’s decision led to increased prices or if costs were awarded against them.

232. We therefore recommend that the current system (where the CC makes recommendations on the price cap to the CAA) should be replaced with a system where the regulator determines the outcome of the review without prior reference to the CC but the CC considers appeals on the merits of the CAA decisions. We also recommend that rights to appeal should extend to all parties with a sufficient interest, including airline customers and consumer bodies. It would probably be necessary to have mechanisms to prevent excessive appeals: these could include disallowing frivolous or vexatious appeals and awarding costs against unsuccessful party/parties.

Aspects of the full regulatory model applied to Heathrow

233. It is not our intention to attempt to set out a new regulatory structure for Heathrow, nor to write its licence. However, reflecting our analysis as set out in our provisional findings, we would expect a licence to impose a set of obligations on the airport owner, with the regulator having powers to enforce the obligations if it failed to perform adequately.
234. The licence for Heathrow should contain similar obligations to those generally imposed on other utilities, in particular obligations relating to quality of service, prices, provision of information, including annual and long-term plans, access to facilities and non-discrimination provisions and the appointment of a compliance officer.

235. In paragraphs 181, 186 and 191 we set out undertakings that we have provisionally decided to put in place in relation to Heathrow. We recommend that these undertakings should be rolled forward as licence conditions, as they address some of what we consider to be key failings of the current regulatory regime.
236. In addition, we would expect the licence to give the regulator adequate information gathering powers and that the mechanisms for ensuring compliance with licence obligations would comprise statutory powers for the regulator to impose financial penalties for past and current breaches and to serve orders requiring compliance in future. We would also expect requirements for regulatory functions to be carried out through processes that are transparent and predictable. We anticipate the regulator would carry out regular reviews of the airport's performance and make major efforts to obtain the benefits of comparative competition by benchmarking against relevant UK and overseas comparators.
237. We believe that, in designing the new structure, the DfT should take into account our experience with the current regulatory regime, as reflected in our regulatory reports under the Airports Act and our market provisional findings in this inquiry. There are some proposals that would be most unlikely to meet the needs of consumers at Heathrow. For example, we do not believe that 'lighter touch' options such as price monitoring, with a threat of formal regulation (as used in Australia), would be appropriate to Heathrow since, as we stated in our provisional findings, there is a need for a more effective, not a lighter touch, regulatory system. Another option that we would not expect to see involves basing price caps on aeronautical costs and assets (dual till) instead of all airport assets (single till). This was fully discussed in our 2002 regulatory reports and it remains our view that the dual till has significant disadvantages, including higher fares to the detriment of consumers (since higher

airport charges would to some extent be passed through in higher fares).³⁵ We have also considered, in our regulatory reports in 2002 and for Stansted in 2008, options that seek to link prices to long-run incremental costs. While we acknowledge options of this sort could have, at least, theoretical benefits in reducing congestion and improving investment incentives, we do not think these benefits would necessarily be great—any incentive of airports to over-declare slot capacity can be adjusted through regulatory means, while we have not seen clear evidence of distortions to investment at unregulated airports.³⁶ In the context of Heathrow, linking prices to long-run incremental costs could significantly increase airport charges and hence, given some pass through to fares, would be to the detriment of consumers. Also, such a proposal may not be consistent with the spirit, and possibly the letter, of the International Civil Aviation Organisation (ICAO) guidelines and international obligations which require prices not to exceed the full costs of providing services, including a reasonable return on assets after depreciation.

238. The Independent Panel has indicated in its emerging thinking that, following practice elsewhere, it would anticipate use of a RAB-based price control wherever the existence of persistent market power warranted it.³⁷ The Panel also envisages that, to protect users, licence obligations would also establish the outputs to be delivered by the airport, in terms of capacity, standards of service, etc and a framework for monitoring, thereby creating the ability for the regulator to take enforcement action if these outputs were not delivered. A further licence requirement which has the Independent Panel's support is for effective consultation with both airlines and end users. In these respects, the Independent Panel's emerging thinking is very much in

³⁵Heathrow, like other large airports, raises most of its airport charge revenue from passenger (rather than landing or parking) charges: an increase in the airport passenger charge represents an increase in marginal cost for airlines and would be expected to be at least partially passed through to passengers in higher fares.

