

Part II

Background and evidence

3 Background to the inquiry

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Introduction

3.1. Under the Economic Regulation of Airports (Designation) Order 1986, Manchester Airport is one of four airports in the UK designated for the purposes of section 40 of the Airports Act (see paragraphs 3.16 and 3.19), the other three being BAA's London airports at Heathrow, Gatwick and Stansted. The charges to airlines of these four airports are regulated by the CAA. This chapter gives background information on Manchester Airport; and on the system of regulation, the regulatory history and the CAA's consultative process over the last two years. Some of the key terms used in connection with airport regulation are defined in Appendix 3.1. Others will be found in the Glossary.

Manchester Airport

Basic facts and figures

3.2. Manchester Airport is located 10 miles south-west of central Manchester, close to the M56, and lies between Altrincham to the north-west and Wilmslow to the south-east. In terms of passenger throughput it is the third largest airport in the UK handling, in 2001, some 19 million passengers (though following 11 September, the estimated passenger total for 2002/03 has fallen to 18.3 million). The 19 million figure compares with the two largest airports, Heathrow (61 million) and Gatwick (31 million); and with the fourth largest, Stansted (14 million.). Charter flights are a very significant component of the airport's activities. 51 per cent of Manchester's passengers in 2001 (9.7 million) used international charter flights; 35 per cent (6.6 million) used international scheduled flights; and the remainder (2.8 million) flew on domestic scheduled services. After Gatwick, it is the largest charter airport in the country and offers more scheduled routes than any UK airport outside London.

3.3. Almost 100 airlines use the airport as well as around 300 tour operators. The airport has two 3,058-metre runways, R2 having opened in February 2001. It has three passenger terminals and one cargo terminal. The passenger terminals incorporate roughly 15,000 square metres of catering and retail space comprising 127 retail units. Currently its terminal facilities have a capacity, annually, of about 23 million passengers (projected to rise to 25 million at the end of Q4). Its runway capacity already exceeds 40 million passengers a year. The airport achieves an air transport movement (ATM, the landing or take-off of an aircraft) rate of 59 per hour. In surface area terms, the airport covers an area of approximately 550 hectares, bounded by Wythenshawe to the north, the M56 motorway to the west and the Bollin valley, Mobberley and Styal to the south and east. In 2001/02 there were some 2,400 employees, mainly in MAAS.

3.4. Most of the airport's passengers come from the North of England, the majority from the North-West, mainly Greater Manchester and Merseyside, but a significant proportion from Yorkshire and Humberside and from North Wales. On international scheduled services, 61 per cent of passengers come from the North-West and 19 per cent from Yorkshire and Humberside. Nearly half Manchester's holiday charter passengers come from the North-West and about one-quarter from Yorkshire and Humberside. Within the North-West and Yorkshire and Humberside taken together, Manchester is by far the largest airport, accounting for 74 per cent of passenger traffic, compared with 9 per cent at Liverpool and 6 per cent at Leeds Bradford, its nearest competitors. Manchester also takes a substantial share of passengers from neighbouring regions (see Tables 7.2, 7.3 and 7.4).

3.5. The amount of cargo handled at Manchester reached a record level of 123,000 tonnes in 2000/01, though in terms of Manchester's share of UK cargo aircraft movements, this is a relatively modest 5 per cent—see Table 7.4.

3.6. Manchester manages a property portfolio of some 120,000 square metres with almost 300 tenants in over 400 separate tenancies.

Organization

3.7. MA was until 28 March 2002 the holding company for most of the airport's trading operations. However, as a result of Manchester's acquisition of a majority shareholding in Humberside Airport in 1999, and of East Midlands and Bournemouth Airports in 2001, the size and complexity of the business

was substantially increased. In consequence, the shareholders decided on a significant restructuring of the company. The key aims were to sharpen the focus of each of the constituent businesses and to assist delivery of agreed objectives within a framework of proper accountability. The restructuring, carried out in 2001, was largely completed in 2002. As from 28 March 2002 the new corporate structure consists of a group company (MAG) with several trading subsidiaries reporting to it (see paragraphs 3.9 and 4.2 to 4.8, and Figure 4.1). Some of the subsidiaries are grouped together and operate together for management purposes. MAG has a board and Chief Executive. Its role is to deliver the group and financial strategies for the business as a whole and to provide a policy framework within which targets for individual component businesses can be set and monitored.

