

RESPONSE BY

BRITISH AIR TRANSPORT ASSOCIATION

TO CAA PRELIMINARY CONCLUSIONS CONSULTATION

PAPER -NOVEMBER 2001

In the following response each paragraph in italics is our summary of a particular CAA proposal and is followed by our comments.

1. **Single Till/Dual Till** (pages xvi-xviii)

- The CAA acknowledges the ongoing interdependence of airlines and airports. "Airports provide facilities and services that allow other firms to provide air transport for passengers and freight, and commercial activities." (page xiii)

The high levels of retail profits achieved by airports, particularly Heathrow and Gatwick, result in the application of lower airport charges. The Monopolies and Merger Commission in their 1996 Report on the BAA highlighted the value of the interdependence between airport charges and commercial activities "without which airport charges and BAA's profits would be considerably higher" (MMC4 para 2.21). The CAA continues to acknowledge this position but the proposals now indicate a significant shift away from this over-riding interdependence and places all the profits accruing from these activities directly to the benefit of airports and their shareholders.

The designated airports have a monopoly on the provision of retail facilities but despite the need to address rent issues there has been no apparent input from the retailers.

- "It is likely that the CAA's preferred proposals set out in this paper would result in a shift of economic rents to the airports." The CAA's view is that airlines should have no automatic claim on scarcity or locational rents. (page x)

The users are not seeking all the benefits which accrue from locational rents but are looking for an element of those benefits by way of reduced airport charges in implicit recognition of the inter-relationship between airports, airlines and passengers in creating the opportunity for airports to earn profits on commercial operations.

Users question whether economic rents are, in fact, in operation at the designated airports. Airlines have to operate in a highly competitive market whereas airports are in a monopoly environment. This ensures that they are enabled to maximise rentals and therefore profits to provide guaranteed returns.

- Transfer from the Single Till to a Revised Regulatory Cost Base (Dual Till) - a vehicle to

raise prices towards (but not a full move to) market clearing prices as a signal and incentive for investment.

The MMC Report considered the single-till approach in some detail and whilst recognising that this gives rise to “evident problems” also acknowledged that “the existence of the opportunity for BAA to earn profits on commercial operations is due to the airline industry”. In its conclusions the MMC ***clearly acknowledged the difficulties but endorsed the single till as being the best available option.*** At that time the CAA also strongly supported maintenance of the single till principle (MMC.4, paras 2.21 and 2.22).

- The Consultation Paper also puts forward an opposing view that “while market clearing prices may provide good signals to airports where new capacity is desired, they may not provide good incentives to actually deliver it the airport may earn better returns through ongoing exploitation of current scarcity than it would by expanding capacity the price cap must strike a balance”. (page xiv)

It would appear from this statement that the CAA will be overly reliant in future on the good will of BAA to expand as and when required to meet the needs for additional capacity. In prioritising their future capital investments airports will always invest optimally to ensure that their commercial revenues are maintained and, if possible, increased. Overall the balance of investment incentives appears to be wrong - the most critical problem presently facing the industry is the need for provision of additional runway capacity in the south east.

- “a move to the RRCB as specified by the CAA would result in price caps that are generally higher than the single till as currently applied they would have the effect of transferring economic rents from intermediate airport users to the airports, and in raising the profitability of airport operations overall”. The CAA recognises that their proposals will increase the level of benefits accruing to airport shareholders more than continuation of the present single till approach. (para 18.48)

One of the CAA's statutory objective is to ***further the reasonable interests of users of airports within the United Kingdom.*** (page ix) The principle of raising costs through a positive regulatory action is patently contrary to this objective. There is no evidence of any benefits accruing to passengers from a transfer to the dual till - prices will increase without any mandatory commitment for the airports to invest. In terms of investment incentive there is no supporting rationale and there is no user support for the proposed changes.

Airlines operate on low margins and must, of necessity, therefore pass on directly any increase in airport charges by way of increased fares which will serve to further depress demand in all market sectors at a time when the industry is under intense pressure. In the present economic climate the airline market is especially sensitive to price increases. For example the charter market is highly responsive to variations in airport charges - a 1% rise in charges is calculated to result in a 3% variance in the market demand.

Users consider that under the dual till principle there will be very significant difficulties in

equitably allocating costs, particularly in relation to common-user areas and services, within terminal infrastructures, and in their future policing. Regardless of whether the single till is continued or not users consider that there is an urgent requirement to develop a code of practice on the allocation of costs for commercial common user areas and security provisions.

The manner in which surface access assets are treated ie whether they are to be considered as Regulated or Non Regulated, will have a significant impact on pricing to users. Despite the fact that the Heathrow Express was funded from the single till it is now proposed that this be removed. This also raises the critical question as to how the T5 access infrastructure should be funded.

- *“In relation to demand conditions and forward looking incremental costs these price increases would be rather modest. However, they would have the effect of transferring economic rents from intermediate airport users to the airports, and in raising the profitability of airport operations overall”*. (pages xix-xxi)

The resultant inequity should these proposals be implemented has already been addressed above. Users should not be expected to pay in advance for future outputs which reflect incremental costs.

