

Airport Regulation

looking to the future – learning from the past

May 2004

Executive Summary

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Introduction

1. Good regulation means ensuring that regulatory frameworks and processes fit the circumstances of the industry being regulated. The CAA's consultation paper on airport regulation sets out how the CAA believes that airport regulation should develop in the run-up to the next airport reviews and beyond with the aims of ensuring that:
 - the CAA regulation of designated airports remains proportionate and cost-effective given the commercial nature of the parties on both sides of the regulatory bargain;
 - there is a clear definition of the role and responsibilities of other parties within the regulatory process;
 - the CAA leaves the greatest scope for constructive engagement between the commercial parties as the best means of fulfilling its statutory duties;
 - the position of smaller users, new entrants, and passengers is protected.
2. That we are still some four years from the earliest date for the setting of new price caps for designated airports gives time for all parties to think about what the CAA proposes and, crucially, to develop their own organisations to get the best out of it.
3. Good regulation also means learning the lessons from past exercises. While the recommendations in this document look forward, they also take full account of the experience of the reviews concluded in 2003. There are lessons there for the CAA certainly. But for other parties too. The intention of the CAA's consultation document is to draw these out and to map out a way forward which builds on what has gone before, recognises the contribution regulation can make (but also, crucially, its limitations) and places greater responsibility on those best placed (including the commercial parties) to deal with each aspect of the regulatory process.

The Regulatory Context

4. The last price reviews of the Manchester and BAA designated airports culminated in new price controls from 1 April 2003. From the launch of the first CAA issues paper in July 2000, the entire process (including input from the Competition Commission) took almost three years. It involved a significant commitment of resources from the regulatory bodies as well from industry participants materially affected by the decisions finally reached.
5. The CAA has taken the opportunity to reflect on this experience in preparing for the next review leading to new price controls from 2008. This has included seeking views from interested parties. As a result, the CAA acknowledges that on a number of fronts it has room for improvement. However, it believes that the key to better results next time around is for the CAA, airlines and airports all to consider how they can most effectively contribute to the regulatory process.
6. The purpose of this summary document, and the detailed report from which it is drawn, is to set out how the process and the contributions of all parties might indeed be rethought for next time. The CAA encourages comments

(which should be delivered by end July 2004) on both the merits of its proposed approach and how it might be improved upon.

Lessons from the Last Reviews

7. The regulatory debate that took place over the course of the last reviews was vigorous. Not only was there a wide range of views about the merits of the policies pursued by the CAA, but also significant differences in expectations about the approach of the CAA to regulating BAA's south east airports and Manchester airport, and in particular, how it assesses their business planning information.
8. Many users did not feel able sufficiently to influence the CAA's agenda or believe that it adequately reflected their needs. There were a number of reasons for this, partly stemming from the length and complexity of the process and partly from the decisions themselves. Of course, it would be a rare regulatory process that left all parties content. Nevertheless, there are important lessons here for the CAA. Some of these relate to matters of organisation, presentation and skills. But a general lesson is that a greater degree of shared ownership of the regulatory process and agenda by airports and users is critical to a successful review next time around.
9. While some review issues are indeed most appropriately led by the regulator, there are others more focussed on the organisation, cost and nature of the services provided by airports where there is scope for airlines (in conjunction with airports) to play a more proactive role, in the context of a framework set by the CAA. They should be better placed than the regulator in terms of their knowledge, operational experience and commercial focus to deal with those issues which most directly affect the cost and quality of the services they receive. This recognises that where information is both imperfect and imperfectly distributed, determining who is best placed to do what is central to making good decisions. It is also important in ensuring that regulatory burdens and staffing are kept to the necessary minimum.
10. To support this evolution of the regulatory process, the CAA is prepared to commit to specific improvements in its conduct of the reviews both to deal with criticisms that have been made but also to facilitate better airport/user dialogue. These are:
 - adopting a more evolutionary approach, so that fundamental regulatory choices are not revisited at every five yearly review;
 - making its consultation and decision documents more accessible;
 - describing more clearly the effects of its proposals on users generally, and on particular user groups;
 - taking better account of empirical and market data in its analyses;
 - publishing separate short documents at the same time as consultation documents to summarise the key questions and the implications of policies;
 - continuing to use workshops and seminars to draw out debate on key issues;
 - developing the advisory panel so that it also provides an external aviation perspective on the economic policy being developed; and
 - seeking to agree a single and audited financial model for each price controlled business, that models the effect of alternative revenue, cost

and volume scenarios, and should be operable by any competent user.

