

# Economic regulation: A review of Gatwick Airport Limited's commitments framework

## **Findings and conclusions**

CAP 1502



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# Executive summary

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## Background

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1. In 2014 we introduced a new lighter touch framework for our economic regulation of Gatwick Airport Limited (GAL). This is based on a set of commitments, given by GAL, which include a maximum level of airport charges over the seven years to March 2021 and a system of service quality rebates. Following a consultation in March 2016 and confirmation of the scope of the review in July 2016, this document sets out the findings of our mid-term review of the new framework.
2. Reflecting the fact that on-time performance at Gatwick has been poor in recent summers, and taking account of feedback from stakeholders, our review has focused on three main issues:
  - GAL's service quality and airport resilience (including on-time performance);
  - GAL's investment performance; and
  - GAL's relationship with airlines and other stakeholders.

## Main findings

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3. Many aspects of the new framework appear to be working well. Among other things:
  - GAL has agreed bilateral contracts with airlines representing more than 85 per cent of passengers;
  - traffic growth has exceeded expectations and overall passenger satisfaction has increased since the start of the commitments period;
  - GAL has held its charges below the 'fair price' benchmark we established in 2014 and met most of its service quality targets; and

- none of the airlines we spoke to argued for a return to the form of regulation we previously applied to GAL (and continue to apply to Heathrow Airport Limited).
4. One of the potential advantages of the commitments framework is that GAL has more flexibility to tailor its **investment** to the needs of airlines and in response to changing circumstances. GAL has implemented a number of new or accelerated investment projects, especially in terminal facilities and processing. The total volume of investment each year has been close to the forecasts that underpinned our fair price benchmark, and substantially higher than the annual average of GAL's minimum commitment. However, GAL has not yet expanded airfield capacity in response to stronger than expected traffic growth. It is now discussing some proposed projects with airlines.
  5. GAL and its airline users have quite different views on whether or not the resulting capacity constraints on the airfield are contributing to poor **on-time performance**. There are many different causes of delay (including air traffic control delays and ground handling problems) and GAL has introduced a number of operational initiatives, in co-operation with airlines and others, to address some of the likely causes of poor on-time performance. It is unfortunate, therefore, that GAL and the airlines have made little progress in agreeing whether airfield capacity constraints are exacerbating delays and, if so, taking action to address the situation.
  6. GAL's **relationships with airlines** appear mixed, with certain aspects of these relationships raising possible areas of concern. On the positive side, some airlines told us of good relationships at the commercial, strategic and financial level and of some recent improvements for example in capital investment consultations. GATCOM's Passenger Advisory Group told us of GAL's enhanced willingness to engage with them under the new framework and to give serious consideration to their comments. But airlines also told us of a poorer relationship at operating level and with airline representative bodies. They feel that there can be a lack of genuine

engagement and that, when they raise issues, GAL's response can be defensive and sometimes abrasive.

7. We welcome GAL's decision to set its **charges** below our fair price benchmark during the first few years of the new regulatory framework, and also its recent offer to airlines that, over the commitments period as a whole, it does not intend to exceed our fair price benchmark. If GAL were to increase its charges above our fair price benchmark, we would need to consider the most appropriate regulatory response.

## Conclusions

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8. We are encouraged by the general support the new regulatory framework continues to receive, and have not seen evidence that the problems noted above are leading to a material adverse impact on passengers. Indeed, traffic growth has continued and GAL has met most of its service quality targets.
9. Therefore, we are not proposing specific changes to the commitments framework at this stage. However, we have potential concerns about the progress of airfield investment projects and some aspects of GAL's relationships with airlines, and will include both of these issues in our ongoing monitoring of GAL's performance under the commitments framework.
10. We look to GAL to make good progress with its current proposals to provide additional pier capacity and to accommodate passengers arriving from the Common Travel Area, and to adopt a proactive approach to identifying and addressing possible future airfield capacity constraints. If capacity constraints are not being addressed, or if there is evidence that airfield capacity constraints are having a material impact on on-time performance, then we may need to consider further measures.
11. It is important that GAL takes steps to improve its relationships with airlines, especially at operating level. This requires a genuine willingness to listen to and respond constructively to airline views. If there is evidence

in future that GAL is acting in a way that risks having a material adverse impact on passengers' interests, then we will consider whether further intervention might be required.

12. The quality of GAL's relationships with airlines and other stakeholders is also an important factor (along with others, including GAL's investment performance and any impact on on-time performance) that we will take into account in any future consideration of the need for and form of economic regulation at Gatwick, including any future Market Power Determination or any review of the form of economic regulation to apply at Gatwick after March 2021.

## Next steps

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13. We will continue our ongoing monitoring of GAL's performance under the commitments framework. As well as requiring an annual performance report, we will continue to have regular meetings with both GAL and its main airline customers to review recent developments and consider any problems arising.
14. Separate from this review of the commitments framework, CAA is carrying out a wider programme of work to understand the challenges facing congested airports in the UK (see box).

### **Operating resilience of the UK's aviation infrastructure**

CAA is currently carrying out a wider review of the operating resilience of UK aviation infrastructure. This will examine the current balance of delay and punctuality against the number of flights, particularly in the industry's planning and operational processes, and will comment on how well it reflects the user interest. We are also undertaking an independent study of the causes of delay at Gatwick, focusing on planning and scheduling processes and the operation of the first wave. We intend to publish our recommendations in spring 2017.

15. We are not setting a specific date for any future reviews of the commitments framework. If GAL makes good progress on the issues

noted above, and if no significant new problems arise, then our next review of the framework could well form part of a wider programme of work looking at the regulation of GAL beyond the current commitments period (which ends in March 2021). We are likely to need to start considering these issues within the next two to three years.

16. However, if any serious problems arise, and especially if there is a risk of a material adverse impact on passengers' interests, we will consider whether earlier intervention is required. In addition, if we were to conclude in the light of further evidence, such as our wider work on the causes of delay at Gatwick, that an economic regulation remedy was necessary and proportionate, we would expect to discuss this with stakeholders within the current regulatory period.

## Chapter 1

# Introduction

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## Purpose of this document

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- 1.1 This document reports the findings and conclusions of our mid-term review of the economic regulatory framework that we now apply to Gatwick Airport Limited (GAL). It follows a consultation document that we published in March 2016<sup>1</sup> and an update that we published in July 2016 confirming the scope of the review.<sup>2</sup>
- 1.2 When implementing the new framework in 2014, we said that we would carry out a ‘short and focused’ review in the second half of 2016 to consider whether it was operating in passengers’ interests. In our consultation document we described the review as an early ‘health check’ on a new regulatory framework, rather than a reopening of the conclusions we reached during the ‘Q6’ review.
- 1.3 Nevertheless, in our July 2016 document we also noted that on-time performance at Gatwick had been poor in recent summers. Reflecting this, and the possible ways that the commitments framework might affect on-time performance, we proposed that the review should focus on three main areas: GAL’s service quality and airport resilience (including on-time performance); GAL’s investment performance; and GAL’s relationship with airlines and other stakeholders.
- 1.4 Our findings in each of these areas are reported in Chapter 2 to Chapter 4 below. We also looked at some aspects of GAL’s charges, as described in Chapter 5. Our conclusions on how well the commitments framework is working and our overall policy conclusions are set out in Chapter 6.

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<sup>1</sup> CAP 1387, Economic regulation: A review of Gatwick Airport Limited’s commitments framework – A consultation document. Available at [www.caa.co.uk/cap1387](http://www.caa.co.uk/cap1387).

<sup>2</sup> CAP 1437, Economic regulation: A review of Gatwick Airport Limited’s commitments framework – Update. Available at [www.caa.co.uk/cap1437](http://www.caa.co.uk/cap1437).

- 1.5 During the course of the review we benefited from discussions with GAL, airlines and passenger representatives, and from GAL's response to a previous information request. We thank all of these parties for their co-operation.

