

Agenda Item:	Reference: HACC.508
Date: November 25 2007	
Heathrow and Gatwick Airports – CAA Price Control Proposals – November 2007	

Report by the Technical Adviser

BACKGROUND

1. The Civil Aviation Authority published its final proposals for the setting of new price controls at Heathrow and Gatwick airports for the next five year period from 1 April 2008 to 31 March 2013 (the Q.5 period) and for addressing a public interest finding made by the Competition Commission in relation to security queuing and queue times at the two airports.
2. The CAA is also inviting views on a number of proposed changes to the scheme of standards and rebates at Heathrow and Gatwick established under the conditions on service quality that were imposed on the airports in 2003 and to conditions imposed to remedy previous public interest findings by the Competition Commission.
3. The HACC has considered several reports in the CAA's runup to the production of these proposals since December 2006 as well as associated investigation and reports on BAA's Price Controls by the Competition Commission; it has responded to certain of them. This report by the Commission is quite separate from the ongoing work which is being undertaken into the future control and organisation of BAA.
4. The Commission published its report on 25 September 2007 and, in order to give Members time to consider the quite voluminous documentation associated with it, copies of this together with website links were despatched by e-mail to those using it or by post to those without access to it.
5. To an extent, that documentation has been subsumed into the CAA proposals which have considered the Commission's recommendations and taken note of them as considered appropriate. The CAA is proposing to depart from these recommendations in those respects where it considers that the proposals in its own document are likely better to meet its statutory duties or where new material information has emerged since receipt of them.
6. The Authority expects written responses to the consultation by 21 January 2008 and will conduct oral hearings on the responses on 28/29 January; it expects to issue a price cap decision together with new or modified public interest conditions which will be effective from 1 April 2008.

CAA'S REGULATORY APPROACH FOR Q5 AND BEYOND

7. The Authority recognises that this review is taking place at a time of considerable change in UK aviation, including the potential for change to both the structure of the industry being regulated and – in due course – the regulatory framework itself. The CAA would stand ready to advise the Secretary of State, if called upon to do so, on any implications of a change in competition circumstances for the continued designation of the airports.

8.CAA is clear that BAA and its owners and financiers should be held accountable for the adoption of particular financing arrangements: users should not be expected to carry these risks. CAA does not intend to adapt its assumptions regarding the cost of capital to reflect emerging financial arrangements. The Authority also considered the other steps it might take to prevent the risks associated with the particular financial arrangements from being transmitted to users through channels other than price (e.g. investment).9.The Authority proposes to add to or to modify its future regulatory policies in a number of areas including:

- **the treatment of capital expenditure on a third runway (with or without mixed mode) at Heathrow**
- **increasing emphasis on the consistent quality and resilience of service provided to passengers**
- **the potential risks associated with the highly leveraged financial arrangements that have been (and will be) entered into by BAA and / or ADI**
- **uncertainty associated with cost changes, including any consequences for costs flowing out of the conclusions of the Competition Commission's current market investigation into BAA**
- **potential changes in the UK and European airport regulatory frameworks**

HEATHROW EXPANSION

9.The consultation refers to the conclusion reached by the Commission about expenditure when it said, " We believe it is premature for us to recommend the preferred way forward, but to recommend the appropriate mechanism should be decided after further consultation between BA and the airlines, allowing the CAA to take into account any further views before taking its final decision on airport charges. This will require Constructive Engagement between these parties.

10.BAA has provided to CAA and the Heathrow airlines its current provisional estimates of the potential scale and timing of costs for implementing a third runway and a sixth terminal and associated traffic projections, including variants under which mixed mode operation on the existing runways might deliver additional capacity up to the opening of the third runway. These costs and capacity projections are necessarily tentative and high-level.

11.BAA estimates total undiscounted costs in 2007/08 prices of up to £9 billion for all three aspects (mixed mode providing greater runway aircraft movements, and hence passenger numbers, Runway 3 and Terminal 6). This would represent the largest increase in the airport's regulatory asset base since privatisation in 1986.

12.On BAA's current estimates, the prospective costs of expanding Heathrow capacity in the next five year period, could amount to some £0.65 billion, of which ~£300 million relates to land acquisition and blight costs and the remaining ~£365 million relates to precursor construction projects and the planning, legal and management costs associated with developing a proposal and then taking it through a planning inquiry.

