

3 Background

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Introduction

3.1. This chapter gives background information on BAA; the history and development of demand at the airports; the system of regulation; and the regulatory history.

BAA history and organization

3.2. The British Airports Authority was established by the Airports Authority Act 1965, and assumed ownership and responsibility for the three London airports, Heathrow, Gatwick, Stansted, as well as Prestwick airport in Scotland, in April 1966. (Later, Edinburgh, Aberdeen, Glasgow and Southampton Airports were added. Prestwick was subsequently sold.) The Government announced its intention to privatize the British Airports Authority in the Airports Policy White Paper (Cmnd 9542) and the Authority was dissolved, and its property, rights and liabilities transferred to BAA, under the Airports Act 1986. BAA had been formed on 13 December 1985. We refer to Heathrow, Stansted and Gatwick airports as the BAA London airports.

3.3. Separate companies were established to operate the airports, namely HAL, GAL, STAL and Scottish Airports Ltd. We refer to HAL, GAL and STAL as the 'airport companies'. The holding company of each of the three airport companies is LAL, which is in turn a subsidiary of BAA. On 16 July 1987, 500 million shares in BAA were offered for sale and the company was listed on the International Stock Exchange, London, on 28 July 1987, becoming the world's first listed airport operator. Since then the company's shares have been listed on both the Canadian and Australian Stock Exchanges.

3.4. BAA currently has approximately 400,000 shareholders, over 95 per cent of whom are private individuals, who together hold just over 15 per cent of the share capital. The two most substantial shareholders are FMR Corporation and Fidelity International Ltd, which together have interests of approximately 4.17 per cent in the company's share capital. After privatization, the Government retained a residual 2.9 per cent stake in BAA, but it sold this stake in 1996 for approximately £145 million. The Secretary of State, however, still retains a Special Share in BAA (referred to as a 'golden share'). Under BAA's articles, certain matters are deemed to be a variation of the rights attached to the Special Share and would therefore require the consent in writing of the Secretary of State. Such matters include a provision preventing any individual from owning more than 15 per cent of the shares of BAA, and another restricting the disposal outside BAA of any airport designated for price regulation (currently BAA's London airports: Heathrow, Gatwick and Stansted). The issue of golden shares is currently being reviewed by the European Commission which has argued that these types of shares—which give national governments a casting vote over takeovers and major decisions in firms in which they no longer hold a majority stake—are contrary to EC rules on the free movement of capital, and therefore should not be allowed. In 2000, the European Commission filed a case against the UK Government over its failure to relinquish its golden share in BAA. This case is still pending before the European court.

BAA other business activities

3.5. After privatization BAA evolved into an international airports and retail operator. Management pursued a strategy to expand away from regulated activities as much as possible, by developing new streams of unregulated income. Areas that were expanded into included hotel development, cargo handling, duty-free retailing, property development and, more recently, rail operations.

BAA Lynton

3.6. BAA acquired Lynton plc (Lynton), a property company, in 1988 to develop its airport land holdings. Lynton was subsequently relaunched in April 1997 as BAA Lynton, the specialist airport property developer, focusing on property development and investment at and around airports, including locations which have or will have transport links to airports. In 2002 BAA Lynton signed an agreement with Radisson SAS to open a 500-bed, four-star hotel at Stansted, to open in 2003.

BAA McArthurGlen

3.7. In March 1995, BAA opened Cheshire Oaks, an outlet centre for designer and brand label surplus stock, in a joint venture with McArthurGlen. BAA McArthurGlen has now expanded with 12 centres operating in six countries, comprising over 1,000 shops. BAA and McArthurGlen dissolved the joint venture, however, with effect from 30 August 2002, as BAA furthered its strategy of exiting from non-core airport interests.

World Duty Free

3.8. In July 1997, BAA acquired the US company Duty Free International (DFI). In May 1998 DFI was renamed World Duty Free Americas and merged with the UK-based operation, WDFE, to create a new integrated duty free global holding company called WDF. World Duty Free Americas, however, was considered to be under-performing, and BAA subsequently sold it in October 2001, returning its focus to core UK airports business. BAA's UK operations now include 58 stores across BAA's seven UK airports. As well as the WDF stores, BAA also operates a range of stand-alone specialist stores including World of Whiskies, The Cigar House, The Wine Collection, and the Beauty Studio.

3.9. In February 1998, BAA's in-flight retail division, Inflight Duty Free Shop Inc (IDFS), was awarded a five-year contract by bmi to operate its in-flight tax- and duty-free sales business; the first time a major in-flight contract from a British airline had been awarded to third party specialists. However, IDFS was subsequently sold due to poor performance.

3.10. In March 1999, BAA signed a major contract with Eurotunnel to operate retail facilities in its Folkestone and Calais/Coquelles terminals. However, BAA rescinded the contract in June 2000 and initiated a High Court action against Eurotunnel for damages for misrepresentation and breach of warranty. This action was settled to BAA's satisfaction.

Heathrow Express

3.11. BAA launched the £500 million Heathrow Express in 1998, providing a direct link between central London and Heathrow. In 2001/02 over 4.8 million passengers used the service (around 11 per cent of Heathrow non-transfer passengers).

International management and consultancy

3.12. BAA has continued its involvement in international consultancy and the management of airport facilities. Outside the UK, the group now has management contracts or stakes in 12 airports including Pittsburgh, Indianapolis, and Boston Logan in the USA, six in Australia, including Melbourne and Perth, Naples in Italy and two in Oman.