## **Our primary statutory duty**

- 1.6 The Civil Aviation Act 2012 ('the Act') gives us a single primary duty to carry out our economic regulation functions in a manner that we consider will *further the interests of users of air transport services*. Under the Act, users of air transport services are defined as present and future passengers and those with a right in property carried by the service i.e. cargo owners.
- 1.7 The scope of our primary duty concerns the *range, availability, continuity, cost and quality of airport operation services*. We must carry out our functions, where appropriate, in a manner that will *promote competition in the provision of airport operation services*.
- 1.8 In discharging this primary duty we must also have regard to a range of other matters.<sup>3</sup> These include:
- the need to secure that GAL is able to finance its provision of airport operation services;
  - to secure that all reasonable demands for airport operation services are met;
  - to promote economy and efficiency in the provision of airport operation services;
  - the need to secure that GAL is able to take measures to reduce, control or mitigate adverse environmental effects;
  - any guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and
  - the better regulation principles.

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<sup>3</sup> See section 1(3) of the Act.

## Overview of the commitments framework

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- 1.9 The commitments framework was introduced in 2014 at the conclusion of our Q6 review of the price caps at Heathrow and Gatwick airports. For Gatwick, we decided to base our regulation on a set of commitments offered by GAL, rather than a price cap set by us. Among other things, we felt that the commitments framework would encourage bilateral contracts that could be better tailored to the needs of individual airlines and their passengers, and would facilitate efficient investment as GAL would have flexibility to tailor investment to the needs of airlines.
- 1.10 In summary, the commitments include:<sup>4</sup>
- a price commitment – based on price paths of the Retail Prices Index (RPI)+0% for the ‘blended’ price (which takes accounts of discounts agreed in bilateral contracts) and RPI+1% for the published price;
  - a service standards commitment, incorporating a system of service quality rebates similar to those included in GAL's Q5 price cap;
  - an investment and consultation commitment, including a commitment to develop the infrastructure to allow GAL to meet service quality standards and to invest at least £700 million during the seven years of the commitments; and
  - other conditions relating to a continuity of service plan, operational and financial resilience, and a financial information commitment.
- 1.11 We decided that the commitments would be backed by a licence, to ensure that they are honoured and so that we can continue to act where appropriate to protect passengers. We also made it clear that we would monitor how the new commitments and licensing regime was operating in practice.
- 1.12 During the Q6 review we continued to develop our own view of a fair price (based on our calculation of a traditional price cap). By the end of the

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<sup>4</sup> Formally, the commitments are a collection of specific contractual obligations included in GAL's Conditions of Use. These are listed in Condition C1.11 of GAL's licence.

review our fair price benchmark was RPI-1.6%, somewhat lower than GAL's commitment for the blended price.

1.13 To date, our ongoing monitoring of GAL's performance under the commitments has focussed on four main areas:

- the level of charges – specifically we compare the outturn blended price with our fair price benchmark;
- service quality, and especially any repeated failures (since if GAL misses a particular target for six months in a financial year then no further rebates are payable for that target during the rest of the year and GAL's incentives are therefore diluted);
- shadow regulatory asset base (RAB) – we require GAL to calculate a shadow RAB in case tighter regulation needs to be reintroduced;<sup>5</sup> and
- operational resilience – GAL is required to consult on and publish its operational resilience plan by 1 October 2014, and then to review the plan annually.

1.14 GAL publishes an annual performance report each year, including information on traffic growth, airport charges (including a comparison with our fair price benchmark) and service quality. These reports are available on GAL's website.<sup>6</sup>

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<sup>5</sup> We also said, however, that there would be no presumption that GAL's shadow RAB number would be used as the basis for a future price cap.

<sup>6</sup> See [www.gatwickairport.com/business-community/about-gatwick/company-information/how-we-are-regulated](http://www.gatwickairport.com/business-community/about-gatwick/company-information/how-we-are-regulated).

## Chapter 2

# GAL's service quality and airport resilience

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## Introduction

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- 2.1 In our July update document we confirmed that on-time performance would feature prominently in our review of GAL's service quality and airport resilience. On-time performance is important to passengers and had been poor at Gatwick in each of the previous two summers. However, we noted that on-time performance is affected by many different factors, and we are also carrying out a wider review of the operating resilience of UK aviation infrastructure. We stressed, therefore, that the current review would focus on whether any aspect of the commitments framework is making the problems associated with poor on-time performance worse.
- 2.2 Our wider review of operating resilience will examine the current balance of delay and punctuality against the number of flights, particularly in the industry's planning and operational processes, and will comment on how well it reflects the user interest. In support of this we have undertaken an industry request for information<sup>7</sup> and qualitative consumer research.<sup>8</sup> We are also undertaking an independent study of the causes of delay at Gatwick, focusing on planning and scheduling processes and the operation of the first wave. We intend to publish our recommendations in spring 2017.
- 2.3 In relation to other aspects of service quality, as well as looking in general at how well the system of service quality rebates in the commitments framework is working, we said that we would consider how exemptions

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<sup>7</sup> CAP 1420, Operating resilience of the UK's aviation infrastructure: A request for information. Available at [www.caa.co.uk/cap1420](http://www.caa.co.uk/cap1420).

<sup>8</sup> CAP1472, Consumer research attitudes to journey disruption - A qualitative research report. Available at [www.caa.co.uk/cap1472](http://www.caa.co.uk/cap1472).

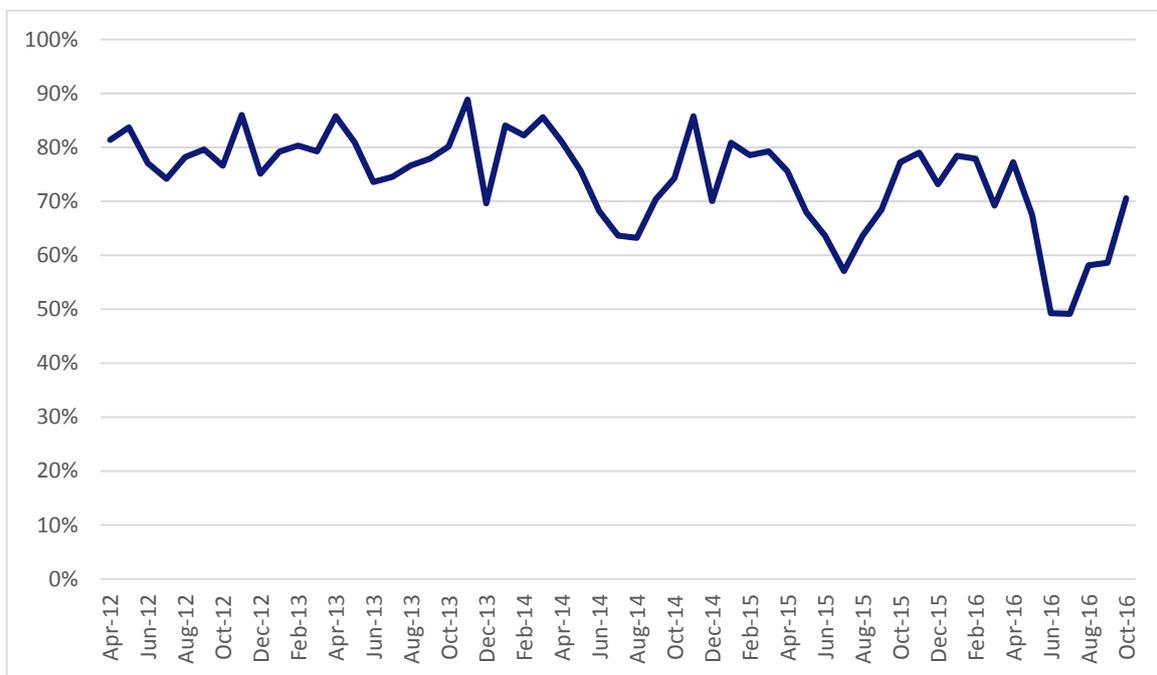
from these rebates have been applied and how this has affected passengers' interests.

## Developments since the start of the commitments period

### On-time performance

2.4 Figure 1 below shows that on-time performance at Gatwick has been deteriorating over the last few years. Each year, the proportion of delayed flights has increased during the peak summer months. In June and July 2016, more than 50 per cent of flights were delayed.

