

Structure of the Q5 BAA price control

Introduction

1. This appendix lists the features of the high-level structure of the proposed control, and outlines the arguments developed by stakeholders, where there have been any, on both sides. There is little or no debate on many of the issues mentioned in this note between the CAA, BAA and other parties, as one might expect after four price control settlements and three references to the MMC/CC.
2. The issues identified on the high-level approach are:
 - (a) RPI-X versus rate of return;
 - (b) single versus dual till;
 - (c) airport versus system regulation;
 - (d) revenue yield versus tariff basket; and
 - (e) scope of non-regulated charges.
3. In addition, this appendix covers areas on the non-yield elements of the price control condition:
 - (a) volume term;
 - (b) security term;
 - (c) capital expenditure triggers; and
 - (d) correction factor.
4. Finally, the appendix discusses briefly the charges for non-passenger aircraft.
5. In addition, there has been a proposal for an investment term, but as it is not clear what this would comprise or how it would work, we do not discuss it here.
6. This appendix has one annex, consisting of the CAA's table of the incentive properties of the Q4 price control, which is similar to the price control it proposed in its reference.

RPI-X versus rate of return

7. After four price control settlements in aviation and three references to the MMC/CC, and dozens of similar reviews in other regulated sectors in the UK since the mid-1980s, the RPI-X form of regulation appears well established. There are other forms of control, such as rate of return regulation used for the Independent Public Gas Transporters, or cost-sharing, but these have never been adopted for large, privatized utilities in Britain. Most stakeholders appear content that RPI-X has delivered benefits to customers of those utilities, mostly through reductions in cost

which are passed on to customers at the next periodic review and that therefore the Q5 control be set in this way, as the CAA envisages.

8. The only significant opposition was from Virgin, which argued that the RPI-X methodology as practised by the CAA gives BAA strong incentives to increase traffic while cutting costs, hence reducing standards of service. Virgin cited the poor quality of service which it said it and its passengers faced at Heathrow. Virgin argued that many passengers of BAA's customers regarded much of the service they received from BAA's airports as poor or unacceptable, regardless of the QSM figures, which painted a more positive favourable picture. We accept that price caps do indeed incentivize companies to compromise on standards of service by placing a high premium on reducing opex. However, BAA faces incentives to improve quality of service through the service quality regime (see Appendix L). We address the structure and size of these incentives elsewhere in this report. Furthermore:
 - (a) many of the constraints on quality of service have more to do with ageing or constrained infrastructure due for replacement under the HET or other initiatives; and
 - (b) Terminal 5, which has been delivered under RPI-X, should improve customers' experience in Heathrow terminals by reducing overcrowding.

Single versus dual till

9. The Q4 control was set on the basis of a single till. BAA and the CAA had both argued for a dual-till approach, but the airlines and most other stakeholders were overwhelmingly hostile. It was argued that a dual till would increase incentives to invest in aeronautical rather than retail facilities; increase the efficiency of runway utilization by raising prices; and eliminate the de facto regulation of commercial activities at the airports.
10. The CAA accepted the CC's recommendation to opt for a single-till approach. We had recommended this approach partly because of the difficulties in splitting out commercial activities satisfactorily, but also because of the large windfall gains to BAA at the expense of the airlines which would have resulted from a dual till control. The CAA has maintained this approach in its proposals for Q5. BAA's response noted this, though indicating what it regarded as flaws in the CAA's arguments. BAA has argued that the CC's position was inconsistent with its position on system regulation, as airlines were incentivized to demand more investment than would otherwise be efficient. However, while airlines may demand this investment, BAA and the CAA have control over whether or not it takes place, and this does not appear to be a convincing objection.

Airport versus system regulation

11. The Q4 control was set on the basis of price controls on individual airports. The CAA favours individual price controls to retain investment incentives and to avoid distorting competition by cross-subsidies between the airports. BAA, however, identified what it perceived as limited flaws in the CAA's arguments, but overall its response has seemed to accept separate regulation of the airports.

Revenue yield versus tariff basket

12. The Q1-Q4 price controls have all been set on the basis of capping the allowed revenue per passenger (revenue yield). There are many different ways to set price

controls, and the CAA raised a move to a tariff basket approach as one of the possibilities for this control, without supporting it. Such a control might weight the various elements of charges using predetermined factors, thereby avoiding the incentive for a regulated company to rebalance charges to increase traffic. However, none of those consulted supported a move to a tariff basket control, and some airlines opposed it on the grounds of its extreme complexity.