³⁶This is discussed in more detail in Appendix 8: 'Potential distortions from interaction between price-capped and unregulated airports'.

³⁷We note that in its 9 December price control proposals for Stansted, the CAA announced a two-year work programme to develop further its thinking on alternative approaches to price control regulation that facilitate—rather than distort—competition.

line with our own views on the future regulation of Heathrow and we agree with the Independent Panel that its approach would permit a proportionate approach to dominance in individual cases such as Heathrow's.

Recommendations relating to the regulation of Gatwick and Stansted under separate ownership

239. As discussed in paragraphs 25 to 28, we consider that even a reformed regulatory system will remain an imperfect and uncertain mimic of competitive rivalry. We therefore conclude that regulatory reform is unlikely to be an effective alternative to divestiture in addressing the AEC resulting from common ownership of the three BAA London airports. We recognize however that because of capacity constraints in the short to medium term in the South-East and Heathrow's market power as the UK's only hub airport, a need for the economic regulation of some or all of these three airports will persist even under separate ownership.³⁸

240. Against that background, the focus of our deliberations has been on those aspects of economic regulation which have the potential to facilitate or impede the process of competition. In particular, we consider:

- (a) what regulatory conditions should be set for Gatwick and Stansted and how should these evolve to support the development of competition following their divestiture;
- (b) what distortions of competition between Heathrow, Gatwick and Stansted might arise if regulation evolves to the point where only Heathrow is subject to binding price caps; and
- (c) what role terminal competition could have in a reformed regulatory regime.

³⁸ Because at a site-constrained airport, such as Heathrow, long run incremental cost based on the cost of new developments could be considerably above existing costs including a reasonable return on assets after depreciation.

Regulatory models for Gatwick and Stansted

241. As already noted, there will be a period of time before there can be confidence that competition between separately owned airports is sufficiently effective to substitute for regulation. It is difficult to predict precisely how and with what speed competition will develop. Hence there may be a need for continued regulation beyond Q5.
242. The Secretary of State has said that changes would not be made to the basis on which the Q5 price caps were set. Recognizing this, we indicated in our Remedies Notice that we proposed to proceed on the basis that the Q5 price-cap settlements would not be reopened in contemplation of, or following, a divestiture.³⁹ As we expect regulation to continue only for a transitional period at Gatwick and Stansted, it would anyway probably not be appropriate to introduce any significant changes to regulatory methodology at these airports. Should, however, a need for regulation of Gatwick and Stansted persist even under separate ownership, we consider that it may well be appropriate in due course to use an alternative to the current RAB-based methodology. In that regard, we welcome the CAA's recent announcement that it intends to keep competition between airports under review and to put in place a work programme to develop its thinking on alternative approaches to economic regulation that facilitate competition.
243. As the Independent Panel has pointed out, proportionality and the avoidance of over-regulation are principles of better regulation that are particularly appropriate for a marketplace where competition is expected to become increasingly workable over time. Faced with just such a marketplace, the challenge for the regulator of airports will be to modify regulation appropriately to promote competition and as competition develops. There appear to be two risks:

³⁹We note that the price cap settlement can be re-opened with the agreement of the airport operator.

(a) that the regulator is too ready to weaken regulation to the detriment of existing users; and

(b) that the regulator is too reluctant to relax regulation. If, even under separate ownership, price caps are expected to continue indefinitely, airport owners may not have adequate incentive to invest in their regulated airports or to act innovatively. This would not be to the long-term benefit of users.⁴⁰

244. It might be argued that regulation cannot disadvantage users as it imposes a cap, not a floor, on prices. However, this argument overlooks the fact that users may be disadvantaged if a price cap gives insufficient incentive to invest in new capacity.⁴¹ This could arise if, once the new capacity comes on stream, there is a possibility of a regulated airport not being able to price up to a RAB-based price cap, for example because passenger growth is weak. Assuming a RAB-based price cap is based on the regulated airport's cost of capital, the airport then faces some probability of earning less than the cost of capital (if passenger growth is weak) and some probability of earning just the cost of capital (if passenger growth is strong)—this is sometimes referred to as asymmetric risk. Under these assumptions, a regulated airport's expected return from expanding capacity may be less than the cost of capital, even if users would be willing to pay for the new capacity.⁴² As a consequence, price-capped separately owned airports may not have adequate incentive to expand capacity to the benefit of users.