BAA London airports

The airport businesses

3.13. Within the airport framework BAA is directly responsible for the provision and maintenance of airport infrastructure, such as runways, terminals and equipment; and the provision of essential services, including passenger and staff search, perimeter security, and fire-fighting. The airports contract out cleaning, catering, retailing, car parks management, electricity distribution and a large proportion of maintenance. BAA also allocates resources, both between airlines (for example, check-in desks) and between commercial concessionaires (such as car hire franchises).

3.14. Some services are not undertaken by the airport companies or any contractors on their behalf, but are carried out by licensees acting on their own behalf. These services include Air Traffic Control (ATC) (provided by NATS) and baggage and passenger handling (provided by the airlines themselves or handling agents employed by the airlines).

History and development

Heathrow

3.15. Heathrow was designated as London's main airport in 1944 and commercial services began in 1946. It has grown consistently and is now the world's fourth largest airport, and the world's busiest international airport, handling 64.3 million passengers in 2000/01. It is also the oldest of the world aviation hubs.

3.16. Heathrow has two runways and four terminals. Terminal 2 (T2) opened in 1955, T1 opened in 1968, and T3 opened in 1970. By 1977 demand for Heathrow had developed to such an extent that the Government implemented traffic distribution rules to redirect certain categories of traffic to Gatwick whilst a fourth terminal was being planned for Heathrow. T4 eventually opened in 1986. These terminals have all subsequently been extensively remodelled and extended. On 17 February 1993, an application for planning permission for a fifth terminal was submitted. It was approved in outline (subject to conditions) on 20 November 2001, following the longest planning inquiry in history. T5 is now planned to open in spring 2008 (ie after the end of Q4).

3.17. Heathrow is the closest of the BAA airports to central London, and is connected by road, and rail links: including both the London Underground and the BAA Heathrow Express.

Gatwick

3.18. Gatwick was developed as a second airport for the South-East following a public inquiry in 1954. The terminal building was opened in 1958. The restrictions on the categories of traffic allowed to use Heathrow from 1977 assisted traffic growth at Gatwick, leading to the construction of a second 'North' terminal, which opened in 1988. These traffic distribution rules were relaxed in 1991, resulting in a significant transfer of scheduled services from Gatwick to Heathrow.

3.19. Gatwick has only a single runway, but it is one of the busiest in the world with 48 movements per hour scheduled throughout most of the day. In 1979, the British Airports Authority (forerunner of BAA) signed an agreement with West Sussex County Council not to build a second runway during the next 40 years.

3.20. Gatwick is 24 miles from Central London, and has rail connections to central London and the rest of south-east England, and links to the national motorway system.

Stansted

3.21. The Government identified the development of Stansted as the third London airport in December 1979, to accommodate the overspill from Heathrow and Gatwick. The growth in air travel demand during the 1980s resulted in BAA being requested to bring forward the proposals for Stansted's development. The plans were approved in 1985 and a new terminal opened in 1991.

3.22. Demand for Stansted in the beginning did not meet expected forecasts, due in part to the Gulf War and the removal of the traffic distribution rules referred to above. However, it has grown strongly in the last five years, and has become one of the fastest-growing airports in Europe, largely due to the unprecedented growth of the low-fares airlines.

3.23. Stansted currently has one runway and one terminal. It has a rail link to Central London and is connected to the national motorway network.

3.24. In September 2002 permission was granted to develop the airport to serve another 10 mppa, beyond its then existing consent of about 15 million. BAA has indicated that it expects work to start on a further terminal extension in 2004, and the airport is expected to handle about 25 mppa, by around 2010.

Capacity and demand at the BAA London airports

3.25. Heathrow, Gatwick and Stansted are the main airports serving London and the South-East of England. Table 3.1 shows that BAA's three London airports currently account for 92.8 per cent of the passengers and 88 per cent of the ATMs of the 'London area airports' as classified by the CAA.

TABLE 3.1 **Number of passengers and ATMs at London airports, 2001**

	<i>ATMs</i>		<i>Passengers</i>	
	<i>'000</i>	<i>%</i>	<i>m</i>	<i>%</i>
Heathrow	457.6	47.1	60.4	53.3
Gatwick	245.2	25.2	31.1	27.4
Stansted	152.5	15.7	13.7	12.1
Luton	59.7	6.2	6.5	5.8
London City	54.9	5.7	1.6	1.4
Southend	1.4	0.1	0.0	0.0
Total all London area airports	971.3	100.0	113.3	100.0

Source: BAA—Initial Position Paper to the CC, February 2002.

3.26. The main elements of airport capacity are reviewed twice a year (summer and winter season) as part of the schedule coordination process. Heathrow and Gatwick declare a set of scheduling limits (hourly aircraft movements on the runways, passenger flows in the terminals and at Heathrow, the number of aircraft parking stands), which cannot be exceeded by the schedule coordinator. The scheduling process at the London airports is coordinated by an independent company, Airport Coordination Limited (ACL). ACL aims to match demand to fly with available capacity.

3.27. Airport capacity in the wider sense is usually expressed in terms of mppa and is a function of the individual capacities of the airport's runways, terminal buildings, aprons and ground access.

3.28. At Heathrow and Gatwick, runway capacity is primarily assessed by NATS in consultation with airlines and BAA. NATS defines capacity as the number of movements that can be handled on the runway over a period of time, such that the average delay to individual movements is 10 minutes. Runway capacity in practice may vary from hour to hour, depending on factors such as the proportions of aircraft of different sizes and weather conditions. The actual hourly movement rate may also vary considerably from these figures due to the random bunching of actual operations.