Non-regulated charges

13. The CAA's current position is based on Constructive Engagement and BAA's arguments:
 - (a) to adopt the projections for such charges arising from Constructive Engagement;
 - (b) to retain consistency between the objectives, such as cost-reflectivity, and the projections for the charges;
 - (c) to allow recovery of the costs for these services through cost-based non-regulated charges as agreed through Constructive Engagement;
 - (d) to leave cabin waste costs to be covered by airport charges;
 - (e) to cease charging the fuel turnover levy; and
 - (f) to include baggage infrastructure costs to be recovered by airport charges.
14. The airlines held differing views on these issues, but it would be a fair generalization to say that they were:
 - (a) disappointed at the level of information and forecasts provided by BAA, though this may no longer be the case as BAA has provided the airlines with extra information as part of Constructive Engagement;
 - (b) divided on the merits of moving baggage infrastructure costs into airport charges; and
 - (c) concerned that BAA should not over-recover whatever the level of charges set, and that no double-counting of costs should be allowed.

Volume term

15. BAA's price control, being a price-per-unit cap rather than a revenue cap, gives it a strong incentive to maximize volumes, or traffic (in this case the number of passengers). It is correspondingly exposed if traffic falls significantly, which could happen through events which are outside BAA's control. It is therefore arguable that BAA's price control might include a mechanism to compensate BAA (and thereby safeguard its financial viability) if traffic falls, though this would inevitably limit the incentive on it to increase traffic. This might be managed through a 'volume term', such as was introduced in Royal Mail's last price control review, under which Royal Mail is allowed to raise prices if postal volumes in any one year fall more than 2 per cent below the projections at the time the price control was set.
16. There has been little support for this idea from those consulted by the CAA. Even BAA, the respondent which might be expected to be most in favour of it, argued against it in its March 2006 submission to the CAA. Any such mechanism would

compensate it at the expense of its customers, who would be likely to be hit even more heavily by a reduction in volumes, which would cause more problems for BAA than the additional revenue would solve. A further argument against this proposal is BAA's ability to ask the CAA for a price review in the event that it finds itself in financial difficulty, thereby obviating the need for such a mechanism.

Security term

17. The CAA, supported by all those consulted who expressed an opinion, is proposing to maintain the security pass-through in its current form. BAA's support was qualified by its opinion that the term had not been used in Q4, and hence it was difficult to regard it as a success or otherwise.
18. However, the CAA proposed that 90 per cent of unanticipated security costs over a limit of £14 million at Heathrow and £6 million at Gatwick be recovered, rather than 75 per cent. BAA had argued for 95 per cent. The CAA's and BAA's proposals would give BAA a much weaker incentive to manage these costs once the limit is reached, but the CAA considers that it might enable it to set lower baseline security estimates, since unanticipated risks beyond the limit can be almost entirely recovered from airlines. The extent to which this is a serious matter for airlines or passengers is uncertain, as the term has not been invoked in Q4, and the scale of any additional future security requirements is uncertain. The 2007/08 charges have been set without any additional recovery, though we understand that the extra security measures put in place since August 2006 may breach the limit and require extra revenue in the first year of the next quinquennium.

Capital expenditure triggers

19. Capex triggers were introduced on an asymmetric basis in the Q4 control. BAA would forfeit 2 per cent of revenue for each year that five milestones in the T5 project were missed, and 1 per cent for delay of a project at Gatwick. The CAA proposes to include new triggers in the Q5 price control. BAA had supported them at the previous review; believed they had worked well; and argued that they should be extended to Q5, though there were still issues to be resolved through the Constructive Engagement process. All other parties who commented supported the principle of these triggers.
20. The identity and extent of capital expenditure triggers is to be confirmed, though it is likely to include whatever components of the HET project fall within Q5; the inter-terminal baggage system; and some projects in Terminal 3 and Terminal 4. The CAA considers that the delivery of Terminal 5 should not be incentivized as there is already a sufficient reputational and commercial incentive on BAA. From the CAA's reference it appears that the airlines and BAA are discussing this in their Constructive Engagement process.

