

Summary of main issues

1. As part of its inquiry into the BAA London area airports the CC is putting a list of detailed issues to BAA and CAA. The Commission has already received a considerable volume of evidence from third parties; it is publishing this summary of the main issues to give such parties the opportunity to comment on any matter on which they may not have commented to date. The background to many of these issues, including the CAA's recommendations to the Commission, is available on the CAA website (<http://www.caa.co.uk>) and evidence to date of some parties to ourselves is to be made available on the CC website (<http://www.competition-commission.org.uk/inquiries/baa.htm>).

2. The Competition Commission are required to investigate and report on:

- (a) The maximum level of airport charges that can be levied by Heathrow Airport Ltd, Gatwick Airport Ltd, and Stansted Airport Ltd for the five years beginning 1 April 2003 (the fourth quinquennial period – Q4).
- (b) Whether any of these airport companies (including any associated company of Heathrow Airport Ltd) has pursued any course of conduct against the public interest in relation to the activities specified in the reference in the period of about 6 years up to the date of the reference to us.

The level of charges

3. To date, airport charges have been set such that the three BAA London airports together can be expected to earn a reasonable rate of return on the regulatory asset base.

4. Among the main elements of that approach:

- (a) The CAA sets a formula for the maximum percentage change in airport charges, ie £ per passenger covering the next five years.
- (b) It has been based on the 'single till' approach, in which effectively the significant profits from commercial activities are used to offset the level of aeronautical charges. Hence, there was also allowance for the effect of loss of intra-EU duty free income from July 1999.
- (c) In setting the asset base for regulatory purposes on which a return would be allowed, there was allowance for assets in the course of construction – particularly BAA's key investment in Terminal 5 (T5) at Heathrow, in effect a prefunding of that investment. (In the last report, to avoid a sudden price increase there was also an element of 'smoothing' of prices and returns between Q3, the current quinquennium (originally 1997/98-2001/02) with an RPI-3 formula but a relatively high return, and a suggestion of price increases of RPI+2 (reflecting the increasing marginal cost, particularly of T5) but lower rates of return in Q4 (originally 2002/03-2006/07)). However, the length of the planning inquiry meant that investment in T5 was not undertaken, although BAA did spend more than expected on other projects.
- (d) New security requirements introduced during the course of the charging period are subject to 'cost pass through', at 95 per cent of the estimated level of those costs (the 'S' factor).

5. The issues relating to setting the level of X can best be distinguished between (a) issues relating to the general approach and structure of the formula; (b) issues relating to setting the level of X within the general approach adopted. Further issues arise in the context of public interest.

The general approach – main issues

Issue 1: Whether any aspects of BAA's performance over the current quinquennium (Q3) have relevance to the setting of charges for the next quinquennium (Q4).

6. Main aspects of performance include:

- (a) Passenger numbers significantly above forecast;
- (b) Higher depreciation charges;
- (c) Significantly lower investment, in particular on T5;
- (d) Property rents significantly higher than expected;
- (e) Lower retail income than expected; and
- (f) Overall return on capital value similar to that previously projected.

We will also have to consider whether other aspects of performance, for example quality of service, have been acceptable. The implication of some of these points to our inquiry are included under relevant issues below.

Issue 2: Whether the CAA proposals are consistent with Airports Act objectives.

7. It has been argued to us that the framework of economic efficiency adopted by the CAA, ie maximising net gains to users and airports combined, may be inconsistent with the requirements of the Airports Act as regards the objectives of the CAA when exercising its regulatory functions, eg to further the reasonable interest of users. Similarly it has been argued that the Act does not require the CAA to promote the efficient use but the efficient, economic and profitable operation of airports.

Issue 3: The appropriateness of RPI-X form of control

8. This has not been significantly questioned in the current inquiry, and the CC is unlikely to depart from this approach.

Issue 4: Whether there should be regulation of system or individual airports

9. The CAA has proposed each of the three London airports should be regulated separately. Considerations include:

- (a) Whether there is inter-dependence of demand between the airports;
- (b) Whether relative charges should reflect relative pressure of demand: hence if excess demand is greater at Heathrow than Gatwick, or at Gatwick than Stansted, charges should be highest at Heathrow, lower at Gatwick and lower still at Stansted;
- (c) Alternatively, whether the 3 airports can be regarded as largely serving separate markets, or separately used by airlines with limited substitutability – and should be regarded separately for pricing and/or investment;
- (d) Whether, if there is any cross subsidy between the airports, in particular of Stansted, this is undesirable, and would be prevented by abandoning the system approach;
- (e) Whether the system approach distorts the pattern of investment rather than ensuring investment is where users want it; and
- (f) Whether in the longer term requirements for new investment and constraints at particular airports could change the relative desirability of a system and individual airport approach.