3.8. MAG is owned by Manchester City Council and the other nine Greater Manchester district councils, as follows:

- 55 per cent—Manchester City; and
- 5 per cent each—Bolton, Bury, Oldham, Rochdale, Salford, Stockport, Tameside, Trafford and Wigan.

3.9. The four trading subsidiaries and one grouping (dealing with the regional airports) are as follows:

- (a) *MA*. This is the owner and operator of Manchester Airport; it is responsible for both passenger and freight traffic and its objectives include increasing the airport's aviation and related commercial businesses. It owns most of the airport assets and is entitled to the commercial income from those assets. It also owns the retail and car parks operations. Responsibility for operating the airport's car parks has been devolved to MAAS (see below) which operates and manages them under a concession agreement.
- (b) *MAAS*. This is a service company established to provide the major labour-intensive services that are essential to the airport's operations. These include passenger- and baggage-handling services and the aviation security, fire, engineering, car parks and passenger transfer businesses and services. Some of these services—baggage and passenger handling, together with coach services between terminals and aircraft parked on remote stands (remote coaching)—are provided by MAAS's subsidiary, RHS. MAAS's services are provided to MA; and these are arranged through a series of inter-business agreements that detail, among other things, outputs and service levels. The relationship between MAAS and MA has not been negotiated on an arm's length basis. Large numbers of MAAS's staff are still technically MA employees, but it is intended increasingly to develop an arm's length contractual relationship. The objective has been agreed that, over a three- to five-year timetable, the functions provided by MAAS should be put out to competitive tender. It is also intended that MAAS should in the future provide services to MAG's other airports. (The position of RHS is different in that a substantial part of its business, particularly the provision of ground handling services, is obtained from third parties in competition with other suppliers.) MAAS is also responsible to a lesser extent for services to MAV, MAD (see below) and external companies.
- (c) *MAV*. This company is derived from the Manchester's former commercial ventures arm. It is responsible for motor transport activities, commercial opportunities such as on-site advertising, photography, design and print business and training, and for the operation of the airport petrol stations. Apart from motor transport, most of MAV's work is derived from third parties. However, its future as a separate entity is currently under consideration: its functions have temporarily been brigaded with other MAG businesses [*Details omitted. See note on page iv.*].
- (d) *MAD*. When fully operational, this company will be responsible for MAG's property interests. It also aims to provide specialist design and procurement expertise for building projects; and to maximize the potential for airport-related development opportunities as part of its responsibility for managing the capital programme at all the airports in the group. Its activities include on-site developments and ancillary business growth such as remote car parks and remote check-in facilities.
- (e) *Manchester Airport Regional Airports*. This management grouping currently reports to MA, but is intended to report to MAG from October 2002. It consists of Humberside International Airport

Limited (Humberside), East Midlands International Airport Limited (East Midlands) and Bournemouth International Airport Limited (Bournemouth). East Midlands and Bournemouth have their own holding company, Crow Aerodromes Limited, which was set up as a special purpose vehicle for the acquisition of these airports, which are wholly owned by MAG (while Humberside is majority owned).

3.10. For the purposes of calculating the maximum level of *airport charges*¹ in this inquiry, the scope of regulation encompasses the assets, costs and revenues of MA (including the GTI and its associated office block), as well as those of MAAS (apart from its subsidiary RHS²), MAV motor transport and MAD. The costs, revenues and assets of these entities are included within the scope of this inquiry to the extent that they meet three criteria. The first is that they relate to activities at Manchester Airport and not at another MAG airport. The second criterion is that where activities are carried on now that have been carried on in earlier quinquennia, they should have formed part of earlier regulatory reviews. The third criterion is that the relevant activities are not being provided by one of the MAG subsidiaries either in competition with other independent suppliers at the airport—such as some of the baggage-handling tasks which RHS carries out—or after winning a fully competitive tender.

The system of regulation

The legislation

3.11. Part IV of the Airports Act provides for economic regulation of airports by the CAA, and definitions of some of the key statutory terms can be found at Appendix 3.1. Together, Manchester and the other three airports mentioned in paragraph 3.1 are known statutorily as designated airports. Limits on airport charges at designated airports are set by the CAA at five-yearly intervals for each forthcoming quinquennium following reference to the CC. The CC's terms of reference for the present review are set out in Appendix 1.1 and summarized in paragraph 3.16. The current *airport charges* conditions applying to Manchester, in what is the third quinquennium (Q3, 1997/98 to 2002/03) since regulation of charges began in 1987, are due to expire on 31 March 2003. For Q4, 2003/04 to 2007/08, the CAA has proposed changing the basis on which Manchester can levy airport charges from what is known as the single till to an RRCB, more commonly referred to as the dual till. The single- and dual-till approaches are explained in a later section of this chapter.