Correction factor

21. The correction factor allows BAA (customers) to recover any undercharging (overcharging) of revenue, two years in arrears. All price controls (other than some of those based on a tariff basket have a correction factor of some kind). Its existence and high-level structure are not in debate for the Q5 control, but the CAA has proposed a change: currently the term is based on an amount per passenger, which, if traffic is growing, gives BAA a small incentive to under-recover at the start of a control. The CAA proposes moving towards a mechanism whereby the correction

factor is calculated as a total amount. All respondents who commented supported this change, BAA with the rider that it did not game the control in this way.

22. The CAA has said that it was minded to propose a mechanism whereby any correction factors incurred in the last two years of the Q5 control would be recovered in the next control period, to take effect at the end of the Q5 control. BAA has supported such a mechanism, as a matter of principle rather than because it believes the amounts will be large.

Non-passenger aircraft

23. The Q4 control limits prices on non-passenger aircraft to the level at which movements of analogous passenger aircraft are priced. The CAA has proposed continuing this simple arrangement, and neither BAA nor any other respondents have argued for change.

The CAA's view of incentive features of the Q4 price control

| <i>Feature</i> | <i>Incentive implications</i> |
|--|---|
| The charge conditions set a limit on the 'revenue yield' per passenger: | <ul style="list-style-type: none"> - the airport bears passenger volume risk; and - there is an incentive to maximize passenger throughput within the control period. |
| The revenue is calculated on the basis of published tariffs (before any unpublished discounts): | <ul style="list-style-type: none"> - gives the airport an incentive to introduce discounts only to the extent that the additional revenue is greater than incremental cost; and - allows the evolution of separate contracting for a higher or lower level of service. |
| The condition is based around an RPI plus or minus X formula: | <ul style="list-style-type: none"> - breaks the link between charges and costs during the 5-year control period; and - gives airports an incentive to reduce opex, particularly in the early years. |
| There is a correction factor K which makes an allowance for any over- or under-recovery per passenger two years in arrears subject to an asymmetric rate of interest: under-recovery: average Treasury Bill Rate; over-recovery: average Treasury Bill Rate + 3 per cent | <ul style="list-style-type: none"> - the fact that the correction is per passenger against a growing market, and the asymmetrical interest rates applied to under- and over-recovery, gives a strong incentive not to over-recover; and - in theory, at least, there may be an incentive to under-recover and to recover the full cumulative under-recovery in year five. |
| A provision to pass through costs of unanticipated security standards subject to: minimum cumulative threshold the price cap is then increased to reflect 75 per cent of the costs above the threshold | <ul style="list-style-type: none"> - passes a portion of the residual risk of extreme and unanticipated security measures to airlines and passengers; and - the fact that it is not 100 per cent means there is some incentive for the airports to meet requirements at lowest cost. |
| The maximum allowed revenue yield per passenger is reduced where specified milestones in the investment programme are not achieved: five triggers at Heathrow linked to progress on T5— with a penalty of 2 per cent airport charges a year each; one trigger at Gatwick—with a penalty of 1 per cent airport charges a year: An additional incentive to increase average declared capacity in peak hours (at Heathrow only) subject to an effective aerodrome congestion term being in place: | <ul style="list-style-type: none"> - provides an incentive to deliver part of the investment programme assumed at the previous review. |
| A scheme of Standards & Rebates by which Heathrow and Gatwick airports are required to pay rebates (of up to 3 per cent of revenue) to airlines in each terminal if certain standards are not met: | <ul style="list-style-type: none"> - encourages the airport to find ways to increase movements; and - made subject to an aerodrome congestion term to ensure that this was not at the expense of greater delay. |
| <i>Aircraft not carrying passengers</i> Airport charges are not higher than for the equivalent aircraft carrying passengers: | <ul style="list-style-type: none"> - addresses the CC finding that charges do not vary with quality to the extent that would occur in a competitive market; and - counteracts any incentive on the airport to reduce costs at the expense of quality. |
| | <ul style="list-style-type: none"> - stripping out non-passenger aircraft from a passenger-based cap allows airport to obtain some benefit from serving non-passenger aircraft. |

Source: Adapted from CAA draft proposals Table 18-1.