245. If the regulator is too cautious about lifting price caps, there is a danger of a vicious circle whereby airports do not have incentives to expand capacity, the existing

⁴⁰As a separate point, the continuation of price caps tends to undermine the incentive for airports to agree fixed-price long-term contracts for airport use.

⁴¹Under separate ownership, weak passenger growth would likely be associated with weak prices and airports would not necessarily be able to increase prices to offset lower volume.

⁴²The argument can also be expressed as follows. Assume the return from expanding capacity is x with probability p and y with probability $(1-p)$, where x is less than the cost of capital, c , and $y > c$. In the absence of a price cap, the expected return is $xp + y(1-p)$ which is assumed greater than c , reflecting the value to users of the increase in capacity. But with a price cap, the expected return is reduced to $xp + c(1-p)$ which is less than c .

situation of capacity shortage continues, and real competition never emerges. To address this danger, the regulatory regime needs a credible advance signal about appropriate modification to price caps.

246. The CAA stated that its interpretation of the CC's provisional findings was that it argued both for tighter regulation and for divestment. The CAA argued that the tightening of regulation might undermine the credibility that competition would be allowed to develop and reduce the gains from divestment. The CAA suggested that event-contingent removal of price caps (as in lifting price caps when new capacity comes on stream), if credible, might distort the incentives to invest of both the regulated and competing airports.
247. The CAA also pointed out to us that once competition had been established, it was reasonable to expect there to be future periods of both relative capacity excess (with relatively low prices for airlines which do not have long-term contracts) and relative capacity shortage (with relatively high prices for airlines which do not have long-term contracts); it was therefore important for the regulator to establish with credibility that the regulator would not re-introduce price caps whenever capacity started to become tight and prices to rise, as the perception that the regulator would do so would undermine incentives to invest in the first place.
248. We noted earlier that, under the system currently favoured by the Independent Panel, the regulator would have to make a finding of SMP before re-imposing price caps. In a situation in which price caps have been lifted and new capacity comes on stream, we would expect it to be used and volume to increase rapidly. Alternatively if underlying traffic growth was weak, we would expect to see the airport owner making attractive offers to airlines. If sharply rising prices were observed instead, with volume stagnating or falling, it would suggest exploitation of market power and the

regulator would need to consider re-imposing price caps or other appropriate actions. This is different from a situation in which prices rise in a competitive market due to a tightening of the supply-demand balance.

249. We accept the point made by the CAA that once competition has been established there may be periods of relative capacity shortage and rising prices when it would not be appropriate to re-impose price caps and also note that if airports expect price caps to be re-introduced whenever capacity starts to tighten they are unlikely to have adequate incentive to invest. Nonetheless, we support the use of an SMP test to determine whether to re-impose price caps which, if properly applied on a forward looking basis as envisaged by the Independent Panel, should not give rise to the problems raised by the CAA.
250. The system currently favoured by the Independent Panel, including the imposition of an SMP test, will provide some reassurance to airport owners that, once lifted, price caps will only be re-imposed if there is evidence of dominance which is expected to persist. However, we consider that the regulatory regime also needs a credible advance signal about appropriate modification to price caps. Clearly a decision on whether or not to lift price caps as new capacity comes on stream will require the balancing of risks based on the consideration of a number of factors, including the nature and intensity of competition that develops in the period following divestiture of Gatwick and Stansted. It is therefore not possible for us now to recommend the promulgation of a clear-cut rule that the price caps at Gatwick and Stansted be lifted at a particular date (such as the end of Q5) or at the point when the existing situation of capacity shortage has been eased to a particular extent (such as through certain projects or specified quantities of new capacity coming on stream). We however strongly support the reduction and removal of regulation, as competition develops.