Regulated charges

3.12. From 1986, the start of the regulatory arrangements under the Airports Act, regulation of *airport charges* has been effected through a system of price caps. These caps are applied to the aggregate of the *airport charges* covered by the Airports Act. The charges in question (on which see also paragraphs 7.32 to 7.35 and related sections of Chapter 7) are for the following activities:

- (a) *runway use* (take-off and landing);
- (b) *aircraft parking*;
- (c) *passenger facilities* (charges which are made for the use of the airport's facilities, such as lounges and passenger transfer facilities, and which are levied by reference to the number of passengers); and
- (d) *passenger security*.

Runway charges are differentiated, so that larger aircraft pay more, and cargo aircraft pay less. *Aircraft parking charges* are levied daily (after an initial 'free period') and are weight related. *Passenger facilities charges* are lower for domestic passengers than for international, and cheaper in winter than in summer. Recently, reductions for off-peak flights have been introduced. *Passenger security charges* are levied on

¹Definitions of this and other key statutory terms can be found in Appendix 3.1. In this chapter and in Appendix 3.1 the statutory terms defined are rendered in italics.

²In fact, RHS is included in our modelling calculations because of difficulties in splitting RHS data from MAAS in Manchester's model. However, RHS is forecast to break even as a whole over Q4, so its inclusion has no impact on the price cap calculation. See Chapter 9.

all departing passengers. In 2000/01, passenger facilities charges accounted for 43.7 per cent of Manchester's regulated income, runway charges for 34.5 per cent, passenger security charges for 20.4 per cent, and aircraft parking charges for 1.4 per cent.

3.13. This basis used to establish what the maximum aggregate level of *airport charges* should be, since the commencement of price caps at Manchester in 1987, has been the single till. *Airport charges* are also referred to as regulated charges, to distinguish them from other charges directly relating to aviation business operations but which are unregulated.

Unregulated charges

3.14. The significant unregulated charges are for:

- check-in desks;
- baggage systems;
- other desk licences (transfer and information desks);
- staff car parking;
- staff identification cards;
- fixed electrical ground power;
- hydrant refueling;
- airside licences (including catering and bonded stores levies);
- cable routing; and
- maintenance, utility and heating services.

This last category incorporates a number of charges, for example the different charges for the separate utilities.¹

'Aeronautical' and 'commercial'

3.15. Together, the regulated and unregulated charges listed above cover the airport's aeronautical activities and these are sometimes referred to as the 'aeronautical till'. Aeronautical activities are so called to distinguish them from commercial activities, such as the letting of shops, restaurants and the provision of car parking. Manchester's revenues in 2000/01 amounted to £232 million. Revenue from the regulated airport charges was £129 million (56 per cent of the total) and from other aeronautical (unregulated) activities £23 million. Commercial activities contributed a further £80 million, almost 35 per cent of the total (see Table 7.1).

Obligations of the CAA

The CAA's task with regard to airport charges

3.16. The CAA has powers to impose conditions upon airports that hold permission to levy airport charges; and at the four designated airports the CAA has to modify conditions relating to *airport charges* every five years. Before doing so, under sections 40 and 43 of the Airports Act, it is required to make a reference to the CC in respect of each designated airport, unless the Secretary of State directs otherwise.² Under section 43, these references must be framed to cover two aspects:

¹At a more disaggregated level, the number of unregulated charges is far wider than this. The total extent is indicated in the airport's annual *Fees and Charges* publication.

²After consulting the operator the CAA can extend a price cap into a sixth year and so postpone a reference for one year.

- (a) *airport charges*: the maximum amounts that may be levied by the airport operator by way of airport charges for the succeeding five years; and
- (b) public interest: whether the airport operator, or any of its associated companies, has pursued a course of conduct which has in the current quinquennium operated or might be expected to operate against the public interest, in relation to (i) any *airport charges* levied at the airport; (ii) any operational activities carried on relating to the airport; or (iii) the granting of a right to another person/persons to carry out *operational activities* at the airport. If so, the CC has to address the question whether the effects of such a course of conduct could be remedied or prevented by the imposition of any condition or by the modification of any conditions already in force.