Figure 1: On-time departures at Gatwick,<sup>9</sup> April 2012 to October 2016



Source: Eurocontrol

2.5 A number of different factors are likely to have contributed to this situation. In each of the last three summers at least one of the ground handlers operating at Gatwick has experienced significant resourcing problems. Congestion in European airspace has been increasing. And in summer

<sup>9</sup> This is the proportion of flights departing Gatwick within 16 minutes of the scheduled time.

2016 there were two temporary closures of the main runway due to damage to the runway surface.

- 2.6 GAL has devoted considerable effort to identifying and addressing the causes of the current poor on-time performance. Among other things, it has commissioned independent analysis that identified five main causes of poor on-time performance: poor first wave performance; late or slow turnaround of aircraft between flights; late inbound aircraft; on-stand aircraft maintenance; and congestion in European airspace. In collaboration with airlines and ground handlers, GAL has implemented a number of operational measures in response to this analysis, including initiatives to ensure all parties are 'first wave ready', reduce ground movement delays, stabilise the flow of traffic, ensure more timely boarding of passengers, recover from late incoming aircraft and improve turnaround times. In addition, GAL has worked closely with ground handlers, for example introducing direct financial incentives for good performance, assisting with ramp staff resources to help with turnarounds, and encouraging resource planning to improve their readiness for the summer peak.
- 2.7 An important related factor is the strong traffic growth that has occurred in recent years at Gatwick, which has put increasing pressure on an already congested airport. In response to strong demand from airlines, GAL has increased the maximum number of movements per hour to 55 (up from 50 in 2009). The pressures created by strong traffic growth are not directly connected to the commitments framework. However we note that the commitments framework does strengthen GAL's incentives to increase passenger volumes (because of the longer regulatory period than previously), and it has also encouraged GAL to agree bilateral contracts which may contain incentives for individual airlines to grow volumes. GAL may also have encouraged traffic growth by holding its charges at a relatively low level (below our fair price benchmark) during the early years of the commitments period.

2.8 A stronger direct connection between the commitments framework and poor on-time performance may arise as GAL has not yet expanded airfield capacity in response to stronger than expected traffic growth. As described in Chapter 3, GAL appears to have adopted a cautious approach to identifying and responding to the need for additional airfield capacity as traffic has grown.

2.9 A number of airlines argued that airfield capacity constraints (including stands and taxiways) are exacerbating the impact of delays. Among other things, airlines have argued that:

- there is now a greater volume of towing and push and hold operations as aircraft are removed from stands in order to free up the capacity for other aircraft. This contributes to a greater volume of movements on an already congested airfield, ties up ground handling resources that may be needed elsewhere, and in some cases an aircraft that was towed away from a stand can be delayed when it needs to return to a stand prior to departure;
- a shortage of remote hold stands, or insufficient ground movement control capacity to facilitate push and hold movements, means that aircraft may remain on the stand when they could move instead to a remote hold stand. This reduces the stand capacity available for incoming aircraft and also ties up ground handling resources that may be needed elsewhere; and
- the high volume of traffic means that airline staff can experience difficulties contacting ground movement control over the existing communications frequencies. This can delay departures or prevent aircraft from freeing up stands (and associated ground handling resources).

2.10 GAL disagreed that airfield capacity constraints are exacerbating the problem of poor on-time performance. ANS Limited, which provides air traffic control services at Gatwick, told us that tows have the lowest priority so would not be allowed to hold up a departing or arriving aircraft (also that tows are planned and the total volume of tows is capped).

Similarly it stated that push and hold movements do not delay other services as (except in times of extraordinary disruption) aircraft use push and hold stands that are on their normal route to the runway. And it argued that congestion on communications frequencies is caused by non-essential communications from airline staff rather than the high volume of movements.

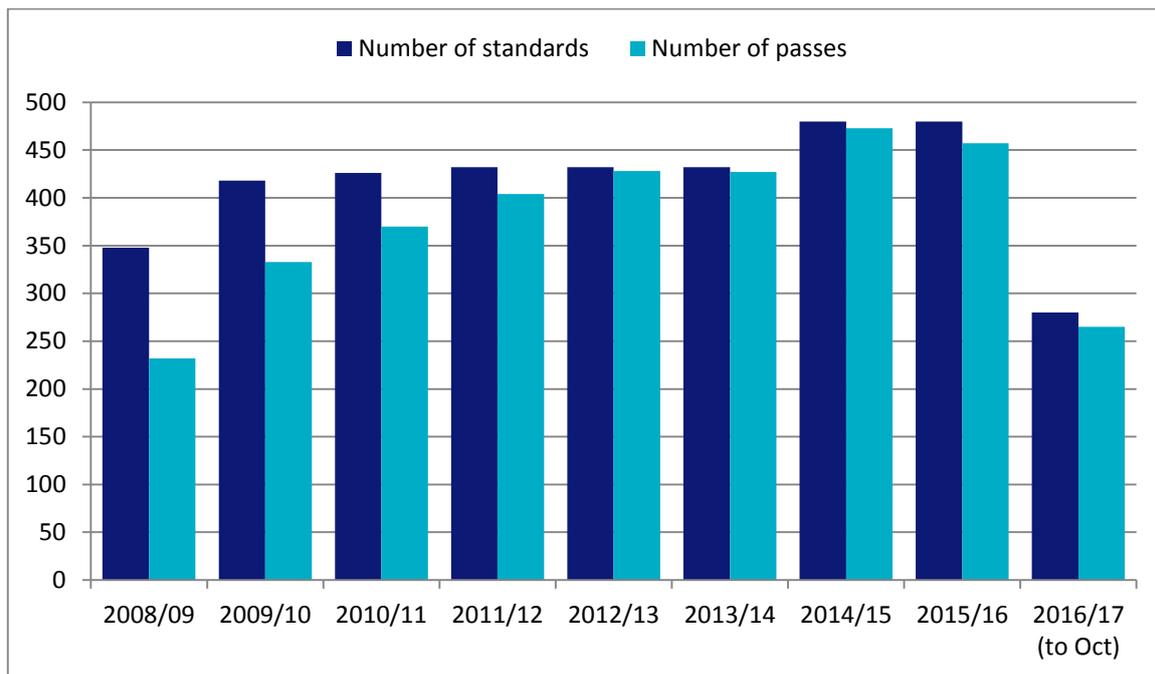
- 2.11 Instead, GAL has argued that successful on-time performance at Gatwick is dependent on aircraft turnaround times and airline schedule adherence. It argues that airline schedules that incorporate insufficient resilience and overambitious aircraft turnaround times are a major contributory factor. It states that stand availability is dependent on airlines operating to plan, and that in practice late departures, early arrivals and other changes lead to changes in stand usage that add to operating complexity.

### **Other aspects of service quality**

- 2.12 GAL's service quality commitment includes a set of service quality rebates, similar to those included in GAL's Q5 price cap,<sup>10</sup> that are payable if GAL misses certain service quality targets. The targets cover passenger satisfaction measures, security queues, passenger operational measures, airline operational measures and an aerodrome congestion term. GAL's performance is assessed monthly, and separately for each terminal. The maximum amount of revenue at risk is 6.75 per cent (South Terminal) and 7.25 per cent (North Terminal). GAL's performance is documented in monthly reports that are published on its website and displayed at the airport.
- 2.13 As shown in Figure 2, GAL has met the majority of its service quality targets, and has maintained the high pass rate it achieved towards the end of the previous regulatory period.

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<sup>10</sup> Some changes were introduced for the current regulatory period. These include the elimination of performance bonuses, a daily measure for central search (in addition to a standard based on monthly average) and new standards (daily and monthly average) on outbound baggage performance.

**Figure 2: Summary of GAL's service quality performance 2008/09 to 2016/17**

Source: GAL

2.14 Figure 3 shows the specific targets that have been missed since the start of the commitments period. GAL missed only 45 out of a total of 1240 targets over this period.

**Figure 3: Service standard failures April 2014 to October 2016**

Area	Service standard	No. of failures
North Terminal	Passenger satisfaction - cleanliness	8
	Security queues - central passenger search	12
	Passenger sensitive equipment - priority	2
	Airline operational - outbound baggage	7
	Airline operational - stands	3
	Airline operational - jetties	3
	Airline operational - fixed electrical ground power (FEGP)	3
South Terminal	Security queues - central passenger search	5
Airfield	Airfield congestion / availability	2

Source: GAL

2.16 GAL's failure to meet target cleanliness scores was due, in part at least, to its decision to redeploy cleaning resources in summer 2014 to support

ground handling operations, as one major ground handler was suffering significant resourcing problems.<sup>11</sup> Subsequently, GAL has put in place a separate contingent workforce so that support can be provided to ground handlers without jeopardising other aspects of service quality.