251. It seems to us that one means of signalling in advance the lifting of price caps that we can recommend now is for the regulator to be under a statutory duty not to set price caps or impose related licence obligations or to retain them unless its market analysis shows that there is a material risk of the relevant airport charges being set at an excessively high level with adverse consequences for end users. This might be supplemented by including in the relevant licence conditions, the following:

- (a) requirements for price caps (and associated matters, such as the service quality regime) to be reviewed at fixed intervals, most likely every five years, as is currently the case for water company licences; and/or
- (b) provision for the licence conditions to be disapplied if the licence holder requests it and the regulator does not make a reference to the CC relating to the removal of this condition.

Potential distortions from interaction between price-capped and unregulated airports

252. We have considered whether there could be significant distortions between a price-capped airport and a substitute unregulated⁴³ airport under different ownership and have concluded that no remedial action is required to mitigate this risk. Our analysis of this issue is set out in Appendix 8.

Introducing terminal competition

253. As stated in paragraph 34 we consider that STOD or terminal competition is unlikely to be as effective as divestiture in addressing the detriments we have identified where airports have the potential of competing. However, where divestiture is not viable or is unable to address anti-competitive features terminal competition may have a role.

⁴³Here this means an airport without a price cap.

254. The separation of terminal ownership or operation from the ownership and operation of the airfield has been adopted in certain countries as a path to privatization. In the UK, the decision was taken to privatize each airport as a whole. The evolution of the airport sector and the legislation underpinning it reflect this political choice.
255. Under the Airports Act and other legislation relevant to the safe operation of airports, there are severe limitations to the ability of a company to operate terminal facilities within an airport, independently from the operator of the airfield. There is, however, no reason in principle why this should not be permitted (as explained in more detail in Appendix 7) and, in our view, significant benefits could be derived from introducing terminal competition, particularly at airports that are under weak competitive constraints from other airports, either because of their isolated geographical position or because of some other unique characteristic which confers SMP on them.
256. Given that a reform of the economic regulation of airports is under way, it seems to us that the legislation should now be amended to allow for terminals to be developed or re-developed and to be operated separately from runway facilities.
257. Within a reformed regulatory regime, we can envisage at least two sets of circumstances under which terminal competition could be introduced for a specific facility, following a detailed consideration of the costs and benefits of doing so by the CAA:
- (a) new terminal facilities could be put out to tender by the regulator; or
 - (b) a persistent failure by an operator to meet one of its core licence conditions (eg in relation to quality of service) could result in the mandatory outsourcing of the operation of terminal facilities by the regulator to another party.

258. In relation to BAA airports, there appears to be limited scope for introducing terminal competition over the next few years, given the current timetable for development at Stansted and the difficulties of coordinating the redevelopment of Heathrow across several terminals. However, it could be envisaged that the building and operation of Terminal 6 at Heathrow could be the subject of a tender managed by the CAA. Similarly there appears to be no reason in principle why the South and North Terminals at Gatwick could not be operated by different companies if the operator of Gatwick were to fail to meet the requirements of one of its licence conditions. At Stansted, it would be difficult to carry out a STOD remedy in the short term, given the timetable for the SG2 planning inquiry. However, it is currently envisaged that the terminal will only be fitted out for less than a third of its ultimate capacity, and there is no reason why in future, this terminal could not be developed further and operated by a separate terminal operator.

Wider considerations

Aspects of passenger experience

259. Our terms of reference and hence the scope of our provisional findings and remedies, are limited to the supply of airport services by BAA, but the passenger experience at airports also results from the operations of a number of different parties, including public sector bodies such as the UK Border Agency as well as airlines and their agents, and the interaction between them. A competitive market would normally be expected to deliver a good customer experience: separate ownership of airports and competition between them may itself be expected to act as an incentive on airport operators not only to improve the performance of those activities for which they are directly responsible, but also to stimulate other operators to improve their performance at the airports. But given the role of those other operators, competition between the BAA London airports may nonetheless be

insufficient fully to resolve the current poor passenger experience, particularly at those airports.