3.17. In carrying out its functions under Part IV of the Airports Act, the CAA is required under section 39(2) to perform its functions in the manner which it considers is best calculated:

- (a) to further the reasonable interests 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 its functions.

3.18. Under section 39(3) of the Airports Act 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. The Secretary of State last notified the CAA in May 1994 that, in performing its functions under Part IV of the Airports Act, it should take into account the following obligations of the UK:

- (a) Article 15 of the Convention on International Civil Aviation of 7 December 1944, referred to as the Chicago Convention. This article requires that an airport in a contracting state open to public use by its own national aircraft shall be open under uniform conditions to aircraft of other contracting states. Any charges made for the use of airport and air navigation facilities by non-national aircraft may not be higher than those that would be paid by national aircraft engaged in similar operations (see Appendix 3.2 for the text of Article 15).
- (b) The Agreement for Air Services made in Bermuda on 23 July 1977, known as Bermuda 2. This agreement, between the UK and US Governments, was amended and supplemented by an Exchange of Notes of 11 March 1994.¹ Among other things, the Exchange of Notes replaced the user charges article (Article 10) in Bermuda 2. Under the new Article 10, which has a number of provisions, ‘User charges shall be just and reasonable ... and equitably apportioned among categories of users’ and ‘User charges shall not be unjustly discriminatory ...’. Paragraph 3 of the article further provides that:

... user charges ... are just and reasonable only if they do not exceed by more than a reasonable margin, over a reasonable period of time, the full cost to the competent charging authorities of providing the appropriate airport, air navigation, and aviation security facilities and services at the airport or within the airport system. Such full costs may include a reasonable return on assets, after depreciation. In the provision of facilities and services, the competent charging authorities shall have regard to factors such as efficiency, economy, environmental impact and safety of operation.

(See Appendix 3.2 for the full text of the article.)

- (c) Any other bilateral air services agreements between the UK Government and other governments.

3.19. Pursuant to section 40(5) of the Airports Act, the conditions imposed or modified by the CAA:

- (a) may provide for:

¹Treaty Series No 76 (1977), Cmnd 7016.

- (i) an overall limit that may be levied by the airport operator by way of all airport charges at the airport; or
 - (ii) limits to apply to particular categories of charges; or
 - (iii) 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.

Except with the agreement of the airport operator concerned, conditions imposed by the CAA may not be modified by the CAA other than at the end of each quinquennium.

3.20. Following the CC's report, the CAA's role, as laid down in section 46 of the Airports Act, is to impose the conditions and modifications it considers best calculated to meet its statutory duties under the Airports Act. In setting the maximum level of charges, the CAA must, under section 46 of the Airports Act, have regard to the CC's recommendations. These recommendations are not, however, binding on the CAA. Before imposing conditions, including any relating to public interest issues (see next paragraph), the CAA invites representations on its proposals from the airport concerned, and from other airport operators, airlines and airline and airport representative bodies in accordance with Regulation 12(3) of the Civil Aviation Authority (Economic Regulation of Airports) Regulations 1986. Following this consultation the CAA's decisions are made and published in a statement, as required by section 46(5) of the Airports Act. The CAA has been content to conduct the three designated BAA and Manchester airport reviews in parallel so as to help achieve consistency of regulatory approach and to allow common issues to be addressed jointly. The new price caps will be set for each of the four airports for the five years from 1 April 2003 to 31 March 2008.

The role of the CAA with regard to public interest issues

3.21. As paragraph 3.16 indicates, section 43 of the Airports Act also requires the CC to investigate and report on whether the airport operator, or any of its associated companies, have pursued a course of conduct which has operated or might be expected to operate against the public interest; and if the CC finds effects adverse to the public interest, it must examine possible remedies. As with the CC's recommendations on charges, the CAA must have regard to any CC recommendations for conditions or modifications. Where the CC finds that an airport has pursued a course of conduct against the public interest, the CAA is required to impose conditions to address that finding. These do not have to follow precisely the CC recommended conditions so long as they remedy the adverse effects identified. In addition to the CAA's powers following a reference to the CC, section 41 of the Airports Act enables the CAA to impose conditions to remedy adverse effects resulting from a course of conduct in relation to *relevant activities* as defined in section 36 of the Airports Act (see Appendix 3.1). These powers have been used by the CAA at points between quinquennial reviews in response to complaints about the conduct of airport operators. The CAA also has power, under section 51 of the Airports Act, to fix the duration of any conditions it sets to remedy or prevent adverse public interest effects; and—where these are not of indefinite duration—to extend their duration as it thinks fit.