Issue 5: Whether regulation of airport charges should be on a single till or dual till basis

10. As noted above, airport charges are currently regulated on a single-till basis, the profits of commercial activities being used to reduce airport charges. The CAA has proposed a ‘dual till’ basis whereby the maximum level of airport charges is set to cover the operating costs and rate of return on aeronautical facilities. There would be allowance only for the revenues and costs of a number of aeronautical activities, necessary for airlines to operate at the airport, but which are excluded from the scope of airport charges (such as charges for use of check-in desks) and without ‘subsidy’ from other commercial revenues. For Q4, however, it has proposed a formula of RPI+6 for Heathrow, consistent with the single till, rather than RPI+12 that would be consistent with dual till, offset by higher charges later. The following are among relevant considerations.

Issue 5(a): Whether it is meaningful to separate the cost and assets of commercial and aeronautical activities at all.

11. Relevant considerations include:

- (a) Whether many commercial activities are an essential part of an airport operation; alternatively, whether demand for use of commercial facilities can be regarded as dependent on the usage of aeronautical facilities; whether there are economies of scope or joint and common costs between aeronautical and commercial facilities; and whether any such arguments would suggest aeronautical activities cannot be regarded as separate from commercial activities. Even if any of these arguments did not apply, it would not be possible to provide commercial activities without aeronautical activities – possibly also suggesting commercial activities should pay some aeronautical costs?
- (b) Whether development of commercial revenues could be attributed to the activities of the airlines, hence the benefits should be shared with airlines and airline users.
- (c) Whether social welfare could be reduced at uncongested airports by the dual till, to the extent charges at such airports should be set only at marginal costs.
- (d) Whether in a competitive market, it may be expected that nearby airport operators would compete by using profits of commercial activities to reduce aeronautical charges.
- (e) Whether in undertaking capital investment, it is also to be expected that airports would take into account both commercial and aeronautical revenues.

Issue 5(b): Precisely how one should distinguish the cost of non-aeronautical and aeronautical activities

12. Among relevant considerations:

- (a) Whether the ‘monopolistic bottleneck approach’ proposed by CAA is appropriate - ie whether to be included within an aeronautical till the facility would have to be both essential and significantly monopolisable;
- (b) Whether all surface access should therefore be excluded from the aeronautical till;
- (c) Whether surface access projects should be funded like any other surface transport and the dual till at most be confined to that within the airport boundaries;
- (d) Whether on the other hand all surface access should be allocated to aeronautical costs, including whether it would be inconsistent with previous regulatory practice to do otherwise;
- (e) Whether surface access can be regarded as a potential capacity constraint and therefore allocated to the aeronautical till; including whether if an extension to existing surface access facilities is to be allowed for, it is not also logical to allow for existing facilities too;

- (f) As to other facilities, whether it is possible to separate the tills in any fair and sustainable way. This would include consideration of the basis of the classification of other particular activities (as proposed by CAA, the details of which have been published by the CAA on their website);
- (g) Whether there would be a continuous need to police the boundary of the two tills;
- (h) Whether current liabilities should be deducted from aeronautical assets alone.

Issue 5(c): Whether the dual till is consistent with international obligations

13. Relevant considerations include:

- (a) The side letter in 1994 to the Bermuda Agreement that the UK had no current intention to depart from a single till approach;
- (b) The relevance of the ICAO policies that commercial revenues should contribute to meeting the costs of aeronautical facilities, and the suggestions by ICAO that there should be flexibility in applying the single till or dual till approach, and whether this could imply different approaches at different airports.

Issue 5(d): Whether the dual till is consistent with practice at other international airports

14. We have been told that other international airports – eg Sydney, some US and some European airports - have now gone down versions of the dual till route, but it has also been argued to us that no direct analogy can be drawn given different circumstances.

Issue 5(e): Whether the dual till would improve efficiency in utilisation of aeronautical facilities

15. In appraising whether, by increasing airport charges, the dual till approach would result in users who value use of scarce capacity relatively highly displacing those who give it a lower valuation, relevant considerations include:

- (a) Whether such benefits are merely theoretical, given, for example, the very efficient use already made of Heathrow runways;
- (b) Whether given the degree of excess demand and the low price elasticity of demand for airports, any such benefits from the higher charges that would result from the dual till would also be very limited;
- (c) Whether nonetheless improved allocation of scarce runway capacity at the margin would be of value;
- (d) Whether such an approach rewards the monopolist for not investing in capacity and reduces the incentive to increase capacity;
- (e) Whether such an approach is beyond the regulatory remit of the Airports Act given, for example, EU regulations;
- (f) Whether the circumstances of the airline industry invalidate the theoretical benefit of the dual till approach, including bilateral treaties, EU regulations, degree of state ownership, different financial strengths of airlines, different strategies pursued by airlines;
- (g) Whether charter or low fare airlines, being more price sensitive, would be adversely affected by any such move. Amongst the points made to us is that charter airlines operate larger aircraft, hence any effect on their use of runway capacity would be difficult to justify; alternatively the suggestion that if a particular airline secures capacity through offering a higher price for it, it must be offering a higher net value product; or, the suggestion that in the event of the dual till being adopted the structure of airport charges could be changed so as not to have such an effect;
- (h) Whether it is appropriate to use airport charges to provide efficient allocation of scarce runway capacity, or whether this should not be far more effectively addressed through reconsideration of

