

In Focus

A briefing from the Civil Aviation Authority

January 2014

Preparing for a future with passengers at its heart

Economic regulation at Heathrow, Gatwick and Stansted

Context

On 10 January 2014, the Civil Aviation Authority (CAA) published our final decisions for the regulation of Heathrow and Gatwick airports between April 2014 and 2019. We also announced that Stansted Airport's services to passenger airlines will no longer be economically regulated.

The decisions followed the first review of economic regulation the CAA has carried out under the Civil Aviation Act 2012. This Act gave the CAA a key duty to focus its economic regulation on protecting the interests of consumers (including cargo-owners) where appropriate by promoting the development of competition between airports. The CAA will also ensure regulated airports are able to invest in new infrastructure, when it is in the passenger interest.

A key market change since the last economic regulation review five years ago is that Heathrow, Gatwick and Stansted now all have different owners. New management teams have taken quite different approaches: we have seen significant operational innovation at Gatwick,

while Stansted's new owners have signed long-term contracts with their main airline customers. Although the scope for competition between London airports is limited by capacity shortages, this diversity of management approach can enable innovation and improve passenger experience.

Why we regulate airports

We only regulate airports when competition (including competition law) will not fully protect passengers' interests and where the benefits of regulation outweigh the adverse effects.

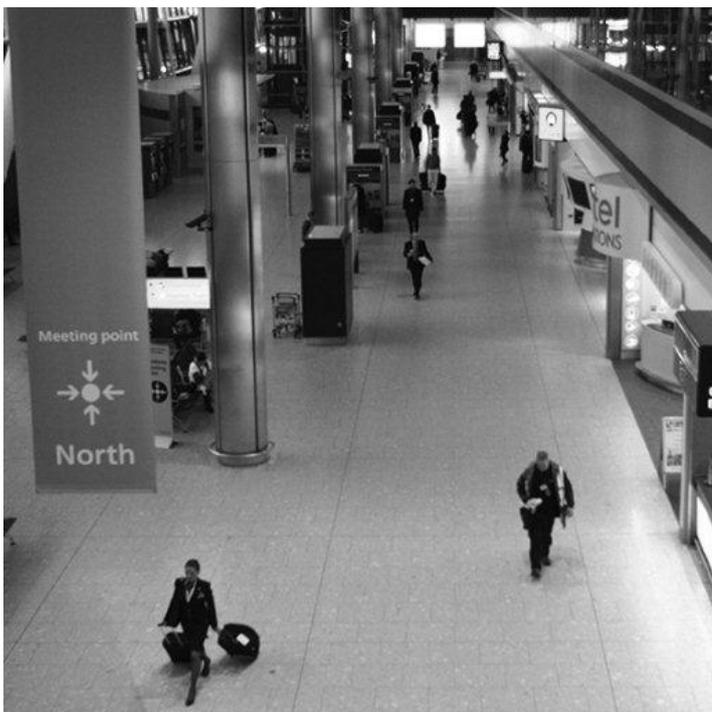
When airlines or passengers have limited or no choice to go elsewhere, for instance because of capacity constraints, airports are not constrained by competition. They can abuse that market power to the detriment of passengers, or air cargo owners. So the CAA regulates them to ensure that passengers are protected, by not being overcharged or having to use facilities that are not up to standard.

If we de-regulated airports with significant market power they could simply increase charges to airlines and ultimately to passengers who have

nowhere else to go, or reduce service quality. This would benefit their shareholders, not passengers. They may have no significant incentives to invest their profits in new terminals, or in ensuring their current ones meet passenger expectations. When an airport has significant market power, regulation is the best way to ensure airport charges fund future investment not short-term gains, while offering a fair return to investors.

Regulating to support a competitive market

Competition pushes companies to innovate and respond to passenger preferences. It is more flexible than regulation and better where competition is in fact possible. Well-designed regulation promotes competition and does not hinder it. For instance, under the CAA's price controls, airports are free to discount charges to individual airlines (within the constraints of competition law), so they can compete hard to win new business. The CAA has promoted the conditions that allow such markets to develop over time, which can remove the need to regulate altogether. This was the approach we took with Manchester Airport, which was regulated until 2009, when sufficient competition from nearby airports had developed to assure us that competition was strong enough to protect passengers in the absence of regulation.