Obligations of the CC

3.22. The CC is required by section 43(5) of the Airports Act, in considering the public interest question, to have regard to the objectives specified in paragraphs (a) to (d) of section 39(2) (see paragraph 3.17). While the Airports Act makes no similar requirements on the CC to have regard to these matters when considering most other aspects of airport regulation, most notably airport charges themselves, it is the CC's practice to carry out its functions as though they did apply, as the CAA, in acting on the CC's recommendations, has to perform its functions in the manner best calculated to meet those objectives. Further, however, with regard to the granting of a right to carry out operational activities at the airport, the same section 43(5) also requires the CC to have regard to 'the furtherance of the reasonable interests of persons granted such rights'.

Single till and dual till

Single till

3.23. Under the single-till approach, the airport charges are derived as follows:

- (a) All airport and airport-related activities, whether aeronautical or commercial, are candidates for inclusion in the calculations. The CAA, guided by CC recommendations, makes the decision which activities to include. Normally the net is drawn widely and includes at least all on-site aeronautical and commercial activities. The result of this process is the establishment of the cost base or till.
- (b) The next stage is to decide, based on forecasts, the level of expenditure—including any changes in the level of capital needed to carry on the activities—which the airport will be required to make on the activities in the till during the quinquennium under consideration, taking account also of depreciation of the airport's assets and an appropriate level of return on its investment.
- (c) The projected net revenues from the totality of these activities are then calculated, with the exception of the four activities whose charges are to be regulated (see paragraph 3.12).
- (d) This process leaves a gap between total spending requirements and total revenue projections—effectively represented by the net needs of the four activities in the regulated sector. So the final step is to determine what revenues are required to finance these activities through *airport charges* which are thus generated as a 'residual' of the process. The result is the price cap, which is normally shown on a £-per-passenger basis (related to passenger forecasts for the period). Under the single till the cap on airport charges is set to allow an expected return across all of the airport's activities in the cost base, including commercial activities, the return reflecting the estimated cost of capital to the airport.

Dual till

3.24. The dual-till basis for setting price caps, under the CAA's RRCB variant, involves a similar process and set of steps to those for the single till. The difference is that the cost base does not include all airport activities (the comparable step to that in paragraph 3.23(a)), but only those which are classed as aeronautical. The expenditures, assets and revenues of the commercial activities are ignored, thus becoming a second 'till' as far as the airport is concerned. The regulatory cost base which results, therefore, is considerably narrower than the cost base produced under the single till.

3.25. As the CAA has explained, since the airport's commercial activities typically generate higher net returns on assets invested, the single till generally results in airport charges that are lower than would be the case if a narrower, purely aeronautical, regulatory cost base were adopted. Under the single till, all commercial profits above the allowed cost of capital are brought into account and used to offset the costs of regulated aeronautical activities, while under the dual till the price cap derived for aeronautical charges simply reflects aeronautical costs.

The International Civil Aviation Organization guidelines

3.26. 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.

3.27. 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 3.2.)

3.28. Commenting on these guidelines, the 1996 and 1997 MMC reports on, respectively, BAA (paragraph 8.14) and Manchester Airport (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.'

3.29. In June 2000, 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 3.2 for the relevant conference report excerpt.) 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 3.2). 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, the relevant section of which reads as follows: '... 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' (see Appendix 3.2).

RPI-X

3.30. Under price cap regulation, the overall level of *airport charges* can be increased up to a level determined by a formula. In the case of Manchester and the other three designated airports, the formula used is known as the RPI-X formula. This provides that maximum charges shall be adjusted each year by the rate of inflation, as measured by the RPI, less an amount per year referred to as X. In the current quinquennium at Manchester X is five. As well as being used to set the price caps for the designated airports, price cap regulation has been used in the UK to regulate the prices of other goods and services, principally utilities such as telecommunication services, water, electricity and gas.

3.31. An advantage of the RPI-X formula is that the regulated company and its customers know the (inflation-adjusted) average level of its *airport charges* for a period of five years. During this five-year period, cost savings above those forecast when setting the cap flow through directly to profits. The company, therefore, has the incentive to improve efficiency. At the end of the five-year period, cost reductions achieved may then be passed on to customers by the regulator setting a tougher price cap. Similarly, higher than predicted commercial profits benefit the company within the quinquennium but are taken into account in setting the price cap for the next period. The process then repeats itself over the next five-year period.