11. The CAA is also considering moving the Manchester airport price control on to a one year lag relative to the BAA price control, through a one-off extension of the Manchester price cap for a sixth year (in recognition of airlines' concerns about managing their resources over time to participate in the regulatory consultation).
12. The CAA will also set out well in advance the regulatory process; and give greater clarity on how it will be minded to consider contributions from airlines and airports. In return, it will be asking both sides of the industry to consider proposals on better integrating - and promoting - dialogue on the business issues driving airport capital and operational spend in the regulatory process. The CAA will continue to be responsible for the process overall and to lead on those parts of the review where its expertise and judgement is most relevant. But the CAA's approach means effective regulation in aviation increasingly deriving from a collaborative effort where the regulator's role is one of facilitating a greater strategic airport/airline dialogue.

Key Features of Designated Airports

13. Airlines have a strong interrelationship with airports which, when looked at in its entirety, suggests to the CAA that they may be uniquely well-placed to provide insights into the some of the key issues that arise in any review:
 - both airports and airlines interact with the final customer - the passenger - throughout the delivery process;
 - the efficient delivery of air transport services depends on close daily operational interaction between airlines and airports;
 - airlines experience many more dimensions of service quality than network users in industries such as water and energy;
 - given the importance of non-aeronautical income to airports, both airlines and airports have a shared interest in increasing passenger throughput.
14. These features together suggest that not only do the airlines have a commercial imperative to contribute to the business planning of the airports, but that they are relatively well-placed to do so because of the insights and information they uncover from their business and operational interactions.

Making Regulation More Effective

15. Airlines, of course, already use their knowledge of airport processes to contribute to airport development, and this often leads to good working relations at operational level. However, this is not always reflected in more strategic interactions, including in regulatory reviews. Indeed, expectations of the regulator's process may tend to discourage strategic engagement between airports and their users since, at least on the bigger budget and cost questions, the expectation is that "the regulator will decide". There are of course good economic reasons why the regulator has a statutory role in the airline/airport relationship at designated airports. But there is a risk of regulatory judgement displacing commercial judgement when in fact the best answers are to be found from those who must use, pay for and live with the decisions that are made.

16. A general expectation of regulation is that the more evident the exercise of market power by the regulated company, the more active and interventionist the regulator is likely to be in addressing it. One feature of this approach is the implication both that “more” regulation leads to better regulation and that, on any given issue, the regulator is automatically best placed to step in as a proxy for market disciplines and consumer preferences in a manner that will lead to the best outcome. That may not be the case, in particular where customers, themselves (often large) businesses rather than individuals, should in principle be able to organise themselves to make their own views felt.
17. Furthermore, this view of regulation underplays the potential role of regulation in achieving results through shaping expectations, defining roles and responsibilities and creating process incentives that promote behaviour leading to efficient outcomes. These factors are important because regulation itself potentially imposes costs and carries risk, for example, from, a regulatory decision pre-empting a more commercially driven solution. Such costs may be difficult to measure, but could include distortion in resource allocation and reduced investment incentives.
18. The focus should therefore be on *effective* regulation: working smarter, rather than necessarily harder. The aim of effective regulation should be to deliver results that exceed its direct and indirect costs and to be flexible in its methods, recognising its own limitations as well as its strengths. Facilitating outcomes reached by market participants may therefore be preferable to direct intervention, where there is reason to believe that they are better placed (than the regulator) to reach the right answers.
19. Such an approach also has the potential to empower users to take more responsibility for shaping key commercial outcomes that affect their business. That will have significant implications for airports. The regulatory process will, in future, mean their focussing more on their customers and less (than in the past) on persuading the regulator.
20. The CAA fully recognises that strategic engagement between airports and their users depends on the willingness of both sides to appreciate the value to them of reaching joint agreement wherever and whenever possible. And where such agreement has not been possible the reasons for its absence should have been revealed and communicated on the basis of genuine attempts to meet the other side’s concerns. A key role for the CAA is therefore to facilitate a framework in which such engagement can occur. That depends on establishing processes which incentivise agreement by placing the onus on each side to demonstrate engagement with the other. This starts with a definition of roles and responsibilities.