TABLE 3.2 **Airport capacity, 2001/02**

<i>Airport</i>	<i>Current utilization (mppa)</i>	<i>Likely future capacity limits (mppa approx)</i>
Heathrow	60.4	90.0
Gatwick	30.5	40.0
Stansted	14.1	25.0

Source: BAA Annual Report 2001/02 and airport announcements.

3.29. Terminal capacity is based on hourly flows of passengers, and is measured by BAA as the flow of passengers which each facility (for example, check-in and security search) can handle whilst just meeting BAA's service standards. The overall capacity of the arrivals or departures process in the terminal is dependent on the lowest capacity for any individual facility.

3.30. The effective constraint at Heathrow is the runway. Current capacity is about 79 movements per hour (averaged on a 17.5-hour day) or about 500,000 on an annual basis, about 92.5 per cent of which is utilized (100 per cent for most of the day).

3.31. Through time, various incremental improvements to the runway are expected to increase its capacity to about 82 movements per hour, which will then require increased stand capacity, to which the

T5 stands will contribute. This together with the use of larger planes and/or higher load factors would allow increasing passenger numbers. There is some spare terminal capacity off-peak but this cannot to any great extent be seen as substitutable for peak terminal capacity. T5 will eliminate the increased strain on terminal facilities at peak periods. Without T5, peak terminal capacity would in time become the effective constraint.

3.32. Similarly at Gatwick, the annual passenger-carrying capacity of the runway will grow as a result of some minor increases in the number of movements which can be scheduled in a day (currently at about 46 movements an hour, averaged over a 17.5-hour day, to increase to around 49 by the end of Q4), higher utilization of that capacity, and growth in the average number of passengers per aircraft.

Heathrow

3.33. Heathrow is the busiest international airport in the world, with 60.4 mppa in 2001, and it is London's primary scheduled service hub. Heathrow is also one of the most congested airports in the world, with demand far exceeding capacity. Current runway capacity is completely full through most of the day with planned capacity reflecting a 10-minute average delay. Supply is rationed using a system of slot allocation, regulated under EC law, which includes grandfather rights.¹

3.34. The level of demand for Heathrow has developed for a number of reasons. It is the closest full-service airport to central London, and is situated on the side of London from which the highest level of demand originates. Heathrow is also the primary business airport for the South-East. The busiest routes are to New York, Paris, Amsterdam and Dublin.

TABLE 3.3 **BAA London airports: purpose of travel, 2001**

	<i>per cent</i>	
	<i>Leisure</i>	<i>Business</i>
Heathrow	62.5	37.5
Gatwick	81.0	19.0
Stansted	79.8	20.2

Source: BAA—Initial Position Paper to the CC, February 2002.

3.35. Heathrow is overwhelmingly used for scheduled flights, with virtually no charter traffic or non-passenger/freight-only flights. None of the main low-fares carriers currently operate out of Heathrow.

3.36. BA is the most dominant single user of the airport, with approximately 38 per cent of the runway slots and 40 per cent of passenger traffic.

3.37. As the long-established base of the major international scheduled airlines, Heathrow has a wide range of frequent interconnecting services, to some 152 destinations, and a high proportion of transfer passengers. In 2001 an estimated 30.4 per cent of passengers were transferring from one aircraft to another.

TABLE 3.4 **BAA London airports: proportion of passengers transferring, 2001**

	<i>% transfers</i>
Heathrow	30.4
Gatwick	20.4
Stansted	6.3

Source: BAA—Initial Position Paper to the CC, February 2002.

¹Airlines that hold a slot in one summer or winter season have the right to the same slot in the following season, provided they have used it for at least 80 per cent of the time. These rights of airlines are known as 'grandfather rights' and are set out in the EC slot regulation.

Gatwick

3.38. Gatwick, with 31.1 mppa, is Europe's sixth largest airport and the UK's largest holiday charter airport; a point reinforced by the Heathrow ban on charters from 1977 to 1991.

TABLE 3.5 Proportion of charter passengers at BAA London airports, 2001

	<i>Charter passengers '000</i>	<i>Total passengers '000</i>	<i>%</i>
Heathrow	120	60,432	0.2
Gatwick	11,203	31,098	36.0
Stansted	1,174	13,650	8.6

Source: BAA—Initial Position Paper to the CC, February 2002.

3.39. It is also a secondary scheduled service hub. Scheduled services built up originally as a result of the traffic distribution rules. When these were largely withdrawn in 1991 Gatwick lost some 19 international airlines to Heathrow. However, Gatwick still benefits from the continued exclusion of certain US airlines and routes from Heathrow under the Bermuda 2 agreement (see paragraph 3.74).

TABLE 3.6 Proportion of long-haul passengers BAA London airports, 2001

	<i>Long-haul passengers '000</i>	<i>% of total</i>	<i>Total passengers '000</i>	<i>% by airport</i>
Heathrow	25,309	66.7	60,432	41.9
Gatwick	12,215	32.2	31,098	39.3
Stansted	397	1.1	13,650	2.9
BAA London total	37,921	100.0	105,180	

Source: BAA—Initial Position Paper to the CC, February 2002.

3.40. Like Heathrow, Gatwick is also described as congested, with the two terminals under considerable pressure at peak periods, particularly in relation to pier service and stand availability. There is currently some terminal capacity available off-peak.