Type of price cap: revenue yield and tariff basket

3.32. Price caps are of two kinds: revenue yield and tariff basket. Under the revenue yield method, the regulator sets a limit on the increase in the total revenue per passenger an airport can earn each year, leaving it to the airport to decide how to adjust individual (regulated) charges within that overall cap. The regulator makes forecasts of traffic and costs and calculates the appropriate change in revenue yield expressing the outcome in £ per forecast passenger terms. Put simply, this approach applies controls to the average revenue yield per passenger using the airport. It is the approach being adopted in the current quinquennium. Following consultation, the CAA has proposed that for the next quinquennium the revenue yield approach should continue to provide the basis on which airport charges are controlled.

3.33. Under the tariff basket approach, the regulator sets a limit on the increases an airport can levy each year in each of the various (regulated) airport charges. The regulator makes forecasts of traffic and costs and calculates charges that give the company the appropriate revenue. The company then calculates the implied change in price, given its forecasts of traffic, and announces the new charges. The revenue yield approach has been objected to in the past on the grounds that passenger movements are not the only outputs of an airport—some planes transport only cargo—and, although most aircraft do carry passengers, the numbers involved in each landing and take-off may vary, as may the costs and revenues of processing them, between peak and off-peak periods. The tariff basket approach—which has been used, for example, in regulating telecommunications—would attempt to address these issues by weighting each element of an airport's charges by the revenue that it generates. If there were a change in relative prices, the weighted average change in prices would depend on the weights used. A tariff basket would normally be based on the latest available traffic figures at the time charges were set. The CAA outlined the arguments for both approaches in the consultation process that it carried out before finalizing the reference. On all sides, the response to that consultation was strongly in favour of the status quo.

The regulatory history of Manchester Airport

3.34. Previous quinquennial decisions by the CAA following inquiries into Manchester Airport by the MMC were made in 1987, 1992 and 1997.

The MMC's 1987 report

3.35. The 1987 reference, for the years 1988 to 1993 (Q1), followed the setting by the Secretary of State of charges for the BAA airports, at RPI-1, and an indication from the CAA that no more onerous a formula should be adopted for Manchester.

3.36. The MMC recommended in its report *Manchester Airport plc: a report on the economic regulation of the airport*, published by the CAA in December 1987, that charges be allowed to increase by no more than RPI-1. Although it did not find that Manchester had been carrying on a course of conduct contrary to the public interest during the previous year, it did identify several areas of concern, including MA's monopoly in ground handling, manpower planning and the deployment of the workforce. Recommendations were made to address these matters and to monitor progress.

The CAA decision for the 1988/89 to 1992/93 quinquennium

3.37. The CAA's decision, published in February 1988, followed this recommendation and stipulated that revenue per passenger from airport charges at the airport for the five years ending on 31 March 1993 should rise by no more than RPI-1.

The MMC's 1992 report

3.38. The second inquiry took place in 1992. The MMC's report *Manchester Airport PLC: a report on the economic regulation of Manchester Airport PLC*, published by the CAA in July 1992, came to the following conclusions:

- (a) It recommended that revenue per passenger from *airport charges* for the five years from April 1993 to 31 March 1998 should increase by no more than RPI less three percentage points (RPI–3), subject to adjustment for changes in security costs.
- (b) As regards the public interest, the MMC concluded that inadequate information for users on the cost of those airline services and facilities that were excluded from the charging formula might be expected to operate against the public interest. The MMC recommended that Manchester be required to provide information to the CAA and users about the factors on which charges were based.
- (c) Furthermore, as regards the public interest, the MMC concluded that Manchester’s restriction of operation of ground handling to a single supplier had operated against the public interest. The MMC recommended that competition be introduced.

The CAA decision for the 1993/94 to 1997/98 quinquennium

3.39. The CAA accepted the main MMC recommendation—and concluded that it was right that the revenue from *airport charges* per passenger should not be permitted to rise by more than the increase in the RPI less three percentage points for the whole quinquennium. The CAA specified that the base year yield per passenger should be the figure used by the MMC (£7.84) but adjusted to take account of actual inflation for the year to August 1992 (3.2 per cent). This produced a base year yield of £7.768. However, in the event, Manchester underrecovered the permitted amounts in each year. Some modifications to the existing form of the airport charges formula had also been suggested, for example to allow MA to recover a larger proportion of costs associated with any additional security requirements introduced by the Department of Transport. In this area the CAA broadly followed the MMC’s recommendations.