2.17 Some of the other failures were also linked to specific events. For example:

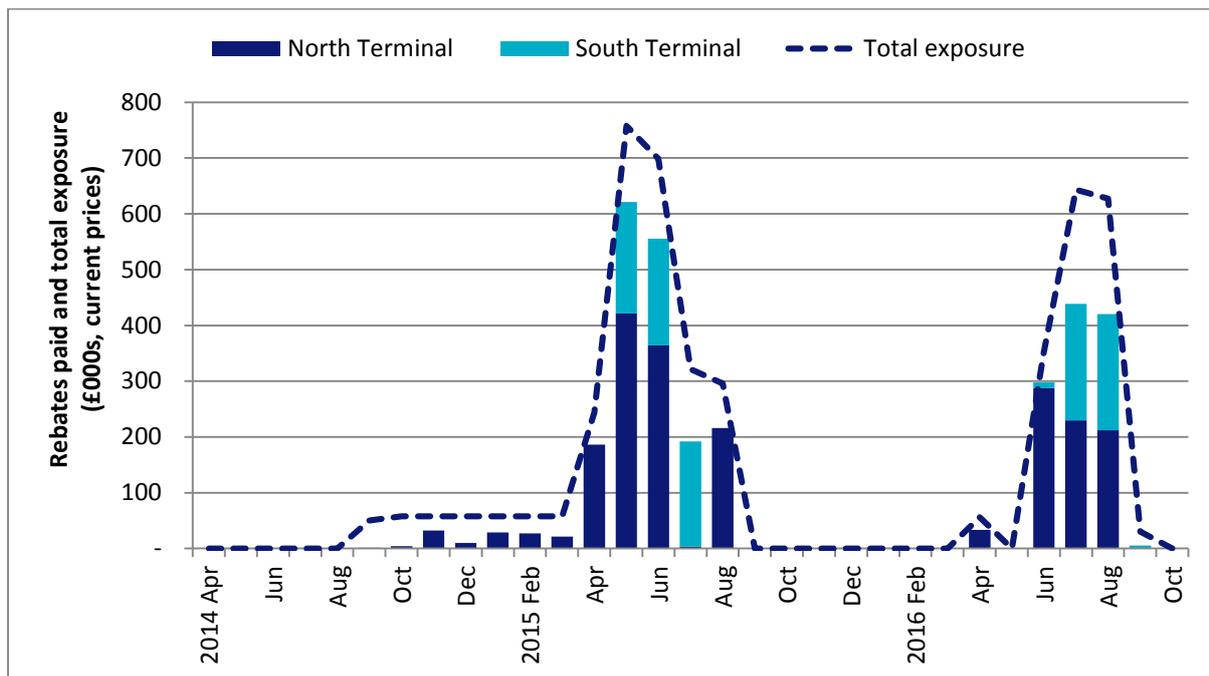
- some of the failures to meet security queue targets were associated with the implementation of a new security process and facilities in the South Terminal in 2015 and in the North Terminal in 2016;
- the failures to meet stand, jetty and FEGP targets were due to overrunning construction work during the refurbishment of Pier 5; and
- the two airfield congestion / availability failures reflect temporary closures of the main runway this year due to damage to the runway surface.

2.18 GAL pays rebates to airlines for each failure. However, a new feature of the commitments framework is that these payments may be reduced for airlines that fail to meet certain service standards for airlines that are included in GAL's Conditions of Use. Currently these standards cover the delivery of arrivals baggage, and will in future cover check-in queues. Figure 4 shows the potential rebates payable by GAL since the start of the commitments period and the amounts that were actually paid (after adjusting for airline service standards).

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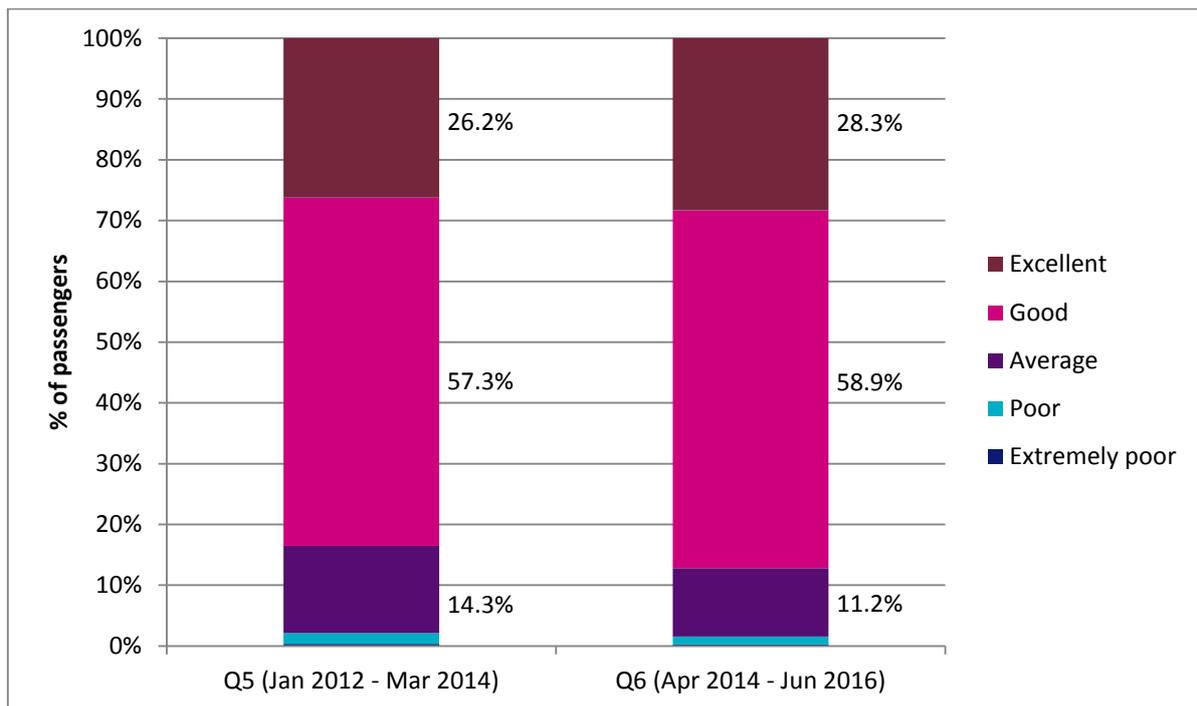
<sup>11</sup> This affected subsequent scores, as the target is calculated as an annual moving average, though the scores were also affected by construction works in the Northern Terminal.

Figure 4: Service quality rebates April 2014 to October 2016



Source: GAL

2.19 Consistent with this overall picture, CAA's own survey shows that overall passenger satisfaction has increased since the start of commitments period. Figure 5 compares overall ratings in the first 27 months of the commitments period with ratings for the final 27 months of the previous regulatory period. Since April 2014, 87 per cent of respondents have rated their experience as 'good' or 'excellent', compared with 84 per cent of respondents in the earlier period.

**Figure 5: How would you rate your overall experience in the airport terminal today?**

Source: CAA departing passenger survey

- 2.20 One comment made by airlines is that GAL's measured performance in meeting pier service level targets (95% of passengers, moving annual average, at each terminal) is distorted by excluding cases where airlines ask to use a remote stand. Airlines state that they choose to use some remote stands so that these operations can be planned (rather than, for example, having to wait until a pier-served stand becomes free) and this also allows better planning of ground handling and other resources.
- 2.21 As a result, they argue that the current performance reports do not reflect the service that passengers are receiving in practice. In response, GAL has argued that a large number of recent requests for remote operations were driven either by easyJet's response to dealing with the problems experienced by its ground handler in summer 2015 or by Common Travel Area arrivals in the South Terminal (see Chapter 3). It argues that, provided remote stand usage related to these two cases is excluded, then it would have met its pier service level targets even if other airline requests to use remote stands had not been excluded from the calculation.