13.The Authority points out that investment decisions would ultimately be a matter for the airport operators and the timing would be for its commercial judgement. In the light of these possible developments, the CAA considers that the scale and timing of the potential costs and benefits, if supported by Government, are such that it needs to set out how it would propose to meet its statutory duties with respect to any proposal from BAA to expand Heathrow.

14. To do so now should provide an opportunity for stakeholders to consider the costs of Heathrow expansion alongside the DfT's principal consultation on the case for allowing additional capacity at Heathrow. Following consultation, the CAA intends to set out its regulatory policy on this issue in the price control decision for the next five year period at Heathrow in March 2007.

15. The report sets out three approaches which CAA might take in its approach to the expenditure associated with Heathrow expansion. It favours three options, particularly those numbered 2(c) or 2(d).

16. Option 2(b) would assume that the CAA grants advance approval in 2008/09, capitalised initial costs (including the return on the assets in the course of construction and on other development expenditure) would be added into the Regulatory Asset Base at the start of the next (Q.6) price control period.

17. Option 2(d) assumes that if the CAA grants advance approval in 2008/09, Heathrow airport charges for years 2 to 5 in the fifth period (Q.5) that now under consultation, increased by a factor to be referred to as "R", set in February 2008, based on allowing a return on initial costs.

18. The third approach which CAA has identified would involve including an additional cash allowance within the Q.5 revenues at Heathrow for a proportion of the initial costs of Heathrow expansion whilst at the same time, postponing consideration of the merits of the investment until the Q.6 review in 2013.

TRAFFIC FORECASTS

19. There is a lengthy discussion in the document of various traffic forecasts made by BAA, the airlines, the Competition Commission and the CAA together with the variety of factors which affect the assumptions made and the forecast numbers of passengers. In the light of this, the Authority has settled upon a forecast for the purposes of price cap proposals:

Millions of passengers per annum	2008/09	2009/10	2010/11	2011/12	2012/13	Q5 Total
HEATHROW	70.0	72.0	74.5	76.0	78.0	370.

SERVICE QUALITY

20. This is of concern for HACC, initially through the Passenger Services Sub-Committee

21. The Authority has placed considerable emphasis on the goal of improving service quality at each airport and it has developed Q5 proposals with the passenger very much in mind. Much of Heathrow will be in a considerable state of flux over the course of Q.5 with airlines moving terminal and a considerable level of upheaval due to building work around the eastern side of the Central Terminal Area.

22. At the time of making the reference to the Competition Commission, airports and airlines were continuing to discuss appropriate mechanisms for service quality through Constructive Engagement, a process which the HACC has joined in. Since then, CAA has arrived at proposals including broadening the scope of the service quality regime, strengthening the incentives under the current scheme of rebates to the airlines, by raising the standards in some areas and increasing the scale of penalty payments for poor service.

23. This table summarises the changes to the scheme proposed by the CAA as they would relate to Heathrow:

COMPARISON OF MAXIMUM PENALTIES AND BONUSES AS A PERCENTAGE OF AIRPORT CHARGES

Heathrow service quality –proposed regulatory regime	Current maximum penalties	Proposed maximum penalties	Proposed maximum bonus
Passenger-facing measures covered by QSM	0.5%	1%	1%
Passenger sensitive equipment	.14%	0.28%	.28%
Central passenger security queuing	0.27%	0.54%	0.54%
New elements	--	0.54%	n/a
Other airline-facing measures	1.09%	1.59%	n/a
Aerodrome congestion	1.0%	0.5%	n/a

24. The Commission had seen no justification for introduction of bonuses as well as rebates but saw advantages in CAA's proposal to encourage publication of performance measures by airlines with any such publication ideally under the auspices of the CAA. The Commission noted that it may wish to consider, in the context of its market inquiry, sources of delay for which BAA is not directly responsible, such as check-in and baggage performance

25. A major source of complaints in the Press and to the HACC have been about the time taken to pass through security checks. The Authority is proposing that central security queuing will be subject to a double test that:

(a) the queuing time should be equal to or less than 5 minutes on 95% of occasions (sampled at 15 minute intervals)

(b) a test addressing the Commission's recommendation for a standard based on a near-maximum queuing time, At Heathrow it is proposed that such queuing time should be less than 10 minutes on 99% of the times sampled./

If either of these standards is not met in a relevant month in a terminal then the standard would not be met for that terminal and a penalty would be paid.