Regulation does not stifle competition; it only protects passengers in its absence.

Process to reach decisions on economic regulation

The decisions are based on the CAA's assessments of market power at Gatwick, Heathrow and Stansted. These assessments set out the level of market power each airport has. Where we have determined that an airport has significant market power, the decisions set out what tailored approach to regulation would best match the individual issues at each airport. In each case, we have reached our decisions to ensure the best deal for the travelling public and cargo-owners. Extensive industry consultation and research into passenger needs has been carried out throughout the process. This has run since 2011, with Initial Proposals in April 2013 and Final Proposals in October 2013, and the CAA's final views were amended to take into account the latest developments. With this work now complete, the final market power determinations and statutory notices about regulation have now been published along with the underlying reasons.

A new licensing system

This was the first review of economic regulation carried out under the Civil Aviation Act 2012, which brings in a licensing regime that allows for much more flexible regulation. Conditions for Heathrow and Gatwick will be set within their licence, which can be amended where necessary (subject to due process). Consistent with better regulation principles, we have not sought to regulate for all eventualities in the first licences granted to the airports but only pick key priorities for inclusion.

Because we understand how important service quality during disruption is to passengers, one of the first licence conditions will strengthen each airport's approach to operational resilience. The conditions will ensure that the airport has robust plans to deal with disruption, and an effective approach to collaboration. This will also ensure there is clear and timely communication with affected passengers.

Our final decisions

Heathrow – investment & efficiency

During the consultation the CAA carried out to reach our final decisions, Heathrow called for a 4.2% annual real-terms increase in its charges up to 2019. Its airlines asked for a 9.8% per year cut. Our final decision on Heathrow confirmed a price control that will see prices fall in real terms by 1.5% per year (RPI-1.5%). That compares to our final proposals in October, which proposed increases in line with inflation (RPI+0%). A key reason for this change is the stronger passenger forecasts over the next five years, whilst the cost of capital has also been revised.

This decision places affordability centre-stage while ensuring there is still a supportive environment for further capital expenditure (with provision for nearly £3bn of investment).

Gatwick – focused and flexible regulation

Gatwick has set out a series of commitments to its airlines on price, service conditions and investment. This includes a commitment to raise prices in-line with inflation only (RPI+0).

Overall, we consider the airport's commitments are in passengers' interests, so long as they are backed by a licence to ensure they are honoured and prices remain fair. Gatwick will have the ability to drop prices below its committed level, and we will monitor prices. Our current benchmark for a fair price path is RPI-1.6% per year. The licence means the CAA can continue to act where appropriate to protect users, for instance if there are reductions in service quality that are against the passenger interest. Finally, the licence will also allow us to scrutinise most second runway costs before they can be passed on to airlines and passengers.

Stansted

On 17 October 2013 the CAA launched a consultation on the impact for market power of recent long-term agreements between Stansted Airport and its airline customers. The CAA also



confirmed in December that we would complete separate assessments for the airport's passenger and cargo markets.

The CAA has now completed its assessment for Stansted's passenger market, and determined that the airport does not have substantial market power. The airport's services to passenger airlines will therefore not be economically regulated from April 2014 onwards. A decision on Stansted's cargo market power is will be published by the end of March 2014.

Next steps

The CAA has now published its final decision documents, with airport licences for Gatwick and Heathrow due to be published on 14 February. The licences should then come in to effect on 1 April 2014 (subject to appeal).

Final decisions

[Economic Regulation of Heathrow, Gatwick and Stansted web page](#)

[Economic Regulation of Heathrow Airport Limited after April 2014: the CAA's Final Decisions](#)

[Economic Regulation of Gatwick Airport Limited after April 2014: the CAA's Final Decisions](#)

[Estimating the cost of capital: a technical appendix to the CAA's final proposals for economic regulation of Heathrow and Gatwick after April 2014](#)