- 2.22 Airlines also commented that there have been some examples of GAL requesting exclusions from service quality rebates in cases that they believe do not satisfy the formal requirements as set out in GAL's Service Standards Handbook. On at least one occasion, airlines state that GAL threatened not to carry out the work in question unless they agreed to an exclusion, and they agreed to GAL's request simply because they wanted to get the work done at a time that would not disrupt their own operations. In certain other cases, airlines and GAL have disagreed over whether or not a particular failure would trigger rebate payments, or GAL has asked for what airlines regard as excessively long exclusion periods for assets entering operation.

## **Our assessment**

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- 2.23 We welcome the fact that GAL has met the majority of its service quality targets and that overall passenger satisfaction scores have increased since the start of the commitments period.
- 2.24 However, on-time performance at Gatwick has been poor in each of the last three summers, and this has been the main development that has had an adverse impact on passengers' interest. We agree that many of the primary causes of delay are factors that are not connected to the commitments framework. A key question for this review, therefore, is whether any aspect of the commitments framework has exacerbated the impact of these delays, and we have heard different views from airlines and GAL about this.
- 2.25 Airlines argue that a failure to provide additional airfield capacity (including stands and taxiways) in response to stronger than expected traffic growth has contributed to recent poor on-time performance. They believe that the underlying problem is the high volume of traffic that GAL has attracted to an already congested airport. They are frustrated that GAL has enjoyed higher revenues and strong profitability as a result of traffic growth but has not invested in additional airfield capacity to accommodate it. And their

frustrations are increased by GAL's failure, in their view, to acknowledge its role in the problem.

- 2.26 GAL in contrast does not believe that airfield capacity constraints affect punctuality. Instead, it believes that ambitious airline schedules and turnaround times are an important part of the problem, highlighting differences in the on-time performance of individual airlines and failures to achieve target turnaround times as evidence of airlines' potential role in improving punctuality, as well as noting its own operational initiatives and the improvements these have delivered.
- 2.27 In addition to the potential impact on passengers, which the parties disagree about, we are also concerned that GAL and the airlines have been unable to make progress on resolving the important question of whether airfield capacity constraints affect on-time performance. This is an example of where relationships between GAL and the airlines on operational issues are not as constructive as they could be, as discussed in Chapter 4. Continued disagreement over the causes of poor on-time performance could increase the extent of mistrust between GAL and the airlines and hamper efforts to work together on those causes of poor on-time performance that can be addressed.
- 2.28 Regarding other aspects of service quality, the main issues raised by airlines during the course of the review were certain of GAL's requests for exclusions from service quality rebates and the method of calculating pier service levels. We have not seen evidence to suggest that these issues have had a material adverse impact on passengers' interests since the start of the commitments period.
- 2.29 Instead, they are further examples of disagreement and possible mistrust which may be affecting relationships between GAL and its airline customers at operating level. And this situation could affect passengers in future, for example if the overall service to passengers could be improved by modifying some of GAL's service quality targets but this does not happen either because GAL and airlines cannot reach agreement or

because poor relationships discourage airlines from coming forward with such suggestions in the first place.

## **Conclusion**

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- 2.30 Poor on-time performance at Gatwick in each of the last three summers is the main development that has adversely affected passengers' interests since the start of the commitments period. The direct causes of most delays are not related to the commitments framework, and we acknowledge that GAL has introduced a number of operational initiatives aimed at reducing delays. Nevertheless, on-time performance has been progressively worse each summer and airlines believe that the commitments framework has contributed to this by providing increased scope (compared with traditional price cap regulation) for GAL to delay airfield investment projects.
- 2.31 GAL and its airline customers have quite different views about whether airfield capacity constraints have made on-time performance worse. Our wider work on operating resilience, which includes a separate data-based study on the causes of delay at Gatwick, may shed more light on this question.
- 2.32 The fact that GAL and airlines still disagree about this important issue is disappointing and suggests that relationships at operating level may not be constructive as they could be. All stakeholders should be working together to identify and address, as far as possible, the main causes of poor on-time performance. Instead, there is a danger that continued disagreement and mutual accusations of blame will obstruct any progress that could be made. We discuss the relationship between GAL and airlines in Chapter 4, and our policy conclusions are set out in Chapter 6.
- 2.33 In relation to other aspects of service quality, we have not seen evidence of a material adverse impact on passengers' interests from the problems raised by airlines, but these concerns by airlines could be further

examples of there not being as constructive a relationship as possible on operational issues.

## Chapter 3

# GAL's investment performance

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## Introduction

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- 3.1 The treatment of investment is one of the clearest differences between the commitments framework and our previous regulation of GAL. The commitments include obligations for GAL to maintain and develop the airport infrastructure so that it can meet its service quality targets, and to invest at least £700 million during the seven year period. However, GAL is no longer subject to triggers in the price cap linked to the delivery of specific investment projects. In principle, this provides GAL with greater flexibility to adapt its investment programme in response to changes in market conditions or new opportunities to improve services for passengers.
- 3.2 In our July 2016 document, we said that we would examine how the investment programme has changed over time and consider how GAL has responded to stronger than expected traffic growth. We also said we that we will want to understand how requirements for additional capacity or other investment projects are recognised, developed and approved, and what the practical consequences may be if investment delivery is delayed.

## Developments since the start of the commitments period

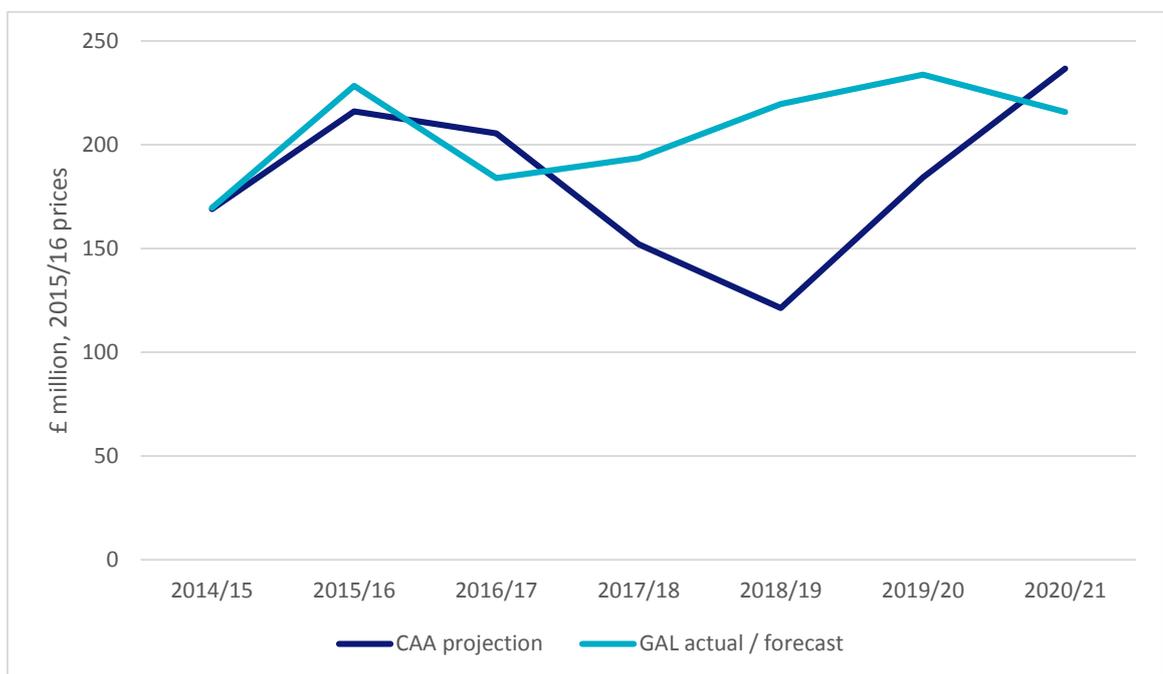
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### Overview of GAL's investment programme

- 3.3 Following consultation with airlines and the GATCOM Passenger Advisory Group, GAL produces a Capital Investment Programme (CIP) each year. It has produced three CIPs (for 2014-16) since the start of the commitments period, and has recently started consultations on the 2017 CIP.