260. As noted in our provisional findings, a main cause of poor passenger experience in the BAA London airports is the shortage of runway capacity and the exceptionally high utilization of the Heathrow runways, with little resilience in the event of operating difficulties. Increases in runway capacity, through allowing mixed mode operations or construction of a third runway, must inevitably involve the Government; but government involvement may also be necessary in deciding on the appropriate balance between maximizing the number of movements using the available runway capacity and allowing for a greater degree of spare capacity to increase resilience, the costs and benefits of which could both be significant.
261. As we noted in paragraphs 6 and 2.96 of our provisional findings, problems in quality of service particularly at the BAA London airports have arisen not only in the operations of BAA but also of other operators at the airports. In particular we noted problems in check-in queues and baggage handling following the increases in security requirements (activities for which airlines and their agents are to a large extent responsible), and the significant problems of queuing at immigration desks, which is the responsibility of the UK Border Agency. The Consumer Protection Group of the CAA has recently at the request of the DfT carried out further work, including a survey of passenger experience at all stages of passing through main airports, the results of which we will take into account when available. The airlines themselves operate in a generally competitive market and it is unlikely to be appropriate for any requirements to be imposed on the service standards provided by airlines equivalent to the service quality regime that applies to BAA.

262. We note the statements in the DfT's recent reviews of passenger experience at Heathrow and Stansted⁴⁴ that:

- (a) Given that there is no transparency to airline check-in times and can be significant variation in individual airlines' performance, the Secretary of State for Transport has written to the CAA seeking their views on the transparency of check-in queue times which would allow passengers to make a more informed choice when booking their flight, and encourage airlines to improve performance.
- (b) While it is ultimately up to the airlines and airports to work together to ensure that passenger journeys are as easy as possible, the DfT works closely with aviation leaders to focus discussions on how the effects of the current security procedures can be minimized for aviation progress. The DfT has also commissioned further passenger surveys of security arrangements to ensure it has a strong evidence base to inform priorities for further enhancements to the security systems.

263. A commitment was made that the UK Border Agency,⁴⁵ the DfT and airport operators would work together to develop action plans for key airports, looking at ways in which the arrival of legitimate travellers into the UK could be made as easy as possible, while ensuring high standards of border security in order to protect society as a whole. Since November 2007, the Border and Immigration Agency and the DfT have been working closely together to deliver this commitment. As stated in the March Budget 2008 report, 'improving the passenger experience at the UK's major airports is critical to UK competitiveness. To reduce delays for travellers, Budget 2008 announces new measures with airport operators to improve average and maximum waiting times at immigration. This will be accompanied by greater use of automated biometric technology and fast-track routes through immigration'. In addition, there will

⁴⁴*Improving the Air Passenger Experience, An analysis of end-to-end journeys with a focus on Heathrow*, Department for Transport, November 2007; and *Improving the Air Passenger Experience, An analysis of end-to-end journeys with a focus on London Stansted Airport*, Department for Transport, August 2008.

⁴⁵Formerly the Border and Immigration Agency.

be service level agreements drawn up with airport operators at the busiest airports over the course of 2008/09 to improve performance on queuing times; the DfT and Home Office Ministers have agreed a process and timetable for drawing up these service level agreements.⁴⁶ If there is further information available on this before the publication of our final report, we will take it into account.

Financial ringfencing

264. In our provisional findings we commented on the absence of ringfencing provisions and the lack of powers to appoint a special administrator as a significant omission in the airport regulation regime compared to with other UK sectoral regulation regimes. The Independent Panel has also indicated that it currently favours such provisions in relation to a small number of key airports
265. In response to our provisional findings and Remedies Notice, the CAA indicated that it did not believe that ringfencing provisions and powers to appoint a special administrator were necessary for airport regulation because, compared with other sectors, (eg electricity networks), the consequences of supply disruption were less severe, airport creditors had strong incentives to continue operations to continue generating cash and airports were not natural monopolies.
266. Following divestiture of Gatwick and Stansted, it is reasonable to believe that the current level of financial risk resulting from reliance on a single highly geared balance sheet for the BAA group will reduce significantly. It also appears reasonable to