3.41. Following 11 September 2001, Gatwick suffered a significant reduction in passenger numbers, with both passenger numbers and air traffic movements falling by 16 per cent compared with the previous year (December 2001 data). BA, the airport's biggest airline, was already restructuring its Gatwick operation following an announcement in December 2000 of a rationalization of its short-haul network and the transfer of a number of long-haul services to Heathrow. This restructuring—which would have cut Gatwick capacity by 40 per cent by summer 2003 (relative to summer 1999)—was accelerated and intensified following 11 September and the announcement of BA's Future Size and Shape strategy on 13 February 2002. Latest estimates suggest that BA will effect a 60 per cent reduction in its capacity in terms of available seat kilometres at Gatwick over the four years 1999 to 2003. However, the impact on passenger numbers will be less significant with the BA seat count, which will actually determine the number of passengers within the airport, likely to be down by 40 per cent and the number of aircraft movements down by 30 per cent. Therefore, the impact on airport revenues will be less marked than the 60 per cent network reduction suggests. Also, the network reductions at Gatwick occur because services are being moved to Heathrow where the revenue lost at Gatwick from reduced flight movements will be offset by BAA from the resultant increase in movements and passengers at Heathrow. Meanwhile, however, other airlines are moving in to take up the capacity BA is leaving at Gatwick. easyJet has recently begun new services from the airport.

Stansted

3.42. Stansted is Europe's fastest-growing airport. In the five years to 1991 Stansted was the subject of a £400 million investment programme to develop it as the third London airport. The new facilities

opened in inauspicious circumstances, during the Gulf War, and just as the air traffic distribution rules were being relaxed. While starting off slowly, the advent of the LFC market has caused a recent boom at Stansted, with current levels peaking above 13 mppa and growing rapidly. Demand and capacity profiles currently demonstrate that Stansted is the least congested of the BAA London airports, with runway utilization only reaching capacity during three daily peak periods (early morning, late morning and late afternoon), reflecting the operational needs of the low fares airlines that make up the majority of the airport's traffic.

TABLE 3.7 Proportion of passengers on low-fares airlines BAA London airports, 2001

	<i>Passengers on low- fares airlines '000</i>	<i>Total passengers '000</i>	<i>%</i>
Heathrow	27	60,432	0.0
Gatwick	685	31,098	2.2
Stansted	11,045	13,650	80.9

Source: BAA—Initial Position Paper to the CC, February 2002.

Government policy framework

3.43. The Government has stated that it intends to publish an air transport White Paper, in early 2003, which will provide a policy framework for the long-term future of both aviation and airports in the UK. Prefacing this, the DfT has released a consultation document on the future of air transport in the UK, which seeks to determine how much additional airport capacity will be needed over the next 30 years, and where it should be sited. This builds on earlier work undertaken in both the 1993 RUCATSE (Runway Capacity to Serve the South East) and the 1999 SERAS programmes of studies.

3.44. For the South-East, the consultation document outlined a range of potential options, which included consideration as to the importance of a world-class global hub airport in the South-East. With the practical limitations at Heathrow, the question is raised as to whether to maintain Heathrow as the premier airport; or to develop an alternative airport into a major hub; or whether the UK needs two hubs. The consultation document identified three options. One option outlined is to build on Heathrow; this could mean an additional shorter runway to complement the runways already there. A second option is to build at Stansted; to develop it as either a hub itself, or to complement Heathrow. A third option is to build a completely new airport, at Cliffe in north Kent. The consultation document also sets out the potential combinations of airport development options.

3.45. The consultation document also looked at where any other new capacity should be located. The Government has stated that it does not propose to overturn the legal agreement that rules out construction of a new runway at Gatwick before 2019. While not putting forward any option for a new runway at Gatwick, the document does, however, note that there is some capacity that can still be developed at Gatwick, and states that this has already been agreed locally.

3.46. As described in Chapter 2, any decision regarding the preferred development option is not likely to be taken until some time after our inquiry is completed. Therefore we have not sought to make a specific allowance for the cost of any new runway in our recommendations. Should work start on a new runway at any of the BAA airports during Q4, however, it would be open to BAA under the Airports Act to seek an interim review if higher charges were necessary in Q4 to finance it.

The system of regulation

The legislation

3.47. The Airports Act provides in Part IV for the economic regulation of airports. The Airports Act prohibits the levying of airport charges at an airport 'subject to economic regulation' (as defined in the

Airports Act) unless permission by the CAA is in force in relation to the airport. Permission is given by the CAA. Four airports subject to economic regulation have been designated by order of the Secretary of State under Part IV.¹ They are Heathrow, Stansted, Gatwick and Manchester. We shall describe the legislation as it applies to designated airports.

3.48. When the permissions were granted in 1986, a condition limiting the amount of airport charges was imposed for five years from 1 April 1987. In the case of Manchester, the permission was granted in February 1988 and a condition limiting the amount of airport charges was imposed for five years from 1 April 1988. Section 40(4) of the Airports Act requires the CAA, each time the condition is due to expire, to extend it for a further five years with or without modification. The CAA can, however, at any time while the condition is in force, extend the period for up to 12 months. In the case of the BAA airports, the charge cap imposed for Q3 was due to expire on 31 March 2002, but the CAA extended the period until 31 March 2003.

3.49. Before the CAA extends a condition imposing a charge cap on airport charges for the following quinquennium it must, unless the Secretary of State otherwise directs, make a reference to the CC under section 43 of the Airports Act. We shall refer to such a reference as a ‘quinquennial reference’. The reference has to cover two aspects:

- (a) *airport charges*: the maximum amounts that may be levied by the airport by way of such charges for five years; and
- (b) *public interest*: whether between the date of the previous reference and the date of the reference, the airport has pursued a course of conduct which has operated or might be expected to operate against the public interest.