3.4 During the first part of the commitments period, GAL's capital expenditure has been close to or higher than the projections that underpinned our calculation of the fair price benchmark during the Q6 review (see Figure 6). We currently expect that GAL will spend significantly more than its minimum commitment £700 million over the seven year period. The most recent forecast is that GAL will spend a total of almost £1.6 billion (in 2015/16 prices) over the seven years as a whole, compared with our projection of nearly £1.3 billion.

Figure 6: Capital expenditure forecasts<sup>12</sup>



Source: GAL data, CAA analysis

3.5 One of the key differences between the commitments framework and a traditional price cap is that GAL's capital investment is no longer fixed by the regulatory period, and so it can be flexible in investing in response to its current situation. It is clear from the CIPs for 2014-2016 that a significant amount of change has occurred. In total 31 new projects have been introduced, 8 projects have been cancelled, 17 projects have been brought forward and 11 projects deferred.

<sup>12</sup> This shows GAL's 'core' capital expenditure forecast. Its 2016 Capital Investment Programme also shows 'development' capital expenditure of between £33 million and £56 million a year between 2016/17 and 2018/19.

- 3.6 One of the largest changes (by value) was the postponement of the Pier 6 southern extension project. This was put forward by GAL as the most suitable approach to maintaining 95 per cent pier service in the North Terminal (including provision for additional stands for long-haul aircraft, particularly A380s). At the time of the Q6 price review this project was not supported by airlines, but it was included in the investment programme that underpinned our fair price benchmark with an estimated cost of £152 million.
- 3.7 By the time of the 2014 CIP, easyJet's proposed consolidation in the North Terminal and associated airline moves were expected to delay the need for new pier capacity in the North Terminal. Because of this, and also to allow time for airlines to settle in and operations to stabilise following the terminal moves, GAL postponed the Pier 6 southern extension project. The expenditure associated with the project remained in the 2014 and subsequent CIPs, but with a new scheduled start time of late 2017.
- 3.8 Another important development occurred in March 2015, when Border Force ruled that GAL's current process to manage passengers arriving from the Common Travel Area (CTA) was no longer appropriate. CTA passengers in the South Terminal are now coached to the terminal and thus a lower level of pier service is achieved. Since this change, GAL has had discussions with airlines over several possible options for addressing this problem.
- 3.9 For each of the 2014 and 2016 CIPs, GAL included summary tables showing the RAG status (red – amber – green) for different parts of the terminals and airfield indicating where it expected to see capacity shortfalls. The 2014 CIP showed either green or amber status for stands, pier-served stands and taxiways in both 2016/17 and 2020/21. In contrast, the 2016 CIP showed red status for stands and piers in both summer 2017 and summer 2020. This applies to both terminals, though in the case of the South Terminal at least part of the change is attributable to the change in the requirements for CTA passengers.

## Views on GAL's investment programme

- 3.10 With one major exception, airlines were reasonably content with the oversight of investment under the commitments framework. While there have been relatively few examples so far of specific working groups outside of the annual consultations on GAL's CIP, airlines reported there had been some good experiences (though they also noted that much depends on the individual project manager leading each group).
- 3.11 Airlines' main concern with investment under the commitments framework is that GAL has been able to postpone airfield investment projects, notably the Pier 6 southern extension project, and it has not yet expanded airfield capacity in response to stronger than expected traffic growth. Airlines accept that they did not support the Pier 6 southern extension project that GAL proposed during the Q6 price cap review. However, they argue that:
- this opposition occurred under the previous regulatory framework, where the process of five-yearly price reviews encouraged airport operators to come forward with overly ambitious investment plans and airlines to oppose as much investment as possible; and
  - stronger than expected traffic growth and a higher number of peak hour movements have placed greater pressure on existing airfield capacity, so that new pier-served stands are now required.
- 3.12 In contrast to their previous opposition, airlines have highlighted the need for airfield investment during more recent consultations on GAL's CIPs. In December 2014 (prior to 2015 CIP consultations) they asked GAL to prioritise projects that would make improvements to the airfield and improve their operational performance. In June 2015 (in their response to GAL's draft CIP) they highlighted their over-arching concern that pier service levels would not be delivered in the long term, and also a concern that on-time performance was being compromised by GAL's efforts to meet pier service level targets. Then in October 2015 (prior to 2016 CIP consultations) they reiterated their concern that, despite faster than

expected traffic growth, GAL had not brought forward a plan to ensure that pier service level targets were met.

- 3.13 Airlines also expressed concern about delays and problems with several other airfield investment projects (including the Pier 1 replacement and Pier 5 refurbishment projects, and resurfacing work on the main runway), and drew a contrast with commercial investment projects that had been delivered early or projects delivered in response to a specific contractual commitment.
- 3.14 In response to specific comments on the Pier 1, Pier 5 and runway resurfacing projects, GAL pointed out that each of these projects was a carry-over from the previous regulatory period. In some cases the initial problems occurred before the start of the commitments framework, and where problems have continued into the current regulatory period they are mainly the result of difficult construction market conditions arising during the previous regulatory period.
- 3.15 In relation to the Pier 6 southern extension project, GAL reiterated that the decision to defer this project was taken after consultation with stakeholders. The forthcoming terminal moves will radically change the schedule and fleet mix in the North Terminal and delay the requirement for long haul stands in particular (which had hitherto driven the scope and timing of the original project). GAL also gave us details of the recent work it has been carrying out on possible projects to provide additional pier-served stands in the North Terminal and to accommodate CTA arrivals in the South Terminal. These have been discussed with relevant airlines and are now included in the proposals being considered in workshops set up as part of GAL's consultations on its 2017 CIP.
- 3.16 Airlines accept that GAL is now making some progress on these projects. However, they are frustrated by the time it has taken to get to this point, and some expressed scepticism that GAL really intends to carry out these projects and to spend the money necessary to provide additional airfield capacity.

## Our assessment

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- 3.17 Our main concerns about GAL's investment performance relate to the progress of airfield investment projects. There is a link to the commitments framework, as GAL is now subject to fewer incentives and controls over its investment programme compared with those it would face under a traditional price cap. Any future shortage of pier-served stands, for example, could lead to more passengers being transferred to or from the terminal by bus and, as discussed in Chapter 2, airlines have argued that airfield capacity constraints are making on-time performance worse.
- 3.18 Some of the other issues raised by airlines do not appear to be directly linked to the commitments framework. For example, the Pier 1 and Pier 5 investment projects were started under the previous regulatory framework and some if not all of the problems that eventually led to delays appear to have occurred before the start of the commitments period. Similarly, the decision to reduce the thickness of the main runway resurfacing was taken before the start of the commitments period, and in any case this decision was discussed with airlines and was the result of bad weather having reduced the amount of time available to complete the work (rather than any link with the commitments framework).
- 3.19 We note that GAL's total investment to date has been close to or higher than the projections that underpinned our fair price calculation (though our projections were based on a lower traffic forecast), and GAL could well exceed these projections in future years. GAL has introduced a number of significant changes compared with the investment programme we considered during the Q6 review. The flexibility to amend its investment programme in response to changing market conditions or airline preferences was one of the potential advantages of the commitments framework that we noted at the time. But this also means that we and the airlines have fewer incentive mechanisms or other pressures that can be brought to bear, for example to encourage GAL to undertake timely investment in airfield capacity.