Users maintain their over-riding support for the single till and are totally opposed to the proposal to move from the present simple single till principle to a complicated dual till mechanism which is acknowledged to be fraught with difficulties.

Users note that the CAA recognises there is no case to move away from the single till at either Manchester or Stansted but are minded to move away from it on the grounds of consistency. If there is such an overwhelming need for consistency then this should read across to all elements of the regulatory process.

2. **Capital Expenditure and Terminal 5 pre-funding** (page xxv/Chapter 11)

- *The CAA is currently proposing to set airport specific caps which would reduce the scope for future cross subsidisation.* (para 11.6)

Users welcome the proposal for stand alone price caps but are additionally seeking the introduction of a mechanism to ***ensure that all cross subsidisation is stopped***.

- *The CAA is proposing in future to rely on incentive properties contained within the price cap as a means of encouraging airports to invest where appropriate. An advance reward based incentive approach would be adopted rather than the imposition of subsequent penalties for any failure by airports to invest.* (Chapter 11)

Users wish to emphasise their position that the provision of appropriate capital investment to enable additional capacity and/or improvements in service quality to be delivered at the right time, and in the right place, to meet future increases in demand and/or changes in service requirements as they arise are of critical importance to the industry.

- *The CAA are not inclined, and see no opportunity, for mandating capital expenditure.*

(paras 11.65 & 11.66)

Users accept that the CAA can have no intellectual ownership of airports' capital investment plans and that any attempt to move toward such a position would significantly compromise both the management and financial accountability of the airport. The users are, nevertheless, strongly of the view that the dependence solely upon purely financial incentives for airports to make appropriate investments is a major weakness. It is their contention that designated airports should in future be made fully accountable for the timely provision of adequate additional capacity and service enhancement. They are seriously concerned at the lack of any such proposals by the CAA to introduce a mandatory accountability requirement and consider that this deficiency will serve to enable airports to continue to obtain financial benefits from the ongoing exploitation of their scarce resources.

In addition users believe that BAA should be required to make provision for the introduction of increased competition, particularly in relation to some specified activities. (para 15.12)

- The CAA recognises the need for airports to provide greater transparency and for enhanced and meaningful consultation with the users. (paras 11.56 & 11.99)

Users welcome the CAA's finding that there is a regulatory obligation for airports to provide fuller disclosure of the integrated information on their investment plans and to "invest" in the development of improved consultative processes with the users. They also fully support the proposal that the CAA will revisit this matter at future reviews should evidence emerge that the airports are regularly and unreasonably ignoring the declared preferences of users.

- The CAA proposes to account for T5 pre-funding by removing this value from the asset base and accepts that an additional element of pre-financing was implicit even if the price cap had remained at RPI-8. The proposal is to reduce by 50% any estimated gains which BAA has made through the deferral of capital expenditure and application of lower levels of investment through the present quinquennium (in fact over a 6 year period) by removing an equivalent amount from the asset base.

Users are broadly in favour of this proposal but require more detailed information on both the reduction in direct expenditure on T5 works and other alternative expenditure undertaken, which may have been brought forward prior to T5 coming on-line, before they can reach any final conclusions. In addition the level of the reduction total appears extremely arbitrary - the total could well have been higher, or indeed lower, than 50% and requires supporting justification.

- The CAA proposes to retain the pre-financing of investment by allowing BAA to add Assets In The Course of Construction to the asset base. (para 11.70)

Users are totally opposed to this approach on the grounds that it will in effect require them to carry the cost burden of paying to the airport a positive return on such assets in advance (possibly over an extended period of time) before they can enjoy any of the additional benefits from increased capacity in regular day-to-day operational use.

However, they are not totally opposed to the basic concept of pre-funding and in certain

specific instances, and with their prior agreement, could consider whether such an approach would be acceptable. Any monies accruing from such pre-funding must be totally ring fenced and/or placed in an escrow account.

- The CAA expects BAA to provide a mechanism which would give users confidence that the resultant higher charges would significantly contribute to the provision of additional capacity. (para 18.32)

The requirement for the provision of greater transparency on capital investment plans and enhanced user consultation has been addressed above. However, the present proposals are entirely subjective and users are seeking for the CAA to provide an objective basis upon which airlines may place as much confidence as possible that higher charges will, in substantial part, be linked to the delivery of capacity enhancements. The degree of user confidence will be in direct proportion to both the future level of charges and the additional capacity actually provided to meet user requirements.

3. **Service quality** - (pages xxii-xiii/Chapter 12)

Users appreciate the CAA's acknowledgement that quality of service is a significant issue for both airlines and passengers. para 12.1

The airlines therefore fully support the introduction of a Q term element into the regulatory process but the individual elements and their weighting must be fully agreed by the users. At the operational level performance must be objectively and totally independently measured and not subjectively assessed as with the passenger perception items. (para 12.13)

The Q term should be set at a sufficiently demanding level as to obviate the need to resort to bi-lateral agreements in order to achieve reasonable levels of both service provision and quality performance.