⁴⁶The agreements will include plans for improvements such as:

- (a) agreed published airport-by-airport targets for average and maximum waiting times, and mechanisms for monitoring and reporting performance against them;
- (b) ways of best matching the availability of frontline border offices and predicted passenger flows;
- (c) a more coordinated approach to flight scheduling to prevent unnecessary pressures when large numbers of flights arrive at the same time;
- (d) improvement, where possible, of the layout of immigration halls, including better signage, to deliver a more efficient and welcoming passenger experience;
- (e) the greater use of automated technology, such as IRIS, an automated clearance scheme for pre-assessed, eligible frequent travellers, to speed up processing times for selected and pre-assessed travellers; and

consider that the consequences of supply disruption in airports are likely to be less severe than for other sectors.

267. However, disruption to Heathrow for a prolonged period is likely to have a significant impact on access to flights and although creditors may have an interest in continuing to operate a BAA airport to generate cash it is possible that providers of key services to the airports may not wish to continue supply if the BAA airport or holding company is in financial default.

268. In our view, ring fencing provisions similar to those adopted in other regulated industries, and special administration provisions in relation to Heathrow, would therefore be worthwhile elements of the regulatory reform for airports.

Recommendations on government policy

269. Having found that the White Paper had the potential to affect competition and certain development prospects adversely we indicated in our Remedies Notice that we would consider recommending that the Government should take the opportunity to review the White Paper in the light of market developments, particularly the proposed separate ownership of London airports, and give explicit consideration to the impact of its stated policies on competition between airports.

270. We also considered that the London Air Traffic Distribution Rules which prevent the operation of new cargo services from Heathrow and Gatwick at peak times were a feature which restricted competition between airports and cargo airlines, although we did not put forward a remedy in our Remedies Notice.

(f) ways in which the presentation of passengers to border control officers could be improved, including better queue management and examining whether airport operators might be better placed to manage presentation on behalf of airlines.

271. We consider in this section recommendations to the DfT in relation to the White Paper and the London Air Traffic Distribution Rules.

The White Paper

Parties' comments

272. Among the points BAA made in its response to the Remedies Notice were that:

(a) At this stage, any review of the White Paper would be counterproductive as it would create uncertainty as to the robustness of the current policy.

(b) It could be argued that the CC's conclusions that BAA's common ownership of the airports in the South-East acts as a constraint on capacity is not rationally sustainable. The problem is government policy. The remedy is not therefore, to split up the ownership of the airport (which would be disproportionate and futile) but to change government policy.

273. We note that these comments are seemingly contradictory.

274. The CAA argued that:

(a) The White Paper constituted an essentially permissive, rather than prescriptive policy and therefore could be interpreted as encouraging airport development at price controlled airports, providing that the environmental externalities were properly taken into account.

(b) Any potential AEC arising from government policy could easily be remedied by the Government clarifying that the location, sequencing and timing of the developments identified in the White Paper was only indicative.

275. In its response to our provisional findings and Remedies Notice and following discussions, the DfT made the following key comments:

- (a) It was the view of the Secretary of State that there was no current need to review the fundamental approach laid out in the White Paper.
- (b) Following a thorough process of research, analysis and UK-wide consultation, the White Paper set out proposals which best represented the policy aims of delivering sustainable capacity. There was strong evidence to suggest that without the White Paper, the optioneering exercise for airport development would have to take place within the planning and development control system; each inquiry and each inspector would be responsible for the need for a particular development and the best location for it, resulting in lengthy, delayed and expensive decisions, in turn creating uncertainty for airport operators and local communities.
- (c) Problems such as these led the Government to promote the Planning Bill on the premise that the establishment of a clearer policy framework for future infrastructure development, wherever possible identifying the Government's preferences in terms of location for that development, would be a key element of the reforms needed to deliver the improvements sought to the planning process. These reforms would apply across various sectors.
- (d) The White Paper did not itself authorize or preclude any particular airport development. The DfT did not see any need to clarify that its policy was permissive, as it considered that it was already clear.
- (e) The White Paper had concluded that there was a strong economic case for additional capacity at Gatwick, but that, on balance, the case for a runway at Gatwick was not as strong as for the options at Stansted and Heathrow.
- (f) It was expected that the next progress report, to be prepared sometime between 2009 and 2011, would report on developments across the range of the White Paper policies since 2006, and take account of relevant changes, including in the marketplace, as well as the outcome of our market investigation.