3.20 We are pleased that GAL now appears to be making progress with initiatives to provide more airfield capacity and to address the problem of CTA arrivals in the South Terminal. However, there are several aspects of these projects that raise concerns that GAL has adopted a cautious approach to airfield investment planning. For example:

- in general, GAL's traffic forecasts have been exceeded. Each of the 2014, 2015 and 2016 CIPs referenced a traffic forecast for the (then) current financial year which was comfortably exceeded in practice (at least for 2014/15 and 2015/16, and current expectations are that the same will happen in 2016/17);
- GAL appears to have been slow to reflect the impact of higher than expected traffic growth in its plans for airfield investment. Successive CIPs have continued to be based around the 'high case' scenario supplied by GAL's independent forecasters in March 2014, even though traffic outturns were close to or above this forecast. GAL's recent plans have therefore been based on a forecast that is increasingly a realistic (or even conservative) one, rather than an optimistic forecast suitable for investment planning. The impact of this is compounded by the fact that even the high case forecast assumes quite modest growth rates (less than 2 per cent a year) after 2016/17;
- in addition, GAL appeared to adopt a conservative approach to predicting the amount of pier capacity needed to accommodate a certain level of traffic. Airlines highlighted the need for additional pier capacity during consultations on the 2014 and 2015 CIPs. In 2014 GAL stated that that additional pier-served stands in the North Terminal would not be required until 2022, and in 2015 it said that this capacity was "certainly not required before the airport reached 45 million passengers per annum". However, the following year GAL published a CIP that projected a shortfall of pier-served stands in the North Terminal in summer 2017, even though its traffic forecast for 2017/18 was 43.3 million (i.e. substantially below 45 million). We understand this change of view reflects, in part at least, the impact of

changes in airline schedules. But it further suggests that GAL had adopted an overly cautious approach to predicting future capacity requirements.

- 3.21 GAL has worked on plans for a number of possible options for providing additional pier capacity and has discussed at least some of these with airlines. We are pleased to see some progress on this issue, especially on a project that airlines opposed in its original form, but also have potential concerns about the time taken to get to this stage and the risk that service quality could be affected in the time before new capacity is now delivered. It is important that GAL and relevant airlines take sufficient time to identify and agree the most suitable option. But we also look to them to make good progress in addressing the need for additional capacity.
- 3.22 Similarly, although we accept that neither GAL nor the airlines could have foreseen the change in immigration requirements for CTA passengers in the South Terminal, it is now more than 18 months since this occurred. Again, we look to GAL and other stakeholders to make good progress in identifying and implementing an appropriate solution.
- 3.23 GAL is also discussing with airlines proposals to extend one of its existing taxiways and to provide additional push and hold stands. This is a welcome development. As discussed in Chapter 2, however, airlines believe that a shortage of stand and taxiway capacity has already led to a situation where airfield congestion is contributing to poor on-time performance.
- 3.24 At this stage, we do not share some airlines' doubts about whether GAL will actually go ahead with investment in airfield capacity. While progress may have been slow in some respects, GAL has devoted time and effort to working up options for both additional pier capacity in the North Terminal and processing CTA arrivals in the South Terminal. Projects addressing both of these have now been included in GAL's consultations on its 2017 CIP.

## Conclusion

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- 3.25 GAL's total volume of investment has been close to or higher than the forecasts that underpinned our fair price benchmark, and it has implemented a number of projects designed to increase terminal, baggage and security processing capacity in response to faster than expected traffic growth. In many respects, therefore, GAL appears to have responded well to the greater flexibility offered by the commitments framework.
- 3.26 However, GAL has not yet expanded airfield capacity in response to stronger than expected traffic growth, and appears to have adopted a cautious approach to assessing the capacity necessary to accommodate a certain volume of traffic.
- 3.27 It is important, therefore, that GAL makes good progress in addressing the need for additional pier-served stands and to accommodate CTA arrivals in the South Terminal. It should also adopt a proactive approach to identifying and addressing possible future capacity constraints on the airfield. These considerations are reflected in our policy conclusions as described in Chapter 6.

## Chapter 4

# GAL's relationship with airlines and other stakeholders

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## Introduction

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- 4.1 In our July document we noted that the commitments framework provides GAL with an opportunity to forge a stronger and more responsive relationship with airlines and other stakeholders. We stated that it is important that this happens, and that GAL responds to the needs of airlines and their passengers, since the commitments framework envisages a lighter touch role for the CAA. If we have a less intrusive role, then it is important that airlines are able to step forward and hold GAL to account.
- 4.2 There are already a number of formal requirements for GAL to engage with airlines and others. Its commitments include an obligation to consult airlines (through the Airport Consultative Committee) and the GATCOM Passenger Advisory Group (the PAG) each year on its rolling investment programme, and also to consult airlines on individual major projects, on its operational resilience plan and before publishing a revised Master Plan for the airport. Under the Airport Charges Regulations 2011 it is also obliged to consult airlines each year on the future level of charges.
- 4.3 Beyond these formal requirements, it is important that GAL maintains an effective and constructive relationship with airlines and other stakeholders, so that all parties can work together in a flexible and co-operative way to deliver services in passengers' interests.

## **Developments since the start of the commitments period**

### **Overview of GAL's engagement with airlines and passengers' representatives**

4.4 GAL engages with airlines and passengers in a number of different ways, many of which pre-date the introduction of the commitments framework. In addition to the formally required consultations described above, other structured engagement between GAL and airlines occurs through:

- the Airport and Airlines Group, which meets bi-monthly to allow strategic high level consultation on topics including service performance, infrastructure projects, process change, passenger feedback, the Capital Investment Plan and master plan;
- a Service Quality Group (with two airline representatives) which meets monthly to review the previous month's performance and to consider proposals for exclusions from or amendments to GAL's service quality targets;
- the Operations Consultation Forum, which was established in September 2015 and meets monthly with a focus on operational issues.<sup>13</sup>

4.5 The commitments framework has provided GAL with enhanced flexibility to agree bilateral contracts with individual airlines, with the charges and services provided potentially differing from those published in GAL's Conditions of Use. It has now agreed contracts with airlines accounting for more than 85 per cent of passengers at Gatwick.

4.6 Beyond the process of negotiating and agreeing contracts, GAL has regular Executive level meetings with most of the largest airlines (by passenger volume) at the airport, and has described its relationship with most of these airlines as positive. For some airlines, it states that it is able to have "robust" conversations without upsetting the overall relationship.

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<sup>13</sup> Engagement on operational issues had previously occurred through GAL's participation in Airline Operators Committee Executive meetings.

- 4.7 GAL also has regular (quarterly) meetings with the PAG, and PAG members review complaints and compliments received by GAL from passengers together with GAL's (and others') responses to these. More generally, GAL monitors passengers' views in a number of different ways, including:
- its monthly Quality of Service Monitor, based on interviews with a target of 1900 passengers each month. GAL's service quality targets (see Chapter 2) include some scores from this survey;
  - participation in the industry-wide Airport Service Quality survey, administered by Airports Council International, which provides GAL with detailed information on passenger satisfaction compared with a number of other UK and international airports;
  - active monitoring of passenger feedback via its website, other direct communications from passengers, and on social media. This contributes to a monthly "feedback dashboard" that is reviewed by GAL's senior management.

### **GAL's relationship with airlines and its Passenger Advisory Group**

- 4.8 Many airlines told us that they enjoy a good relationship with GAL at the commercial, strategic and financial level, though there were a small number of exceptions to this. The airlines most directly affected by next year's terminal moves appear content with the level of engagement on this. And the PAG told us that it feels that GAL is responsive to its input, and it is pleased with its extended role under the commitments framework.
- 4.9 At the operating level, however, many airlines reported a less positive situation, and were also critical of the way that GAL has engaged with airline representative bodies. Some felt there was a lack of genuine engagement by GAL. They reported that GAL can be defensive when airlines raise issues that it perceives as criticisms. Some said that GAL's response in such cases can be unconstructive, for example involving a large volume of letters, some of which may be unnecessarily abrasive and/or escalated to senior managers without good reason.

- 4.10 GAL's Operations Consultation Forum (OCF) came in for particular criticism from airlines. This was established following GAL's withdrawal from meetings of the Airline Operators Committee (AOC). We heard a number of specific comments on the OCF, for example that there was a lack of prioritisation, a lack of information available in advance of meetings, a large number of GAL attendees and that the format of the OCF served mainly to provide information to airlines rather than encouraging meaningful engagement. More generally, airlines felt the OCF to be "over engineered" and that it was difficult for smaller airlines in particular to participate effectively.
- 4.11 There were also a number of criticisms from airlines about the way that GAL has managed the OCF, including examples of an unconstructive response when challenged by airlines and cases where GAL had pressed ahead with its proposals rather than taking account of airline comments.
- 4.12 Many airlines told us that they believed a more informal forum would be more effective, especially if it also allowed airlines to express their views at an early stage of GAL's thinking. At present airlines say they are formally consulted on fully worked-up proposals that they may have had little or no role in generating.
- 4.13 GAL told us that it has been listening to airlines' feedback on the OCF and is taking action such as improving prioritisation, making the agendas more focused and communication clearer. And it told us that it is willing to listen to further ideas about how the OCF can be improved.
- 4.14 However, while airlines acknowledge that there have been some improvements, they doubt whether the overall format of the OCF can allow engagement to be effective, and this can be compounded by what airlines describe as the defensive and unconstructive approach that they have perceived on occasion from some GAL representatives. A common theme of airlines' comments is that GAL has adopted a "tick box" approach, seeking to put in place a process so that it can be seen to have consulted airlines, but without a genuine desire for meaningful engagement.