EU rules on allocation of slots. Alternatively, if action is taken by the EU to prevent slot trading, whether this would leave airport charges as the only means available to improve slot allocation;

- (i) Whether the dual till would result in higher air fares, or lower profits to airlines. One argument put to us is that since increased airport charges would affect all competing airlines on a particular route, they are likely to be able to pass on such an increase in common costs;
- (j) Whether, on the other hand, by encouraging investment and increasing capacity, the dual till could result in lower air fares;
- (k) Whether higher airport charges resulting from the dual till could adversely affect airlines operating services from Heathrow or other London airports to regional airports in the UK adversely affecting not only the services but also the respective regional economies;
- (l) Whether any such higher charges could also adversely affect the cost of mail services using the airport;
- (m) Whether, on the other hand, the single till artificially increases demand;
- (n) Whether there could be any net benefits to passengers, or wider economic benefits, from this aspect of the dual till approach;
- (o) Whether the above considerations apply differently at different airports. As implied in the CAA proposals, should the dual till apply to Stansted at all, where there is currently less pressure on capacity; would the dual till permit misallocation of resources at uncongested airports; is the price cap implied by the dual till at Heathrow (RPI+12) feasible, or should it be confined to no more than (and possibly less than) the RPI+6 as proposed by the CAA; but, if so, is it contrary to efficient resource allocation to apply, as the CAA propose, a single till formula at Heathrow for Q4, hence raising the price cap above single till levels only at Gatwick and Stansted.

We note that some of the issues will need to be addressed whether or not they arise due to the dual till.

Issue 5(f): Effect of dual till as opposed to the single till on investment

16. Relevant considerations include:

- (a) Whether higher airport charges as a result of the single till would encourage investment and increase capacity.
- (b) Alternatively, whether it is unlikely incentives would be improved by the dual till approach, particularly given wider political and environmental constraints on airport investment, and that there is no guarantee the investment would be forthcoming.
- (c) Whether the dual till would allow an improved focus on aeronautical investment.
- (d) Whether the dual till could distort investment by allowing higher return on commercial and capacity enhancing investment.
- (e) Given the single till approach has allowed a return equivalent to cost of capital on existing assets and new investment, why should the higher profitability of the dual till be necessary as an incentive to invest.
- (f) Whether, on the other hand, the dual till would encourage investment through providing up front revenues to finance, for example, T5, or provide increased assurance as to future price paths necessary for investment in T5.
- (g) Whether, if surface access was excluded, the dual till could discourage BAA from pursuing worthwhile but unprofitable public transport investments.
- (h) Whether there is any evidence of under investment as a result of the single till to date, or whether any examples of under investment primarily reflect planning constraints.

Issue 5(g): What are implications of the dual till for commercial activities

17. Relevant considerations include:

- (a) Whether the greater profitability of commercial activities suggests they are monopolistic.
- (b) Whether on the other hand, this reflects locational scarcity rents rather than monopoly rents, particularly given prices are generally not above high street levels.
- (c) Whether, if a dual till approach was to be adopted, it would require greater regulatory intervention or threat thereof to reduce the profits of commercial activities; but whether it is more desirable that any such excess commercial profits should be regarded as a matter for competition law rather than inclusion in the single till.
- (d) Whether the possibility of reverting to a single till in future is an effective threat to ensure improved performance.

Issue 5(h): Whether BAA's development of commercial activities may already have been at the expense of aeronautical activities – or could be, or could be to a greater extent, under the dual till

18. Points we may wish to consider include:

- Relatively low passenger ratings in IATA surveys of aeronautical compared to commercial activities between Heathrow and other airports.
- The suggestion that, where airlines own terminals, there is less element of shopping facilities.
- The proportion of floor area now used by retail space, its prominent layout and poor quality, if temporary, of some seating areas.
- The risk, if funding is finite, commercial investment will be preferred even under the single till.
- Whether therefore the dual till could lead to too much investment in commercial activities to the detriment of aeronautical activities.

Issue 5(i): On the other hand, are there benefits from deregulating such services

19. Considerations include whether it would be desirable for the dual till to give further encouragement to promote commercial activities.

Issue 5(j): Effects of dual till on overall profitability

20. Considerations include:

- (a) Whether the Commission should be concerned about any transfer of economic rents to BAA;
- (b) Whether it is desirable on grounds of regulatory consistency to bring about such a significant change in regulatory approach;
- (c) Whether the dual till proposal puts in question the regulatory asset base used to date by the CAA or Competition Commission. Would a possible alternative be to allocate assets between the commercial and aeronautical tills according, for example, to profitability rather than book value?
- (d) Whether, there are any other mechanisms available under the Airports Act to address any such windfall gains. We would not be entitled under the provisions of the Airports Act to recommend, for example, a windfall tax, although it was suggested to us.