The questions in the reference and the procedures following a CC report are discussed later (see paragraphs 3.61 to 3.68).

Definitions of key terms

Airport charges

3.50. Section 36 of the Airports Act defines airport charges as:

- (a) charges levied on operators of aircraft in connection with the landing, parking or taking off of aircraft (including charges that are to any extent determined by reference to the number of passengers on board the aircraft, excluding charges payable by virtue of section 73 of the Transport Act 2000 (charges for services),² and
- (b) charges levied on aircraft passengers in connection with their arrival at or departure from the airport by air.

3.51. The nature of the charges levied that fall within the definition of airport charges vary from airport to airport. At the BAA London airports, all the charges regarded as airport charges are set out in the Conditions of Use and have three components: charges on landing, charges on departing passengers and aircraft parking charges. The landing charges are differentiated by time (with higher charges at peak times), aircraft size (with larger aircraft paying more off-peak) and noise characteristics (with aircraft in higher noise categories paying more). Passenger charges are regarded as being levied on airlines,³ are levied per departing passenger, and are less for domestic passengers than international passengers. Aircraft parking charges are higher at peak times and include a weight-related element.

¹The CAA (Economic Designation of Airports) Regulations 1986 (SI 1986/1544).

²These relate to charges for air traffic services—see paragraph 3.93.

³The Conditions of Use describe these charges as being ‘collected by airlines/agents’. This would, at any rate, at first sight suggest that this was a charge on passengers with the airlines collecting the charges as agents for one party or the other. However, the airlines regarded the charge as a charge on airlines and not a charge on passengers.

Operational activities

3.52. Section 30(4) of the Airports Act defines operational activities, in relation to an airport, as meaning any activities:

- (a) which are carried on wholly or mainly for the benefit of users of the airport; or
- (b) the revenues from which are wholly or mainly attributable to payments by users.

3.53. Section 82 of the Airports Act defines user in relation to an airport as meaning:

- (a) a person for whom any service or facilities falling within the definition of relevant activities in section 36(1) are provided at the airport; or
- (b) a person using any of the air transport services operating at the airport.

3.54. Section 36(1) defines relevant activities in relation to an airport as meaning the provision at the airport of facilities for the purposes of:

- (a) the landing, parking or taking-off of aircraft;
- (b) the servicing of aircraft (including the supply of fuel); and
- (c) the handling of passengers or their baggage or of cargo at all stages while on airport premises (including the transfer of passengers, their baggage or cargo to and from aircraft).

The section goes on to declare that (c) does not include the provision of facilities for car parking, for the refreshment of passengers or for the supply of consumer goods.

3.55. Section 82 defines air transport services as meaning services for the carriage by air of passengers or cargo.

3.56. It follows that an operator of a cafe for air travellers at an airport is engaged in operational activities, but is not a user of the airport. The same applies to a company supplying fuelling facilities for the aircraft.

3.57. Further instances of operational activities are activities carried out for passengers at airports, such as retailing and catering; and activities carried out for airlines, such as rents of check-in desks and offices and licences for services such as baggage handling.

The roles of the CAA and the CC with regard to airport charges

3.58. The task of the CAA under section 40(4) of the Airports Act is (in effect) to impose conditions on the operators of designated airports to regulate the maximum amount they may levy in airport charges over a five-year period, or quinquennium (see paragraph 3.48).

3.59. The airport charges conditions:

- (a) may provide:
 - (i) for an overall limit that may be levied by the airport operator by way of all airport charges at the airport; or
 - (ii) for limits to apply to particular categories of charges; or
 - (iii) for a combination of any such limits;
- (b) may operate to restrict increases in any such charges or to require reductions in them whether by reference to any formula or otherwise; and

- (c) may provide for different limits to apply in relation to different periods of time falling within the period of five years for which the conditions are in force.

Where a group of airports is concerned, the maximum level of charges may apply to each airport separately or to the airports together as a group. Once set for the five-year period, an airport charging condition cannot be modified by the CAA except with the agreement of the airport operator.

3.60. Before imposing conditions, the CAA must make a reference to the CC, unless the Secretary of State directs otherwise. In making the reference to the CC, the CAA may specify its own view as to the appropriate maximum level of charges. The reference has to require the CC to investigate and report on the maximum airport charges that the airport operator may levy during the five-year period specified in the reference. The CC's conclusions have to take the form of recommendations as to what the maximum amounts should be. Following receipt of the CC report, the CAA has to extend by five years the conditions attached to the permission to levy charges for each airport with such modifications as it thinks appropriate. In setting the maximum level of charges, the CAA must have regard to the CC's recommendations.

The roles of the CAA and the CC with regard to public interest issues

3.61. Every quinquennial reference to the CC has to require the CC to investigate and report on whether between the date of the previous reference and the date of the reference, the airport operator has pursued a course of conduct which has operated or might be expected to operate against the public interest, in relation to (a) any airport charges levied at the airport; (b) any operational activities which it has carried out in relation to the airport; or (c) the granting of a right to carry out operational activities at the airport. In cases where an associated company of the airport operator carries on operational activities or is entitled to grant a right to carry out operational activities, the reference has to require the CC also to report on whether the associated company has pursued such a course of conduct in relation to (a) any operational activities which it has carried out in relation to the airport; or (b) the granting of a right to carry out operational activities at the airport. The CAA may specify in the reference its opinion about courses of conduct considered contrary to the public interest; the CC can also find other conduct to be contrary to the public interest.