3.40. The other key MMC recommendations were also broadly accepted. In particular there was widespread support from users for CAA conditions to improve transparency of costs of services outside the charging formula and Manchester raised no objection to it. This condition followed the MMC recommendations except that the CAA also required that Manchester’s auditors should produce a report on the information supplied by Manchester Airport.

3.41. On ground handling, the CAA accepted the MMC recommendation that at least three ground handling agents be allowed in T1 as soon as possible (and by no later than 1 April 1997), having first explored with Manchester the possibility of bringing forward the date by which it would be required to introduce competition. The conditions imposed were modified in September 1993 and T1 was subject to competition from April 1996.

The MMC’s 1997 report

3.42. The main points of the 1997 MMC report, *Manchester Airport plc: a report on the economic regulation of the airport*, presented to the CAA in July 1997, covering the 1998/99 to 2002/03 quinquennium (Q3), were as follows:

- (a) Airport charges accounted for about half Manchester’s income. In considering the maximum level of airport charges, the MMC—as it had done in previous reviews—took into account Manchester’s projections of income from its commercial activities at the airport.
- (b) The MMC considered that for the five-year period, ending 31 March 1998, Manchester was likely to earn a significantly better rate of return on assets than had been predicted in its previous report, primarily due to a higher than expected growth in the number of passengers in the earlier years of the period.
- (c) In the MMC’s consideration of the maximum level of airport charges, it concluded that 7.75 per cent was an appropriate cost of capital for Manchester. That cost of capital should be applied to a regulatory value of assets based on a recent revaluation of fixed assets, but revalued thereafter by the RPI to reduce the effect of unpredictable fluctuations in construction prices. The MMC believed that there was more scope than assumed by Manchester for it to reduce its operating costs. Manchester had argued that a significant increase in sales development expenditure (comprising rebates and other incentives to airlines to use or increase their use of the airport) was

necessary to achieve its traffic forecasts, which were broadly in line with the traffic growth forecast for regional airports as a whole in the UK. The MMC believed it reasonable to allow for only a more limited increase in such expenditure and the allowance was reduced from a proposed £14 million to £6 million a year. Finally, the MMC believed that Manchester should be able to generate somewhat greater commercial revenue than it had assumed to offset the loss of income from sales of intra-EC duty-free and tax-free goods.

- (d) On the above assumptions, the MMC recommended that the maximum revenue per passenger from airport charges should be £6.74 in 1998/99, at 1996/97 prices. This was equivalent to a reduction relative to the RPI of about 6.5 per cent. For the subsequent four years, the MMC recommended that the maximum revenue per passenger from airport charges should be reduced by RPI-5 each year. Having regard to projected increases of passengers and revenues, it was estimated that this level of charges would be sufficient to compensate for the loss of income from sales of intra-EC duty-free and tax-free goods. The MMC did not believe that these proposals would lead to any financing problem or postponement of investment, despite restrictions on Manchester's ability to borrow. This recommendation was subject to recovery, in addition, of 95 per cent of costs incurred in meeting any additional security measures subsequently imposed by the Government (this is known as the 'S' factor, which is technically the allowable security cost per passenger in the pricing formula). The MMC also recommended that 95 per cent of the costs of land compensation claims resulting from R2 and other developments should be recovered.
- (e) As regards the public interest, the MMC concluded that inadequate procedures for consultation had operated, and might be expected to operate, against the public interest. The adverse effects were the excessive costs directly and indirectly imposed upon airlines affected by ineffective consultation, and the inability of users to determine the appropriateness of charges, leading to excessive charges or a structure of charges not related to the structure of costs. The MMC recommended that Manchester be required to implement consultation procedures to be approved by the CAA. The MMC also concluded that provision of inadequate information to users on the costs and revenues associated with the supply of utilities might be expected to operate against the public interest, Manchester being in a position to impose charges for utilities and increases in them that were not related to cost, and being expected to benefit unduly from this position. The MMC recommended that Manchester be required to make such information available to users.

The CAA decision for the 1998/99 to 2002/03 quinquennium

3.43. On the key areas of the inquiry the CAA largely accepted the MMC's recommendations, the main exception being over the likely losses from the ending of intra-EC duty-free sales. On the basis of its own revised assumptions the CAA concluded that the price formula should be RPI-5 in all five years of the new quinquennium and that the maximum average yield per passenger for the first year should be £7.38 at out-turn prices. The CAA did not agree that the costs of land compensation claims should be recovered through the price formula. However, it adopted the MMC's recommended conditions relating to public interest findings concerning information on the costs and revenues associated with Manchester's supply of utilities and procedures for consultation.