Issue 5(k): Are there possible variations on the dual till approach

21. One possibility previously raised is that the income raised should be ring-fenced and used for investment.

Issue 6: The appropriateness of incremental cost/value based incentives for investment primarily at Heathrow

22. At Heathrow, the CAA is proposing adoption of the dual till over the longer-term. Within Q4, however, this would result in a formula of about RPI+12 (as implied by Table 16.9 of CAA recommendations); the CAA is therefore proposing to adopt a single till price path for Heathrow in Q4 (which would include T5 assets in the course of construction (AICC)), but taking account also what it regards as the maximum reasonable price increase, of RPI+6 at Heathrow, in Q4. That initial price cap would be based on throughput up to the pre-T5 level of capacity, taken as 60 mppa, but there would be an increase in charges when T5 became operational, based on the incremental costs of T5 of £18 per passenger applied to the number of passengers over 60 mppa. This may not apply in Q4, but there would also be, in so far as the Airports Act permits this, a price path commitment (PPC) to adopt the proposed profile of such charges for at least 20 years, subject only to the build up of traffic over 60 mppa and any additional incremental costs of further increases in capacity. Considerations as regards incremental cost as a factor in setting airport charges include:

- (a) How such costs should be measured, for example, should they be related to discrete investment project such as T5, to the investment programme as a whole, or small variances around the investment programme;
- (b) The basis of the figures used (of £18 per incremental passenger through T5), and the uncertainties;
- (c) Whether an incremental cost approach could be used without other aspects of the CAA's proposals such as the dual till or the PPC;
- (d) Whether any such trigger should be based on capacity coming on stream rather than throughput, or a more detailed specification of the facilities to be fully functioning as a condition of charges;
- (e) Whether the incremental cost should be on a dual till or single till basis;
- (f) Whether incremental prices should be based on peak throughput rather than annual throughput;
- (g) Whether the incremental cost approach could increase risk and cost of capital;
- (h) Whether the RPI+6 formula proposed by CAA is reasonable: to which other issues below are also relevant.

Issue 7: Whether it is appropriate to provide for any price path commitment

23. The CAA have proposed that, at both Heathrow and Gatwick, the pricing components of existing outputs and the incremental prices at Heathrow based on the incremental costs of T5 be set for 20 years. Considerations include:

- (a) Whether under the current legislation there can be any commitment as to the appropriate level of prices in future reviews;
- (b) Whether similar effects could be achieved by other means, but without including any 'commitment' – eg policy statements;
- (c) Whether it is desirable or realistic to expect commitment of future prices based on current existing costs of existing operations or estimated costs of T5;
- (d) Whether such an approach would enhance monopoly power and further transfer risk from airport to airlines;

- (e) Whether the PPC could distort investment, eg by not allowing a return on investment to improve quality of service;
- (f) Whether use of fixed prices would significantly increase the risk of new investment or have asymmetrical effects;
- (g) Whether such an approach could imply prices unrelated to costs in future quinquennia, possibly inconsistent with international agreements;
- (h) Whether as a possible alternative there should be no adjustment to the RAB to reflect overspend or underspend on particular projects for 5 years after completion of the project, to maintain incentives for efficiency;
- (i) Whether if the dual till approach was regarded as appropriate, but a price path commitment cannot realistically be adopted, the full dual till approach should be adopted in Q4.

Issue 8: What correction should there be for under investment in present quinquennium

24. The current charging formula was set on the assumption construction of T5 would commence early in Q3. There has been significant delay in BAA's commencing the construction of T5, due to the delay in completion of the planning inquiry; although expenditure on non-T5 projects has increased, the level of investment has been significantly below that when the current level of charges was set. CAA are proposing recovery firstly of the higher charges set on the assumption construction of T5 would by now have commenced, which represented an advancement of revenue for smoothing purposes from Q4 to Q3, giving a higher return than the cost of capital in Q3 but lower in Q4. Secondly of 50 per cent of the underspend on investment in Q3. Considerations as to the treatment of the amount of underspend include:

- (a) Whether given that T5 expenditure will now be allowed for in Q4 and/or Q5, under-investment in Q3 resulting from delay in T5 should be fully recovered;
- (b) Whether, if there is to be recovery of underspend on T5, it is appropriate to reduce the amount of the underspend on T5 by the full amount of other investment;
- (c) Whether any recovery of under investment is justified given that BAA's rate of return over Q3 has been broadly as forecast when its current maximum level of charges was set;
- (d) Whether the CAA proposal of 50 per cent recovery is justified;
- (e) Whether any recovery of under investment should be allocated to airports other than Heathrow;
- (f) Whether any recovery should be applied just to aeronautical charges or allocated also to commercial activities;
- (g) Whether any such under-recovery (including also recovery of revenue advancement) should be spread into the indefinite future (through adjustment to the regulatory asset base) or confined to Q4.