3.62. If the CC finds effects adverse to the public interest, it must report on whether the adverse effects could be remedied by means of conditions and if so what conditions should be imposed. If the CC concludes that the adverse effects could be remedied in this way and makes recommendations as to how it should be done, the CAA has to impose such conditions as it considers appropriate for the purpose of remedying the adverse effects specified in the report.

3.63. Section 41 of the Airports Act enables the CAA to impose conditions, other than as a consequence of a conclusion following a quinquennial reference. It can do so only to remedy adverse effects resulting from a course of conduct in relation to relevant activities. (The meaning of 'relevant activities' is explained in paragraph 3.54.) If following investigations the CAA is minded to impose a condition under section 41, it has to notify the airport operator of the course of conduct concerned and the condition it intends to impose. If the operator objects, the CAA either has to abandon its proposal or make a reference to the CC. The CAA cannot impose a condition unless the CC concludes that the airport operator has pursued the course of conduct referred to in the CAA's notification and that it operates against the public interest. Otherwise the process after the CC report is similar to the process after a quinquennial report.

3.64. The Airports Act specifies that the CAA must perform its functions relating to the economic regulation of airports, in the manner which it considers best calculated:

- (a) to further the reasonable interest of users of airports within the UK;
- (b) to promote the efficient, economic and profitable operation of such airports;
- (c) to encourage investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports; and
- (d) to impose the minimum restrictions that are consistent with the performance by the CAA of these functions.

3.65. The CAA is also required to take into account such of the international obligations of the UK as may be notified to it by the Secretary of State. These are currently:

- (a) the obligations under Article 15 of the 1944 Chicago Convention, which provides a framework of non-discrimination and states that airports should be made available on uniform conditions, including charges, to aircraft of different nations; and
- (b) the obligations under provisions relating to airline charges contained in the 1977 Bermuda 2 agreement between the UK and the USA and a 1994 Exchange of Notes modifying this agreement. This states that, in relation to user charges, regard should be had to such factors as efficiency, economy, environmental impact and safety of operation; and, as revised in 1994, additionally stated that user charges should not exceed by more than a reasonable margin, over a reasonable period of time, the full cost of providing the service to users. Such full cost might include a reasonable return on assets, after depreciation.

3.66. We are explicitly required to have regard to the above objectives in considering the public interest. In considering any matter relating to the granting of a right by virtue of which any operational activities may be carried on, we are also required to have regard to those objectives and to an additional objective, namely the furtherance of the reasonable interests of persons granted such rights. The Airports Act does not explicitly require the CC to have regard to those objectives in recommending the maximum level of airport charges. However, such a recommendation is a recommendation as to how the CAA should perform its functions and, accordingly, we need to have regard to the CAA's duty to act in the manner which it considers best calculated to achieve its objectives, and to its duty to take account of notified international obligations. The CAA disagreed, arguing we were only required to recommend what the maximum amounts should be in the five years in question. We disagree with its view, but in any event our conclusions would be the same irrespective of this point.

3.67. The Airports Act does not provide any guidance of the interpretation of these objectives and does not set out how trade-offs, if any, between the objectives should be judged. However, the CAA has stated that it believes that trade-offs between the objectives should be judged against the criterion that where there are potential inequality in benefits between airport users and airports from different regulatory options, the aim should be to choose the policy that is expected to maximize net gains to users and airports combined. We note that in *R v Director General of Telecommunications, ex parte Cellcom Ltd and others* (*The Independent*, 3 December 1998; *The Times*, 7 December 1998), Mr Justice Lightman said:

25. Section 3(2) requires the Director to exercise his functions in the manner which he considers best calculated (a) to promote the interests of consumers, purchasers and other users and (b) to maintain and promote effective competition between persons engaged in commercial activities connected with telecommunications. The question has been raised as to the relationship of these duties with each other and of the duties inter se in respect of consumers and other purchasers (and in particular ISPs). In my view it is plain that the various duties imposed by s.3(2) may pull in different directions and may conflict; there may be a conflict between the duties in s.3(2)(a) and s.3(2)(b); there may be a conflict between the interest of the consumers, purchasers and other users specified in s.3(2)(a), and what may promote competition eg between network operators may have a negative effect on competition between service providers. The Director is not paralysed because such a conflict arises: rather he is given the choice how that conflict is to be resolved and to decide priorities, and so long he bears in mind the entirety of his duties, has a predisposition to fulfil all the duties so far as this practicable and with those duties in mind makes a decision which promotes one or other of the objectives specified (and is rational) his decision stands and is not open to challenge.

3.68. Although there are obviously environmental issues regarding airport expansion, these are primarily addressed under the Town and Country Planning legislation, not by the CAA under the Airports Act.

Regulatory history

3.69. As mentioned above, since privatization BAA's London airports have been subject to regulation on a quinquennium or five-year basis. During this review, the CC is concerned with recommending the appropriate maximum level of charges for Q4.

3.70. At the time of privatization in 1987, the Government decided that BAA's London airports would best be regulated by an incentive-based system centred on an RPI-X price control formula. During Q1 charges imposed by LAL were subject to a cap of RPI-1. In 1991 the CC and the CAA undertook the first examination of BAA's prices. The CAA decided that there should continue to be separate caps for Heathrow and Gatwick and the system as a whole with the following formulae: RPI-8 (1992/93), RPI-8 (1993/94), RPI-4 (1994/95), RPI-1 (1995/96) and RPI-1 (1996/97).