276. We have received a large number of representations, the vast majority of which expressed concerns about the impact of a wide-ranging review of the Government's aviation policy on capacity expansion in the South-East. No third party contested our view that the White Paper distorted competition, but some, in particular BA and Virgin, appeared to believe the White Paper to be less constraining than our analysis had suggested. A number of organizations (MAG, Hochtief AirPort, [X]) supported a narrowly-defined review of policies and some supported a more wide-ranging review (Ryanair, Stop Stansted Expansion). More specifically, MAG noted that what the CC was proposing with the break up of BAA was a necessary but radical change in the marketplace that completely altered the market dynamics and, potentially, the situation as far as future capacity provision in the South-East was concerned. In its view, a review of the relevant parts of the White Paper should therefore be undertaken. Recognizing the risks of delay that might result from a wide-ranging review, Hochtief AirPort suggested that the Government should state that it would 'consider a runway development proposed by a new owner of Gatwick with construction starting after 2019 or, if a case can be made that is compelling, before 2019'.

Consideration of the parties' arguments

277. We accept that the White Paper does not itself authorize or preclude any particular airport development. However, we remain of the view that following the reforms of the planning regime, particularly through the Planning Bill, the specificity of the White Paper overly constrains the ability of airport operators to bring forward new projects in response to changes in the market, particularly in the South-East.

278. However, we also accept that the evidence we have received points towards the need for a cautious approach to a recommendation to review the White Paper, both in terms of the timing of a potential review and its scope. In particular, we are mindful

of the impact of such a recommendation on the SG2 planning inquiry. In common with the DfT, we are also keen to ensure that the right framework is in place to help ensure the delivery of additional runway capacity in the South-East as soon as possible and in an economically efficient manner.

279. We are currently of the view that this will be best achieved by instilling competition in the planning and delivery of new runway capacity at London's major airports, in a way consistent with the objectives of the White Paper. We consider that this could be achieved not through a fundamental review of the White Paper but within the process leading up to the formulation of the aviation NPS. This process will take place after our divestiture remedies come into effect.

280. Although this approach would not address all the competition concerns that we have identified, it currently appears to us to represent a pragmatic compromise between effectiveness and practicality, consistent with wider government objectives.

Recommendations

281. In order to remove any ambiguity about the intention of our recommendations and to avoid any risk of disruption to the Stansted G2 planning inquiry, we are currently considering including in our final report the following statements:

(a) We are not questioning the Government's broad policy objectives or the approach taken to the development of that policy, ie balancing the environmental impact and economic benefits, or the proposals under consideration for a second runway at Stansted.

(b) Although in principle, the decision by the Government to support only two runways raises competition concerns, we acknowledge that in making this decision the Government also had to take into account other considerations.

- (c) We recognize the benefits in planning terms of a government policy which identifies the suitability of specific sites for development. Although we are concerned about the potential impact of this approach on competition, we are not minded to recommend that it should be reviewed, given the wider debates taking place in the context of the 2008 Planning Act and Parliament's decision that an aviation NPS should be site-specific.
- (d) We acknowledge the reasons⁴⁷ for the Government's decision not to overturn the Section 52 agreement at Gatwick, which prohibits the building of a second runway at Gatwick before 2019. Given the timescales involved in developing a planning application and obtaining planning approval, we see little benefit at this stage in recommending that the Government should consider overturning this agreement.
- (e) We recommend that the Government should, in the context of the development of the aviation NPS, consider the impact of the White Paper on the aviation market in the South-East, in the light of the divestiture of Gatwick and Stansted and should ensure, in line with the recommendations of Kate Barker's report (Review of Land Use Planning), that the aviation NPS does not unduly constrain this market. In making this assessment, the Government should draw upon our conclusions on the impact of government policy on competition.
- (f) In particular, in developing the aviation NPS, the Government should give due consideration to the ambitions of the new owner of Gatwick airport, including the possibility of a second runway at Gatwick after 2019. In this respect, we note that the White Paper suggested that there was an economic case for the construction of three new runways in the South-East by 2030.