Issue 9: Should there be allowance for assets in course of construction

25. On whether there should be an allowance in the asset base for assets in the course of construction (AICC), on which a return can be earned prior to investment coming on stream, considerations include:

- (a) Whether charges should not increase until the investment generates benefits, ie the assets come into use;
- (b) Whether, on the other hand, some earlier revenue is necessary to secure funding or reduce costs of funding in major investments;
- (c) Whether allowance for AICC is desirable to avoid undue volatility in prices.

Issue 10: Whether further ATMs/stand incentives are necessary or desirable

26. CAA are proposing increases in charges relating to additional peak ATMs at Heathrow, and the coming into use of the Airside Road Tunnel and additional stands. Considerations include:

- (a) Whether any incentive in addition to the increase in revenue from airport charges or commercial revenues generated by additional ATMs and stand capacity is necessary;
- (b) Whether any such incentive can be usefully related only to peak movements;
- (c) Alternatively, whether there should be a disincentive, ie a penalty, for any shortfall in members of ATMs, below an appropriate level.

The general approach - other issues

Issue 11: Should the revenue yield rather than tariff basket approach be maintained

27. Currently, charges are based on ‘revenue yield’ - £ per passenger – rather than a ‘tariff basket’ approach – the weighted average increase of each element of the charging structure. The CAA did not pursue its original proposal to adopt a tariff basket approach, but we may still need to consider the relative merits of the two approaches including:

- (a) The more comprehensive basis of the tariff basket approach;
- (b) The effect of the tariff basket approach on incentives;
- (c) The greater complexity and difficulty in predicting the level of revenue that would result from the tariff basket approach; and
- (d) Any interaction with other issues.

Issue 12: Whether a volume term would be appropriate

28. In previous reports, we have considered use of a volume term, whereby, if traffic growth increases or decreases unexpectedly, average charges would fall or rise accordingly, reducing the effect of any overstatement or understatement of traffic growth on the airports revenues and profits. Considerations include:

- (a) The extent to which effects of traffic growth on revenue could be offset by any reduction in investment;
- (b) Whether resulting price signals are desirable (eg lower prices if volume grows more than expected), and the effect on airlines (eg if charges are higher when volume grows less than expected);
- (c) Whether the term should be symmetric – or only apply if traffic grows more than expected;
- (d) Whether there could be an adverse effect on investment;
- (e) The delay before the volume term is applied.

Issue 13: Should the S factor be retained

29. Relevant considerations include:

- (a) Whether the S-term reduces the incentive on BAA to be as stringent and cost conscious as possible;
- (b) Whether uncertainties as to future security requirements could be adequately encompassed by an allowance for additional and currently unknown security requirements in the base formula;

- (c) Whether retention or modification of the current security term is not a better way of incorporating such uncertainty;
- (d) Whether the operation of the S term could otherwise be improved: for example by reducing the percentage of costs that can be passed through, or by more involvement by Transec or CAA in agreeing efficient costs of implementation.

Issue 14: Is the proposed Q factor appropriate

30. CAA have proposed that 3 per cent of airport charges be subject to meeting specified Quality of Service targets. Considerations include:

- (a) Whether the standards of service proposed are sufficiently comprehensive;
- (b) Whether passenger perception should be incorporated in the Q term, and whether the results of BAA's quality of service monitor (QSM) are sufficiently robust for this purpose;
- (c) Whether existing data from monitoring of SLAs is adequate for incorporation in any Q-term;
- (d) Whether there should be allowance for delays in the Q term, given the various causes of delay. Treatment of stand/jetty availability and planned runway closures for maintenance may also need to be considered;
- (e) Whether the 3 per cent figure for sensitivity of airport charges to the Q term is excessive or insufficient – and how the Q term will work in practice including the par values that would be applied (and whether existing SLA targets and exclusions from them would be good enough for such purposes), the scale of penalties and bonuses, where the maximum is triggered and the effect on incentives;
- (f) Whether there should be rewards for over achievements as well as penalties for under achievements against target;
- (g) Whether the Q factor should apply to Stansted as well as Heathrow and Gatwick or, if not, arrangements be put in place to serve as basis for any future Q-term;
- (h) Whether it would be better to deal with performance standards as public interest questions, with the possibility of these being subject to rebates in the event of poor performance (see below); or whether the Q factor would give greater scope since it would not be limited to remedying specific adverse effects;
- (i) Whether it is appropriate that any expected levels of payment under the Q term (or other standards of service compensation arrangements) – or risk of making such payments – should be reflected in airport charges.

31. The CC may shortly be putting a more detailed paper to BAA, CAA and airlines on the Q factor and service standards, but among more detailed points as to recommendations we may make:

- (a) Would it be feasible for us in practice to formulate the criteria under which performance is assessed in such a way that no element of the formulation is delegated to a third party such as the CAA.
- (b) If not, whether as a matter of law our recommendations under section 45(2) could leave aspects of the formulation of the Q factor to the CAA and if so, to what extent this could be done.
- (c) Whether as a matter of the law the Q factor could contain any criteria that were not directly related to the matters specified in the definition of 'airport charges' in section 36 of the Airports Act 1986; whether they could include all matters within the definition of 'relevant activities'; or whether the scope is wider still.