3.71. The CAA last referred BAA's London airports to the MMC in December 1995 and in October 1996 set a price cap for the period from 1 April 1997 to 31 March 2002. Manchester was referred a year later, in December 1996, and a price cap was set for the five years from 1 April 1998 to 31 March 2003. The CAA's decision regarding the BAA London airports for Q3 was broadly that a formula of RPI-3 should be set for Heathrow and Gatwick combined for each of the five years, with a formula of RPI+1 for Stansted.

3.72. In May 1999, the CAA extended the price cap for BAA's London airports by one year to 31 March 2003 to allow it to take into account the Government's final decision on BAA's planning application for a fifth terminal at Heathrow on the working assumption that this could be published in late 2001. The result of this is that the reviews of the BAA London airports and Manchester took place at the same time. The CAA had previously assumed that these reviews would be conducted under new regulatory arrangements, under which the CAA would carry out the reviews of the price caps with the CC acting in an appellate role. However, the changes to the regulatory procedures were not in place by the time of the reviews. The CAA was content to conduct the BAA and Manchester reviews in parallel so as to help achieve consistency of regulatory approach and to allow common issues to be addressed jointly. Consequently, the new price caps will be set for each of the four designated airports for the five years from 1 April 2003 to 31 March 2008.

Review of regulation

3.73. In its 1998 White Paper on utility regulation, the Government announced its intention that the CAA should become the prime airport regulator with the CC in an appellate role. The CAA supports this intention. The CC agrees that the challenges of airport regulation in the future are likely to demand a more flexible and accountable regulatory framework. However, this change, designed to bring airport regulation more into line with the standard utility regulation model, will require primary legislation or the use of the Regulatory Reform Act, which, as discussed above, has not yet been brought forward. The CC is therefore working on the basis that the statutory framework for the current reviews is unchanged.

International obligations

3.74. The UK Government is subject to a number of international obligations in relation to airport charges. Article 15 of the Chicago Convention (reproduced at Appendix 3.1) provides a basic framework of non-discrimination, stipulating that no airline should be penalized with regard to access or level of charges compared with a national carrier.

3.75. The 1977 US/UK Air Service Agreement, known as Bermuda 2, provides more detail about the structure of charges. In 1994, agreement was reached in a dispute between the USA and UK, which centred on Article 10 of Bermuda 2 and the related 1983 Memorandum of Understanding. This agreement, formalized in an Exchange of Notes between the two Governments, provided for compensation of nearly \$30 million in settlement of a dispute over Heathrow charges. It was agreed that peak passenger charges at Heathrow would be phased out (and not reintroduced until at least 2003) while the relative levels of landing, passenger and parking charges would be maintained (with no weight-related element introduced into landing charges). Finally, Bermuda 2 was amended, to eliminate passenger charges from the definition of user charges. Extracts from the Exchange of Notes are contained in Appendix 3.1 and its effect on the level of airport charges is described in paragraph 3.65(b).

The record of the negotiations shows that the UK Government did not require the adoption of a single-till, and the USA did not dispute this. The 1994 Exchange of Notes cancelled the 1983 Memorandum of Understanding, which had been the basis of the US Government's claims for a single till at UK airports.

The International Civil Aviation Organization guidelines

3.76. The ICAO was created in 1944 to promote the safe and orderly development of air traffic services in the world. It is a specialized agency of the United Nations. Its governing body is a Council, with headquarters in Montreal. It sets international standards and regulations necessary for the safety, security, efficiency and regularity of air transport and serves as the medium for cooperation in all fields of civil aviation among contracting states, numbering over 180.

3.77. Within an overall policy that the operations at each airport should be considered on a case-by-case basis, the ICAO issues statements from time to time on charges at airports. Some of these are of relevance in the debate on the single- and dual-till approaches to airport charges. The ICAO's 1997 guidelines on the appropriate cost basis for charges as set out in its Statement by the Council to Contracting States on Charges for Airports and Airport Navigation Systems reads, in particular: 'In determining the cost basis for airport charges the following principles should be applied: (i) The cost to be shared is the full cost of providing the airport and its essential ancillary services, ... but allowing for all revenues, aeronautical or non-aeronautical, accruing from the operation of the airport to its operators.' (See Appendix 3.1.)

3.78. Commenting on these guidelines, the 1996 and 1997 MMC reports on, respectively, BAA (see paragraph 8.14) and Manchester (see paragraph 8.16) stated that: 'Although only guidelines, several parties referred to this [ICAO] statement as morally binding on the UK Government as a signatory to those guidelines, failure to observe which could lead to adverse consequences for UK airlines operating at overseas airports.'

3.79. In June 2000, however, at an ICAO conference held to discuss charging principles, there was considerable support for more flexibility in the interpretation and application of the single till in view of different airports' differing circumstances. The report of this conference records the following, among other things:

The Conference held a comprehensive and extensive discussion on the concept of the single till. Many delegates supported continued endorsement of the single till concept as it reflects the special role of airports in promoting and developing air transport, serves the purpose of reducing the cost base for charges, motivates airports to develop revenues from non-aeronautical activities, and provides for capital investment ... On the other hand there was considerable support for more flexibility in the interpretation and application of the single till in view of the varying situations among airports, the need to adjust to the changing airport environment, including autonomous organizational and financial structures, and investment requirements The conference therefore agreed that ICAO conduct a study as a matter of high priority ...

(See Appendix 3.1 for the relevant conference report excerpt.)

3.80. The result of this study was a change in wording in the ICAO 1997 guidelines quoted above. This was adopted on 8 December 2000, and the current guidelines, in subparagraph 22, now state: 'The cost to be shared is the full cost of providing the airport and its essential ancillary services, ... but allowing for all aeronautical revenues *plus contributions* from non-aeronautical revenues' (emphasis added)—see Appendix 3.1.