Defining Roles and Responsibilities for the Next Reviews

21. The proposed approach to future price reviews is designed:
 - to empower users and airports to take more ownership of the regulatory process;
 - to place more responsibility on designated airports to demonstrate that their plans reflect their current and future users’ preferred combinations of outputs and service levels under various budget options;
 - to focus the CAA’s contribution on underpinning, rather than supplanting, airport/airline strategic interactions; and

- to make the regulatory process complementary to normal commercial interactions (rather than a potential distortion of them).
22. For work streams in the review process, relating to the regulatory policy framework, where the regulator is best placed to lead the CAA will need to remain the driver of decision-making. However, in areas such as operating and capital expenditure and service quality, users and airports together should take greater responsibility. To do so they need to understand from the outset what is expected of them. So the CAA proposes an allocation of roles which places airports and airlines more directly in touch with each other (than with the regulator) on those issues on which a commercial agreement is likely to yield most value relative to a regulatory decision.
23. The CAA will:
- set out early in the process as clear guidance as possible on the approach it intends to take on specific matters where it is able to "pre-commit" (in policy terms, if not legally). The main purpose of this would be to assist the industry in planning realistic future scenarios by reducing the number of regulatory variables;
 - publish guidance on what issues it expects the airports and airlines jointly to consider, the objectives that the airlines and airports should have in mind in considering these issues, and how the issues would fit into the next price control review. This could be done following this consultation to give the maximum time for the parties to create or augment processes for engagement;
 - require the airport operators to provide airlines with the information they need to take part in this process, building on the approach agreed with BAA and Manchester Airport on enhanced information disclosure and consultation (in annex 4 of the CAA's 2003 decisions on BAA's London airports and Manchester airport¹); and
 - ensure, in particular, that the airlines and airports have special regard to protecting user interests who may not, for various reasons, be well-represented in the dialogue with the airports (including passengers and potential new entrants).
24. Airport operators would be expected to:
- provide the information to airlines in a timely and useful way;
 - engage constructively in discussions with the airlines. This entails exploring with airlines efficient ways of meeting their requirements;
 - spell out clearly the financial consequences, the value for money of, and the trade-offs between, costs and services in relation to options for both operating and capital expenditure; and
 - produce a price control review business plan, that is a result of this strategic engagement. This should flow clearly from the airports' internal processes in time for consideration by the CAA at the appropriate point (probably summer 2006) in the review process;
25. Airlines would be expected to:

¹ The agreement with BAA can be found in Annex 2 of this document. The agreement with Manchester is virtually identical to that with BAA.

- negotiate constructively with airport operators on their requirements in relation to inputs and outputs;
 - reach a clear, defined view upfront about the information they need to review the operators' plans;
 - reach an informed, considered view (jointly or individually) on the airport operators' operating and capital expenditure. Where the airlines are in disagreement with the airport operators or amongst themselves, they should provide systematic and detailed evidence to support any criticisms they make, explaining why current practice or proposed solutions are inefficient, or how their views have not been adequately taken into account.
26. Airports and airlines already interact through a variety of groups and committees, although no single forum currently manages and delivers strategic agreements between the parties in the way envisaged by the CAA. There would therefore need to be some development of existing fora. While the CAA could facilitate the interaction to the extent that this is useful or appropriate, the mechanisms that airports and airlines use to drive the process to deliver the results targeted by the CAA framework would primarily be a matter for them to resolve, with the airports expected to take the lead since they must ultimately aim to deliver the required business plan.
27. The CAA recognises that the consensus view of airlines at a particular designated airport on, for example, the right mix of components in a capital expenditure programme would not necessarily add up to the most appropriate programme for the industry and its users if it foreclosed opportunities for new entrants or other airlines to the detriment of users' long term interests, or if it failed to take into account passenger interests. However, in an imperfect world, the best approximation of where spending should be directed in users' overall interests should give centre-stage, in the first place, to the views of those who must live with the prices and service implied by expenditure decisions. But it will be for airlines and airports to demonstrate to the CAA and the industry as a whole that they have taken into account user interests in the widest sense including over the longer term. However, the CAA will be particularly mindful of these issues when reviewing what is submitted by the airports. Competition law and section 41 of the Airports Act also provide protection to concerned parties.