Punctuality is a key factor in airport operations with good on-time performance offering direct benefits to passengers and indirectly to improved capacity utilisation. Users are now working directly with BAA to develop meaningful performance measures and standards but the work is still in the very early stages. (para 12.89)

- The CAA refers to marked differences of views between airports and AUC on the one hand and airlines on the other. (para 12.14)

In its response to an earlier CAA Service Quality Consultation Paper, which is now in the public domain, BAA published the results of a survey into relative passenger priorities. Whilst airlines acknowledge that there are divergencies on the values of more general public issues the major concerns are those relating directly to operational performance which are common to both airlines and passengers.

- The CAA believes that contractual agreements on service quality are an important part of

service provision and will seek a regulatory framework which will not hinder this. (para 12.45)

Users support the basic principle of contractual agreements where an enhanced level of service is specifically required by a particular operator or group of operators. Such contractual agreements or bi-laterals should only be in recognition of the provision of higher quality standards and they should not be permitted for standards below the generic level. The key factor for users is the need to develop generic service standards which can be equally applied across all users of an airport in return for a standard price.

- The CAA position is that any Q term penalties incurred by BAA should be no more than 3% of revenue per passenger. (para 12.54)

Users broadly accept that an upper limit should be placed on penalties but are concerned at the lack of clarity as to how this limit should be applied - does the total cover both Q and D terms? Users are emphatically of the view that the D term must stand alone and be set such that it will have a significant impact on delays. Users note that work on aerodrome congestion (D term) is very much in the early stages and that a tri-partite working group is in the process of being established.

Users firmly believe that both the Q and D terms should be sufficiently demanding as to provide positive incentives for airports to achieve and maintain improvements in service quality. Whilst there are differences in specifics between the two terms the same basic principles should apply.

- The CAA accepts the need for a delay in fully implementing the Q term.

Users support the need for moderation in the implementation of charging revisions but would prefer a shorter time frame than that presently envisaged.

- The CAA wishes to allow rewards for better performance by BAA as well as imposing penalties for poor performance. (para 12.80)

Users are of the view that the generic standards agreed between an airport and its users provide a basic level of service below which penalties should automatically be incurred. They are **strongly opposed** to the notion that users should pay more for services or standards of service that they do not specifically request. This concept is inconsistent with customer choice, inconsistent with the move towards contracting that CAA say it wants to see, inconsistent with normal business practice and inconsistent with contract law. Improved performance that leads to better utilisation, increased capacity or higher levels of passenger perception will result in increased passenger throughput and increased revenue to the airport. Where higher levels of service or provision are implemented at the specific request of a user, or group of users, these should be the subject of bi-lateral agreements and therefore entirely removed from the regulatory process.

- *The CAA is not inclined to extend a quality term to Manchester.* (para 12.84)

Users consider that despite a number of bilateral agreements which are already in place at Manchester there is a need to apply service quality standards which are equally applicable to all the airport's users. This would also meet the CAA's declared need for consistency of application referred to earlier.

4. Pricing Structures

The tariff basket approach is complex and users are still awaiting data from the CAA's working model on the mechanics and likely implications. Until this data is available users are unable to input any properly considered comments. Overall users are doubtful of the claimed potential benefits arising from a change to what is acknowledged by the CAA as presenting complex problems in implementation and can see no reason to support any change from the present revenue yield approach. (para 14.24 & 14.26)

Users support the CAA's proposal that cost pass throughs should not be allowed in the price caps. The caveat that the CAA will revisit the question of meeting the costs of specific additional security requirements post September 11 is considered to be of particular importance. (para 14.73)

5. Public Interest Issues

As a generic issue users wish to stress the present lack of clarity in airport charges and the need to be able to identify what services are being provided for which charges. BAA suggested a basic list of the services and facilities covered by airport charges. MMC4, appendix 3.2 which users propose should be expanded to provide the required level of detail eg what precisely is included within refuse disposal.

Users believe that it would be in the public interest for details of the services and facilities provided, but not the levels of charges which will be covered by the Q term, to be incorporated within the Conditions of Use of each individual designated airport.

Users believe that a public interest obligation should be placed on the designated airports to provide an infrastructure master plan which has been agreed with users as being sufficient to meet their anticipated capacity requirements.

Users maintain that the lack of transparency provided by BAA and the poor consultative processes adopted are operating against the public interest. Full transparency should be provided to all airport users and regular consultations held with the appropriate airline representatives. (page 218)

Users recognise that there is a guide price system for rents already in operation at Heathrow. However, they consider that there is a requirement in the public interest for further improvements, for the system to be extended to Gatwick and Stansted and to cover all types of airport accommodation. (para 15.39)

Users believe that Manchester should be required in the public interest to provide greater transparency on their overhead and support charges. (page 220)

British Air Transport Association
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