26. The CAA is also proposing to tighten the targets in the following areas (as agreed between the airport and airlines)

seat availability, cleanliness, way-finding, flight information, passenger-sensitive

27. The CAA proposals for service quality rebate levels and for service quality bonus level are attached to this report as Appendix "A"

28. Amongst the various items of operating expenditure, the Committee will be interested to know that the Authority expects that the cost to BAA of its night noise measures at Heathrow is expected to decline from £21 million in 2008/09 to only £6 million in 2012/13. CAA expects that total operating costs will decline from £718 million in 2008/09 to £702 million in 2012/13.

NON-REGULATED CHARGES

29. The CAA proposes to adopt for its price control proposals the projections for non-regulated charges at each airport which were proposed by BAA and endorsed by the Competition Commission in its report

AIRPORT CHARGES PER PASSENGER AT HEATHROW

30. The Authority presents an extremely detailed and lengthy analysis of the pros and cons of the various factors which it has had to take into account in deciding on the maximum level of charges which BAA will be permitted to make at Heathrow Airport, and particularly those raised by the Competition Commission. However, it does not accept all of the points made by the Commission and has presented a schedule of the maximum level of airport charges per passenger at Heathrow in Q.5 (CAA table 13-6) and a copy of this is attached at Appendix B to this report. The relevant reference to passenger charges is the last item in the table headed "Yield per passenger" where charges would rise by 15.6% on current levels in 2008/09 to £11.97 per passenger and continue to rise annually until 2012/13 when they would reach £15.90.

PUBLIC INTEREST CONDITIONS

31 In each of the decisions the Authority has taken for previous price control periods, it has attached to them a number of conditions to require BAA to address various matters which the Commission and the CAA have found to operate against the public interest. The HACC has generally supported the imposition of these conditions, particularly for the present control period when a condition was imposed requiring a contract to be entered into with Heathrow Airport Licensed Taxis which required, amongst other things, the level of information provided at the taxi information desks in each of the terminals to be sufficient to meet passengers requirements.

32. In the earlier consultations by CAA in 2007, the HACC told the Authority that this condition should be continued as it was not satisfied with the outcome of this requirement. There is no recognition in these proposals of that representation and there is no provision for the continuance of the condition in the proposals.

33. The conditions which would continue to be imposed are:

- rebates to be paid by Heathrow Airport to users where quality of service fails to meet Service Standards in accordance with Section 46(2) of the Airports Act 1986
- cost information available to users in respect of Heathrow Airport Limited in accordance with Section 46(2) of the Airports Act 1986 for check-in desks, baggage systems, other desk licences, staff car parking, staff ID cards, FEGP, hydrant re-fuelling, airside parking, airside licences cable routing, maintenance, ticketing and utility services and facilities for bus and coach operators.
- No quantitative restrictions on the use of agency staff and a requirement that they be adequately trained
- the provision of adequate information desks in each of the Terminals

34. BAA has proposed a Revised Agreement on Transparency and Consultation for Q.5 to deal with the development of each of the airports which would replace the current Agreement. CAA looks to responses on the proposal in the context of the Constructive Engagement process at each of the airports. These would include:

- The Airport Master Plan
- The Capital Investment Plan (CIP)
- Consultation on individual projects.

35. Insufficient information is included to be able to judge just what the implications of this proposal for the Committee are but since the HACC is already closely involved in such matters, the Authority should be reminded of this and told that the Committee would wish to continue to be fully involved in the future.

CONCLUSIONS

36. There are few matters arising from the proposal which suggest a corporate response from the Committee although individual members may well wish to suggest that they have an interest which should be put forward. The response should:

- regret that earlier representations re taxis have been ignored
- that, as recorded in para.s 35 and 36, the Committee would expect to be fully involved in any Agreement on Transparency and Consultation for the development of Heathrow Airport and ask for details of this to be conveyed to it.

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