Issue 15: Is the proposed full default cap appropriate

32. CAA have proposed explicit provision for individual contracts outside of the regulated price cap. Considerations include:

- (a) What are the likely benefits of such an approach;
- (b) Whether such an approach is inconsistent with the non discrimination criteria under articles 103-107 of the Air Navigation Order 2000, Section 41(3) of the Airports Act, individual airport licences and international agreements;
- (c) Whether there would need to be a charge cap relating to airport charges paid under individually negotiated agreement and if so the basis on which it should be determined;
- (d) Whether arrangements made would be transparent and made available on the same basis to other airlines;
- (e) Whether users not subject to individual contracts could be disadvantaged by such an approach;
- (f) Whether arrangements would apply in all cases or only in cases of charges higher than standards.

Issue 16: Should treatment of discounts be changed

33. There is general agreement that the current practice adopted for Manchester Airport, in which the revenue calculation is before discounts, also be applied to the London airports, in particular Stansted.

Issue 17: Should there be alternative treatment of non passenger flights

34. Currently, extra revenue from non-passenger flights has to be offset by reduced revenue from passenger flights. It is generally agreed that revenue from non-passenger flights be removed from the cap, but the impact on Stansted will need to be considered.

Issue 18: Should there be a relatively light handed regulation at Stansted

35. CAA have proposed a maximum level of charges for Stansted, which it believes the airport in practice is unlikely to want, or be able, to levy. Considerations include:

- (a) Whether charges could not in practice be raised to the level of the price cap proposed by CAA, particularly as circumstances change;
- (b) Whether, given that the large majority of traffic at Stansted is that of low fares carriers, there should be more not less protection;
- (c) Whether there is little available capacity at other airports to provide competition to Stansted;
- (d) Whether relatively tight regulation would itself act as an incentive to reduce costs at Stansted.

Issues relating to the level of X within the general approach adopted

Issue 19: What are the appropriate passenger forecasts for the 3 London airports

36. The Commission will need to consider the forecast for traffic produced by CAA (and as published on the CAA website) compared to those of BAA, included in BAA's recent 2002 capital investment programme.

37. Those forecasts are for a decline in traffic at the three airports from 109m in 2000/01 to 103m in 2001/02, increasing on BAA's forecast to 131m in 2007/08, and on CAA's forecast to 134m in that year. This represents an average rate of growth of about 2.5 to 3 per cent a year – significantly below historic trends.

Issue 20: What is the appropriate cost of capital for BAA

38. The Commission will need to consider the range of estimates of cost of capital put to us, generally of between 6.6 and 8.5 per cent (or above that in certain circumstances).

Issue 21: How should the regulatory asset base be calculated and what is the appropriate depreciation

39. The Commission will need to consider the current calculations of regulatory asset base, and the extent to which that may be affected, for example, by calculations of depreciation.

Issue 22: What is the appropriate scale of BAA's investment programme

40. The Commission may, for example, need to consider the current contingency allowances in the costs of T5, in addition to other aspects of T5 costs, and costs of other aspects of BAA's proposed investment programme. Different views have also been expressed as to whether account should or should not be taken of the scale of proposed investment in Gatwick and the passenger traffic to be handled.

Issue 23: What changes in operating costs should be allowed for; and

Issue 24: What changes in commercial revenue should be allowed for

41. The Commission will need to consider BAA's projections of both operating costs and commercial revenues.

Issue 25: Other financial variables

42. The Commission will wish to consider the relationship between particular levels of airport charges and other financial variables for BAA.

Financial projections

43. On the basis of consideration of the points outlined above, the Commission will wish to consider financial projections for the 3 airports at different levels of 'X', including consideration of:

- Over what period to equate rate of return with cost of capital: Q4, Q4 plus Q5, or longer.
- How to profile return within as well as between quinquennia, by smoothing or advancing revenues?

Public interest issues

Issue 26: Whether there has been lack of investment by BAA and whether BAA's policies for approving investment are against the public interest

44. Among particular complaints are:

- (a) BAA's allegedly ruling out a new runway at Heathrow;
- (b) Lack of runway development at Gatwick;
- (c) Failure to step up investment in line with passenger forecasts;
- (d) Reduction in investment after September 11 with very little consultation;
- (e) Failure to seek interim review or reduce airport charges given delay to T5;
- (f) BAA's failure to invest in facilities and projects to meet its own planning standards, eg delay in increasing jetty service on Heathrow Metro stands; low pier service at Gatwick; failure to meet or plan to meet standards for minimum connection times

- (g) Delays and reductions in scope in building additional long haul capacity in T1;
- (h) Allegations that BAA seeks to eliminate investment risk or transfer it to airlines, with reference to T1 and T4 projects at Heathrow, of unreasonable funding terms for new investment, and of forcing airlines to pay for additional search facilities to reduce congestion that arose as a result of underinvestment by BAA;
- (i) Suspension of capex on Pier 6 at Gatwick and Victor Pier at Heathrow;
- (j) Delays in improvements to transfer baggage facilities in T1; and poor quality of other facilities in T1, including Pier 4 and disability access facilities;
- (k) Not allowing others to invest where BAA was not prepared to do so;
- (l) On the other hand, criticisms of gold plating facilities at Stansted.