⁴⁷These reasons are set out in paragraph 123 of our working paper on Planning Law and Government Policy: the government was of the view that it would be highly undesirable as a matter of policy and principle to overturn the 1979 Agreement because (a) people should be able to rely on it; (b) to overturn it would seriously undermine efforts to create greater certainty; and (c) there was evidence that West Sussex County Council and others were opposed to the overturning of it.

Air traffic distribution rules

282. The CAA told us that it would be content for there to be a review by the CAA of the Air Traffic Distribution rules, which restricted cargo services and general aviation at Heathrow and Gatwick: since it was now clearer that airport slots could be traded, there was a proven market mechanism to deal with the use of scarce airport slots and the rules might therefore be superfluous. Under section 31 of the Airports Act, there are provisions for the CAA to review the rules at the Government's request. This would involve a consultation of the industry and recommendation to the DfT, which would then make any changes it saw fit.

Recommendation

283. We therefore recommend to the DfT that it should request a review, under section 31 of the Airports Act, of the current air traffic distribution rules relating to cargo traffic at Gatwick.

Conclusions—the package of remedies⁴⁸

284. We consider that a package of remedies consisting of the following key elements would be effective in remedying the AECs and any adverse effects on customers created by the various features of the markets for airport services in the UK as exist in connection with the supply of airport services by BAA:

(a) structural remedies, comprising:

- (i) the divestiture of both Gatwick and Stansted to different purchasers. In relation to Stansted, we are seeking views on the timing of divestiture which is most likely to support the development of competition, although our preference is to initiate it as soon as possible;

⁴⁸This also appears in the summary but is repeated here for convenience.

- (ii) the divestiture of Edinburgh rather than Glasgow. However, we remain open to further views on this issue;
 - (iii) the appointment of a monitoring trustee to monitor the progress of the above divestitures and otherwise assist in managing divestiture risks. The CC will retain the option to require the appointment of a divestiture trustee at any time in specified circumstances;
- (b) behavioural remedies, comprising:
- (i) in relation to Aberdeen, rebates on charges linked with investment incentives and required consultation on capital expenditure;
 - (ii) in relation to Heathrow, and possibly Gatwick and/or Stansted, requirements strengthening the consultation processes, provisions on non-discrimination and provisions on quality of service;
- (c) in relation to the economic regulation of airports, recommendations to the DfT that:
- (i) the Government should adopt a licence-based regime of economic regulation;
 - (ii) the regulator's primary objective should include a duty to promote effective competition between airports and in assessing the interests of consumers, the regulator should have due regard to the view of airlines;
 - (iii) the role of the CC should be changed to that of an appellate body and the right of appeal should be extended to airlines and parties whose interests are materially affected by the CAA's decision; rights of appeal should apply to the airport regulator's determinations on whether an airport holds Significant Market Power (SMP) and associated licence obligations;
 - (iv) the licence should impose a set of duties on the operator of Heathrow. The licence should also give the regulator adequate information gathering powers;
 - (v) the regulator should be under a statutory duty not to set price caps or impose related licence obligations or to retain them unless its market analysis shows

that there is a material risk of the relevant airport charges being set at an excessively high level with adverse consequences for end users; and

(vi) the legislation should be amended to allow for terminals to be developed or re-developed and operated separately from runway facilities;

(d) in relation to air transport policy, recommendations to the DfT that:

(i) it should, in the context of the development of the aviation NPS, consider the impact of the White Paper on the aviation market in the South-East in the light of the divestiture of Gatwick and should ensure that the aviation NPS does not unduly constrain this market;

(ii) in developing the aviation NPS, the DfT should give due consideration to the ambitions of the new owner of Gatwick, including the possibility of a second runway at Gatwick after 2019; and

(iii) the DfT should request a review, under section 31 of the Airports Act, of the current air traffic distribution rules relating to cargo traffic at Gatwick.