The CAA's consultative process and proposals for 2003/04 to 2007/08 (Q4)

3.44. In 1999 the CAA decided to embark on a fundamental review of the way in which airport charges were regulated. In July 2000, it began its review process with a consultation paper, *Issues for the Airport Reviews*,¹ in which it outlined the key issues which it considered the review needed to address. This was followed by a position paper in October 2000, *The CAA Approach to Economic Regulation and Work Programme for the Airport Reviews*, which commented on the response to the July 2000 paper and set out the line of work that the CAA intended to pursue. The CAA set out four fundamental principles to underlie its approach to economic regulation:

- (a) Regulation should focus on monopoly behaviour which is likely to reduce economic efficiency via insufficient capacity, rather than the distribution of non-monopoly rents.

¹This CAA paper and all those noted in this and succeeding paragraphs are available on the CAA's web site: www.caa.co.uk.

- (b) Regulation should be consistent with the CAA's obligation to impose minimum restrictions and encourage commercial solutions.
- (c) The regulatory framework needed to be credible and sustainable over time.
- (d) Regulation must be transparent and predictable.

3.45. The CAA's initial work programme undertook to address seven issues; these, with the associated CAA consultation papers, are shown below:

- (a) the possibility of the price cap acting as a default that would provide a firm base for airports; airport users could then contract for additional services outside the price cap—*Direct Contracting between Airports and Users: a Default Price Cap* (February 2001);
- (b) the separation of the setting of the price cap from the airports' own costs by the use of techniques such as benchmarking or incremental cost estimates—*The Use of Benchmarking in the Airport Reviews* (December 2000);
- (c) setting charges to reflect incremental costs (including for additional outputs rather than for current outputs)—*Economic Regulation and Incremental Costs* (February 2001);
- (d) the treatment of capital expenditure—*Economic Regulation and Capital Expenditure* (January 2001);
- (e) the single till and the dual till—*The 'Single Till' and 'Dual Till' Approach to the Price Regulation of Airports* (December 2000);
- (f) service quality (including contracting outside the price cap)—*Quality of Service Issues* (December 2000); and
- (g) competition within airports and further contracting out of services—*Competitive Provision of Infrastructure and Facilities within Airports* (February 2001).

3.46. The pattern in each case was publication of a consultation paper by the CAA on its web site with an invitation for responses from interested parties. The CAA also arranged workshops for the industry, Government and research consultancies.

3.47. Further papers published by the CAA in 2001 were as follows:

- (a) *Pricing Structures and Economic Regulation* (March 2001);
- (b) *Cost of Capital* (June 2001); and
- (c) *Performance Reports of BAA London Airports and Manchester Airport* (August 2001).

3.48. In November 2001, the CAA produced its preliminary proposals for prices in the 2003 to 2008 quinquennium—*Heathrow, Gatwick, Stansted and Manchester Airport Price Caps, 2003–2008, CAA Preliminary Proposals—Consultation Paper*. This was then discussed with the airports, the airlines and others, the process including formal hearings. The CAA's final proposals for Manchester, *Manchester Airport's Price Cap 2003–2008, CAA Recommendations to the Competition Commission* was submitted to us on 28 February 2002 together with the formal reference (see Appendix 1.1). The proposals for the regulatory framework for Q4 were a slightly modified and expanded version of the preliminary proposals. The submission was placed on the CAA web site at www.caa.co.uk.

3.49. The CAA's proposals for Q4 consist of the following seven key propositions, which are discussed in more detail in Chapter 2:

- (a) adopting the RRCB (dual till) as the basis for charging, with surface access excluded from the aeronautical till;
- (b) terminating the S factor security cost pass through;

- (c) continuing with a revenue yield price cap;
- (d) (in connection with unpublished discounts) compliance with the price cap to be assessed as if airlines were paying the published charges;
- (e) continuing to exclude revenue from non-passenger flights from the average yield calculation. A separate price cap should be set for non-passenger flights;
- (f) setting a cost of capital of 7.5 per cent (real, pre-tax), using the standard methodology which could accommodate debt to assess values within the conventional range; and
- (g) enhanced information disclosure and consultation.

The CAA's view was that this was the package most likely to meet its statutory objectives in relation to Manchester.