The Commission will need to consider whether any of the above matters has had adverse effects on the public interest.

Issue 27: Whether BAA consultation procedures are adequate

45. Among points made to us are that:

- (a) There is a lack of an agreed infrastructure master plan, or mandatory investment and planning standards;
- (b) There is a lack of quantitative information on development options, and opportunity to comment on longer term visions for an airport such as Heathrow, leading to wasteful piecemeal development; there is no proper provision for integration of T5 with other terminals and BAA had failed to produce timely evaluation of options; there had been a failure to consult on Heathrow runway development; similar piecemeal development at Gatwick resulted in failure to provide sufficient pier-served stands;
- (c) Lack of consultation with some airlines at Heathrow, eg on T5 costs;
- (d) There is also inadequate consultation at Stansted resulting in provision of some facilities which do not meet the requirements of low fares carriers.
- (e) The Commission will need to consider whether such matters may operate against the public interest, and with what adverse effects on the public interest. Possible remedies/alternative approaches put to us include:
 - There should be legally binding agreements with continual involvement of the regulator;
 - Charges should be subject to delivery of the investment programme;
 - There should be a mechanism that would require consultation on a development/capital expenditure plan for the south east generally and for each airport subject to specification by CAA of the information to be provided and including participation by CAA and remitting to CAA of disputes over deferment or cancellation of capex;
 - On the other hand, it has been argued that some of the above requirements could risk inflexibility and distorting incentives. Hence, suggestions of provision of more information, but possibly as part of a code of conduct, with obligations on both BAA and airlines.

Issue 28: Issues relating to quality of service performance, conditions of use and compensation

46. This relates to the Q term considered above but among complaints are:

- (a) BAA's Conditions of Use are currently one sided with unreasonable disclaimers. We would, however, wish to consider what, if any, alternative provisions would be reasonable;
- (b) Existing service level agreements (SLAs) lack teeth and exclude capital intensive activities; lack of provision for compensation in SLAs; and failure to cover all aspects of service provision;
- (c) Slow progress in introducing SLAs, particularly with penalties, and flaws in SLAs such as not taking into account maintenance time and long-term outages, and poor measurement of performance (eg of security queuing);
- (d) Limited involvement of some airlines in SLAs;
- (e) Failure to adopt and publicise basic level of service covered by charges;
- (f) Failure to have sufficient airbridge-served stands; long periods airbridges at T4 were non-operational and service standards were not met: compensation offered did not reflect costs to the airlines;
- (g) Inadequate security staffing; poor TTS maintenance;
- (h) Inadequate hours of operation for security screening facilities, and hours of work of terminal services delivery managers; failure to have appropriate procedures for when there is major baggage belt outage; time taken to prepare major operational systems; closure of stands at short notice for insurance inspection;
- (i) Removing stands from service, while being painted for advertising, without compensation;
- (j) Delays in completing the automated baggage system in T1, and the continued lack of an automated direct transfer facility in T1;
- (k) Attracting passengers to retail outlets, increasing walking distances to pier.

47. On the other hand, we have noted the generally satisfactory results of BAA's QSM surveys, which also suggest little overall decline in passenger perception of quality of service over Q4, and of its Service Level Agreements. Some data we have seen also suggests no increases in delays at Heathrow over Q3.

48. The Commission will need to consider whether any of the points above as regards the standard of service currently provided, and/or the absence of specification as to the services provided and legally enforceable standards to which they are supplied can be regarded as operating against the public interest, through any adverse effects on the standards of service to users and/or the costs of airlines or the competitive position.

49. One airline has suggested:

- (a) A clear definition of services should be included in the price cap/permission to levy charges;
- (b) There should be binding generic service standards providing for CAA to promote or impose minimum services level with the delay term;
- (c) There should be rebates for failure against any quality levels, not just the aggregate;
- (d) A delay term in the price cap, without an upper limit; and use of price cap adjustments to enforce planning standards;
- (e) There should be bilateral top up contracts if an airline wishes to receive service above the generic level;
- (f) There should be a dispute resolution procedure;
- (g) Unreasonable disclaimers in the Conditions of Use should be withdrawn.

50. Another airline has suggested that there should be legally binding agreements which exclude 'soft standards' which should not under any circumstances be problematic, should not allow bonuses for over achievement; should include outputs such as baggage sortation excluded from regulated charges; and that such payments should be capped at 10 per cent of turnover.