3.81. The reference to 'contributions from non-aeronautical revenues' implies a greater degree of flexibility for the future as to what the actual level of a contribution should be. With those guidelines established, the ICAO Secretariat on 6 April 2001 issued guidance and an interpretation of the remarks on the single till, relevant sections include (see Appendix 3.1):

... Reaching a common understanding on the contribution of non-aeronautical revenues to defray the cost base for charges is an acknowledgement of the partnership between airports and users.

... Given the different local circumstances and fast changing conditions, with respect to airport ownership and management, as well as regulatory regimes, there are likely to be a range of different appropriate treatments of non-aeronautical income by airports.

... it may be appropriate for airports to retain non-aeronautical revenues rather than use such revenues to defray charges. However, there is no requirement for airports to do so and, in appropriate circumstances, there may be solid grounds for charges to be lower...

Other regulation

3.82. In addition to the economic regulation provided for under the Airports Act, airports are subject to a number of other regulatory measures which prescribe their behaviour.

3.83. The Air Navigation Order 2000 broadly requires aerodromes to be licensed by the CAA if aircraft over certain weights (and certain other aircraft) are to land there or take-off from there. The CAA can grant a licence subject to the condition that the airport shall, at all times when it is available for the take-off or landing of aircraft, be so available to all persons on equal terms and conditions. Such a licence is known as a 'licence for public use'. BAA's airports are each subject to a licence for public use.

3.84. A licence may be granted subject to such conditions as the CAA think fit. The aerodrome licences impose requirements on the operator as to the safe operation of the airport, including rescue and fire-fighting, provision of safety equipment and night use.

3.85. The Secretary of State has powers under section 31 of the Airports Act to direct traffic between airports serving the same area through traffic distribution rules. Such rules are currently only applied to peak-time operations by general and business aviation and all-cargo operators at Heathrow and Gatwick.

3.86. Under sections 12, 13, 13A, 14 and 15 of the Aviation Security Act 1982, the Secretary of State may issue directions to an airport operator in respect of security. Such directions may relate, for example, to baggage search or to the segregation of arriving from departing passengers.

3.87. The allocation of aircraft movements (slots) at the busy airports in the UK is carried out by ACL in accordance with the terms of EC Council Regulation 95/93, supplemented by IATA Scheduling Procedures Guide. This Regulation was incorporated into UK national legislation by means of Airports Slot Allocation Regulations 1993 (SI 1993/1067).

3.88. Section 32 of the Airports Act enables the Secretary of State to make an order imposing a limit on the number of ATMs during any specified period at under-used airports. Stansted is subject to such a limit.¹

3.89. The Secretary of State has made an order designating the BAA's airports under section 80 of the Civil Aviation Act.² This gives the Secretary of State power under section 78 to control airborne aircraft noise and to make a scheme requiring an airport operator to make grants under section 79 towards the cost of soundproofing buildings.

3.90. The Secretary of State has imposed a requirement under section 78 that aircraft taking off from Heathrow, Gatwick and Stansted shall follow specified routes (noise preferential routes) in order to avoid, so far as possible, the overflying of the largest concentrations of population; and imposed a system of night quotas limiting aircraft movements at night.

3.91. Various schemes (now complete) were made under section 79 of the Civil Aviation Act under which HAL and GAL had to bear the cost of insulating dwellings close to the ends of the main runways against noise. A comparable scheme was also carried out by STAL on a voluntary basis, but with Government approval.

¹The Stansted Airport Aircraft Movement Limit Order 1987 (SI 1987/874 as amended).

²The Civil Aviation (Designation of Aerodromes) Order 1981 (SI 1981/651).

3.92. Section 73 of the Transport Act 2000 (the 2000 Act) gives the CAA certain powers in relation to 'chargeable air services'. It can specify such things as the amount, the operators and owners of aircraft who are to pay the charges and the persons (including companies) to whom they are to be paid.

3.93. 'Chargeable air services' are defined in section 77 of the 2000 Act and covers air traffic services. However, air traffic services provided by or on behalf of the owner or manager of an airport are not chargeable air services unless the airport has been designated under the section by an order made by the Secretary of State. The Secretary of State has made an order designating (among others) the BAA airports¹ but not Manchester.

3.94. At Manchester, air traffic services are provided by NATS under contract with the airport operator. The operator pays NATS under the terms of the contract and the cost could be taken into account in assessing the charge cap. In this way the operator would recover the cost through airport charges. These charges are regulated under the Airports Act. As Manchester has not been designated, these charges are not subject to section 73 of the 2000 Act.

3.95. At the BAA airports, as a consequence of the designation and section 73 of the 2000 Act, the airlines pay NATS directly for air traffic services. Accordingly, the cost of providing the services is not borne by the airport companies.

3.96. The DfT has asked the CAA to review the way in which airport air traffic services are charged and to advise on whether direct charging of airlines should be extended to all airports or should be discontinued. In July 2002, the CAA published a consultation paper on this, mentioning the linkages with the reviews of Manchester and the BAA airports under the Airports Act. Were the designation order to be revoked during Q4, arrangements would have to be made for the airport companies to pay NATS under contract and for the airport charges to be raised accordingly. When the Secretary of State makes an order under section 77 of the 2000 Act, he has power under section 103(2) to include incidental, consequential or transitional provisions. This power could possibly be used to make the necessary changes, but it would be for the DfT to decide whether that were possible and appropriate.

¹The Aerodromes (Designation) (Chargeable Air Services) Order 2001 (SI 2001 No 354).