Price Control Review Business Plan

28. There has already been significant progress in airport/user interaction on capital expenditure plans. But this needs to go further. The CAA is open to ideas about the precise content of the airports' price control review business plans, although we would expect them to draw heavily on the requirements for transparency agreed with BAA and Manchester at the end of the last reviews. The important point is that they should *follow* engagement with airlines and that this should itself *precede* submission to the CAA.
29. In the case of BAA, there should be separate price control review business plans for each of the three designated London airports.
30. Given the timing of the next BAA review, which requires new price caps to be in place by April 2008, and taking into account the statutory role of the Competition Commission in the process, the CAA suggests that these BAA price control review business plans need to be presented to the CAA by the summer of 2006. The CAA is also giving consideration, subject to this

consultation, to extending the Manchester price cap for a sixth year in order to introduce a one-year lag for Manchester relative to BAA. If the CAA proceeds on this basis, the Manchester business plan would need to be presented to the CAA by summer of 2007 in time for a new price cap from April 2009.

31. Whilst the requirement to produce the plans naturally rests on the airports, the engagement process from which the plans should result is the responsibility of both the airports and their airline users. Airline contributions need to address preferred outputs, preferred service levels linked to these outputs and a realistic appraisal of what the industry is likely to be required to pay to obtain them. Any airline issues around airport performance need to be dealt with on the basis of evidence. This could most usefully be developed in the context of joint airport/airline working to improve both airport efficiency and mutual understanding of operational and other challenges. The CAA is pleased to note that such work is already beginning in London and at Manchester.
32. This emphasis on an evidenced, costed approach from both sides is important because it should tease out the underlying business realities. That, transparently done, should help to incentivise agreement. There may be concerns from the airports about the confidentiality of business planning data, limiting their ability to provide data that users may want. If this is the case, the CAA will need to assess the legitimacy of these concerns, but it does not believe that such concerns should prevent meaningful strategic engagement.
33. The CAA will continue, as required by law, to set price caps at the four designated airports. The key change is the scope for agreement between airports and airlines to determine key inputs into that decision. The CAA accepts that securing agreements between airlines and airports will be no easy task, particularly against the background of expectations established by a regulatory system. Airlines will need to recognise the need to resource this in the way they would other key business negotiations. And they will need to ensure that differing - and entirely natural - commercial motivations can be accommodated to ensure benefits for all. The challenge for airports will be to see the regulatory process as an integral part of the continuing dialogue with customers.
34. In the absence of agreement the CAA will, as now, provide a regulatory determination. But recourse to regulatory decision-making process should be a last resort. The CAA does not want a mutual standoff in negotiations, based on the underlying assumption by one or both sides that the regulator will provide a favourable fix if the parties themselves cannot do so. The parties need therefore to be aware that - as the CAA has demonstrated in the past - regulation is about reaching a view on the merits of the argument and not about splitting the difference between entrenched positions. In these circumstances parties need to consider - in addition to perceived upsides - the potential downsides of leaving decisions to the regulator.

Competition Commission

35. The statutory requirement for the CAA to make a reference to the Competition Commission adds a layer of complexity to the arrangements for airport regulation. However, the CAA does not believe that it should prevent the parties engaging. If airports and airlines can demonstrate that they have reached a consensus view and agreed costings on key issues, it could be expected that the Competition Commission - like the CAA - would take that seriously into account in reaching its own conclusions, providing it was clear

that the industry consensus was in user interests overall. After all, in other regulated industries, the Competition Commission is only involved at all in these processes where there is disagreement.

Conclusion

36. Regulated companies - and, indeed, users - are often inclined to note the regulatory risks to which they are exposed and how costly this is for them. Generally there are good reasons for the statutory powers regulators are given, and it is difficult for them to eliminate the regulatory risk their presence imposes on industry. However, they can mitigate it, and in this case that includes greater and more structured involvement of those better placed to understand user needs in key decisions.
37. Final decisions and responsibility in a legal sense will continue to rest with the regulator. But if an agreement can be better reached by the parties, the regulator is likely to have a preference for it, provided the regulator is satisfied that the agreement meets user interests overall and is consistent with its statutory obligations.
38. This is part of a recognition by the CAA that regulation in the circumstances of the aviation industry should involve determining more precisely where the regulator can add most value relative to others. This provides an opportunity for airports and users to reduce their regulatory risks and take more control of the regulatory agenda, through embedding it in their own commercial processes.
39. The CAA commends this approach to the industry and invites comments.