51. The Commission will, inter alia, also need to consider the legal basis of imposing such conditions; whether they would be appropriate as a remedy to any adverse effects; whether a condition could require specific criteria to be met (giving the CAA power to order compensation if the criteria were not met) or to require BAA to enter an agreement setting performance criteria and a scale of rebates if the criteria were not met.

Issue 29: Airport charging issues

52. Issues raised with us include:

- (a) Imposition of airport charges that do not vary between peak and off-peak periods;
- (b) Aircraft parking charges, which include taxiing times;
- (c) Whether Stansted charges allow unfair competition with other airports, and expansion of Stansted could adversely affect other airports.

We need to consider if any such conduct has operated against the public interest and with what effects adverse to the public interest.

Issue 30: Whether any practices in relation to non regulated charges are against the public interest

53. Complaints concern:

- (a) Arrangements for ground handlers including requirement for minimum level of business to be able to operate at particular levels; loss of economies of scale due to loss of traffic and relocation of airlines at Gatwick; failure to police business plans of new handling agents, resulting in such operators charging prices below cost and reducing margins for other operators; appointment of a fourth handler at Gatwick; BAA's insistence on airport-by-airport relationships; stipulation of service standards, but with achievement of them beyond the airports control; delay in concluding terms and conditions; handlers remaining responsible for payments if an airline fails;
- (b) Significant increase in property costs at Gatwick; absence of regulatory formula for rents at Gatwick, including rents at Gatwick significantly higher than projected at the time of the previous report, which should be recovered in Q4 charges; charges for check in and other desks at Gatwick;
- (c) Excessive rents at Heathrow, including CIP lounges, new building and perimeter area and ground rents;
- (d) Requirement to compensate BAA for lost retail income, eg if lounges are shared with other airlines, and requirements that passengers have to walk through retail outlets between such lounges and pier; similarly requirement to compensate BAA for lost car park income when an airline wished to establish Fly-Through Check-In facilities;
- (e) Introducing new charges, not flagged up at the time of the quinquennial review;
- (f) Imposition of, and increases in waste disposal charges;
- (g) Excessive charges for staff car parking; water and sewerage; cable way leaves and fuel fees at Gatwick; poor standards of service for FEGP and its price structure;
- (h) Fuel levy on airlines at Stansted;

The Commission will need to consider whether any of the above points operate against the public interest and, if so, the affects adverse to the public interest should be considered.

Issue 31: Whether the scope for regulated airport charges should be widened

54. Issues to be considered include:

- Whether there are any charges levied by BAA other than those set out in the Conditions of Use that fall within the details of airport charges and whether if an airline contracts out a facility, a charge payable by a contractor should be regarded as an airport charge if it would have been an airport charge had it been paid by the airline;
- Whether it would be beneficial to users if the scope of activities included within airport charges were expanded;
- Whether the complexities arising from the drafting of the Airports Act would make the degree of separation of activities the Dual Till would require not feasible until such time as the Airports Act is replaced;
- Whether air navigation services should be included in regulated airport charges;
- Whether transfer baggage facilities should be part of regulated airport charges.

Issue 32: Whether the current requirement to provide information on costs, revenues and profits of specified services should be modified

55. Airlines and ground handlers have complained about the lack of transparency in current specified service conditions, with loading of high overhead cost and opportunity costs into the costs of such services, and in maintenance costs and service charges. We will need to consider whether any such inadequate transparency is against the public interest.

56. One suggestion to us is that there should be cost reflective pricing of charges outside the cap, principles of cost allocation and periodic reports by BAA or its auditors to CAA, and a dispute resolution mechanism. However, it has also been suggested to us that the current requirements are anachronistic, and should be replaced at least in the short term by cost based charges for financially significant activities either based on BAA's current Profit Centre Reports or direct costs plus a % overhead approach; and for other activities market-based charges or increase in line with RPI.

Issue 33: The suggestion to us that more consideration should be given to separate ownership of the airports

57. Some airlines have expressed disappointment at the result of the recent government review of the structure of the BAA and suggested that consideration should be given to separate ownership of the three airports; there is also criticism of BAA not allowing separate ownership of terminals. The Commission would, however, need to consider:

- Whether the Commission would have any power to specify a condition requiring separation or to require separate ownership of terminals.
- Whether such a condition would remedy or prevent any adverse effects resulting from the issues above.
- Whether it would be proportionate to such adverse effects.
- The effects of any such separation.

Issue 34: Other specific complaints

58. These include:

- (a) Arrangements for reduced mobility passengers and emergency medical service.
- (b) Car hire arrangements.
- (c) Discouragement of international business and taxi traffic.
- (d) Taxi services at Gatwick.
- (e) The granting of exclusive concessions to operate VAT refunds at Heathrow and Gatwick and recent extensions without tender of the current exclusive concessions.

The issue has also been raised with us whether any other old public interest conditions should be lifted, including the requirement for a second travel agent to be allowed to operate on the concourse at Gatwick: we would also need to consider whether it is open to us to comment on this point.