- 4.15 Airlines reported fewer concerns about other formal consultations, such as those on GAL's annual CIP, on individual major projects and on its proposed charges for forthcoming years. They noted that GAL had responded to suggestions for example to improve the format of its CIP consultations and to provide more advance notice of the dates of meetings. On major project working groups, airlines commented that there had been relatively few examples so far and that the success of each group was highly dependent on the project manager appointed.

## **Our assessment**

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- 4.16 We are encouraged by many of the developments since the introduction of the commitments framework. These include GAL's agreement of bilateral contracts with airlines representing a high proportion of Gatwick passengers, and reports of good relationships with airlines at the strategic level and on individual projects (including next year's terminal moves). And we were pleased to hear the PAG's views on its strengthened relationship with GAL under the new framework.
- 4.17 We were also encouraged by the general support for the commitments framework, and that none of the airlines we spoke to argued that we should return instead to a traditional price cap. We have kept this overall view in mind when considering some of the less positive specific comments from airlines. Nevertheless, notwithstanding the good relationships reported at the commercial, strategic and financial level, it is concerning that some other aspects of the relationship between GAL and airlines appear problematic.
- 4.18 We have reported above the views we heard from airlines about operating level relationships in general and the OCF in particular. Elsewhere in this document we have reported other developments that risk damaging the relationship between GAL and airlines, including airlines' perception that GAL has been requesting some exclusions from service quality rebates that are not justified under the current rules (see Chapter 2), continued disagreement over whether capacity constraints are contributing to poor

on-time performance (see also Chapter 2) and airlines' frustration when GAL responds by "telling them how to run their business".

- 4.19 The overall view we heard from airlines was that, in certain operational contexts, GAL can be defensive when challenged, unconstructive and sometimes abrasive in its responses to their input, and keen to "tick boxes" rather than necessarily undertake meaningful engagement with them. Such comments do not apply to all of GAL's interactions with airlines or all levels of engagement. Nevertheless, we have heard similar comments from a number of different airlines.
- 4.20 To date we have not seen evidence to suggest that the current situation has had a material adverse impact on passengers' interests. And we recognise that some commercial tension will often arise between suppliers and large customers. Nevertheless the situation raises concerns for us as:
- GAL has substantial market power, and therefore the impact of commercial tensions may lead to an unbalanced position and outcomes that are more likely to favour it than its airline customers (and therefore passengers);
  - the commitments framework envisages a lighter touch role for us. In this context it is important that airlines are able to step forward and hold GAL to account. Where there are changes that could deliver a better service to passengers (either to address problems emerging or to exploit new opportunities arising) then we would be concerned if the airlines and GAL were not able to work together to identify and implement the best course of action;
  - in relation to on-time performance in particular, there is a risk that continued disagreement over some of the possible causes and mutual accusations of blame could obstruct initiatives that GAL and the airlines might otherwise have pursued in order to reduce the risk of delay;
  - if the current situation remains unchanged, the risk of a material adverse impact on passengers' interests is likely to increase over

time (for example because GAL makes poor decisions that could have been improved with effective airline input).

## **Conclusion**

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- 4.21 There are many positive aspects of GAL's relationship with its airline customers and also with the PAG. Many airlines reported a good relationship at strategic level, and some engagement on operational issues appears to have been successful (especially on a bilateral basis).
- 4.22 However, GAL continues to face major challenges. In the short to medium term, it will need to address important questions about the most appropriate level and mix of traffic on its single runway, how best to operate in a constrained environment, and potential investment in airfield and other infrastructure necessary to achieve a sensible balance between cost (hence charges) and operating resilience. It is likely to remain a mixed-use airport, and will have to balance the needs of airlines with quite different business models.
- 4.23 It is important, therefore, that GAL and its airline customers can work together to respond to such challenges in an open and constructive manner. In a light touch regulatory regime, moreover, it is important that airlines can hold GAL to account. And in order to provide the best services for passengers, airlines should be able to raise any operational concerns or suggestions with GAL and have a constructive dialogue about how services to passengers can be improved. This requires GAL to have effective relationships with its main airline customers at all levels. We are pleased that most airlines have reported good relationships at the commercial, strategic and financial level, but also note the strength of feeling expressed about relationships at operating level and also between GAL and airline representative bodies.
- 4.24 While some of the comments from airlines have been directed at the structure of the OCF, others have concerned GAL's responsiveness and its willingness to seek out and take into account airline views. This

suggests that, to address airline concerns, GAL should not only look at the way the OCF is organised but also how it encourages its representatives to engage with, and respond to, airline views. Chapter 6 sets out our policy conclusions in relation to this and our other findings.

## Chapter 5

## GAL's charges

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### Introduction

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- 5.1 As stated in our July document, we have carried out a high level review of the bilateral contracts agreed between GAL and individual airlines, and also validated GAL's calculations of the comparison between its blended price and our fair price benchmark. In neither case have we identified a material cause for concern.
- 5.2 We also said we would consider options for providing airlines with guidance about the likely level of GAL's charges during the remainder of the commitments framework. The issue arises because of GAL's decision, during the early years of the commitments period, to hold its charges below both our fair price benchmark and the somewhat higher cap set out in its commitments. We welcome GAL's decision to hold its charges at a lower level, but it does create a risk that airlines could face significant price increases during the later years of the period.
- 5.3 GAL's commitments include two formal restrictions on airport charges:<sup>14</sup>
- the "Core Yield", which measures GAL's average charge per passenger based on published tariffs (i.e. not taking account of discounts and marketing support), should follow a price path equivalent to the Retail Prices Index (RPI) + 1% on average over the commitments period;
  - the "Blended Yield", which measures the average revenue per passenger that GAL receives after taking account of discounts and

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<sup>14</sup> This covers charges in connection with the landing, parking or taking-off of aircraft (i.e. those set out in Appendix 1 of GAL's Conditions of Use) plus charges for selected ancillary services provided by GAL (staff ID, airside licences, fixed electrical ground power (net of the cost of electricity), airside parking and hydrant refuelling).

marketing support, should follow a price path equivalent to RPI+0% on average over the commitments period.

- 5.4 These commitments apply over the seven year period as a whole, rather than on a year-by-year basis.<sup>15</sup> If GAL holds its actual charges below the relevant price path in any one year, then it will have scope to exceed the price path in another year without breaching its commitments.
- 5.5 While we accepted GAL's commitments package as a whole we said that, when monitoring GAL's performance, we would compare its Blended Yield with the fair price benchmark that we calculated during the Q6 review. This has a lower price path (RPI-1.6%) than the price path for the Blended Yield set out in GAL's commitments (RPI-0%). We said that we would expect GAL to meet the fair price benchmark unless there was a material change of circumstances.

## **Developments since the start of the commitments period**

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- 5.6 Figure 7 below summarises GAL's average charges (before and after discounts) since the start of the commitments period. It also shows a comparison with the price paths included in GAL's commitments and our own fair price benchmark.
- 5.7 During the first three years of the commitments period, GAL's published airport charges have been 3-4 per cent below the RPI+1% price path set out in its commitments. And after taking account of discounts and marketing support, GAL's charges have been 7-9 per cent lower than the RPI+0% price path for the Blended Yield, and 3-6 per cent lower than our fair price benchmark price path of RPI-1.6%.

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<sup>15</sup> Formally, GAL has stated that the cumulative 'revenue difference' between the Core or Blended Yield and the relevant price path will not exceed zero (i.e. it will not over-recover) by the end of the commitments period. In addition, the cumulative revenue difference for the Core Yield will not exceed £10 million in any year during the period.

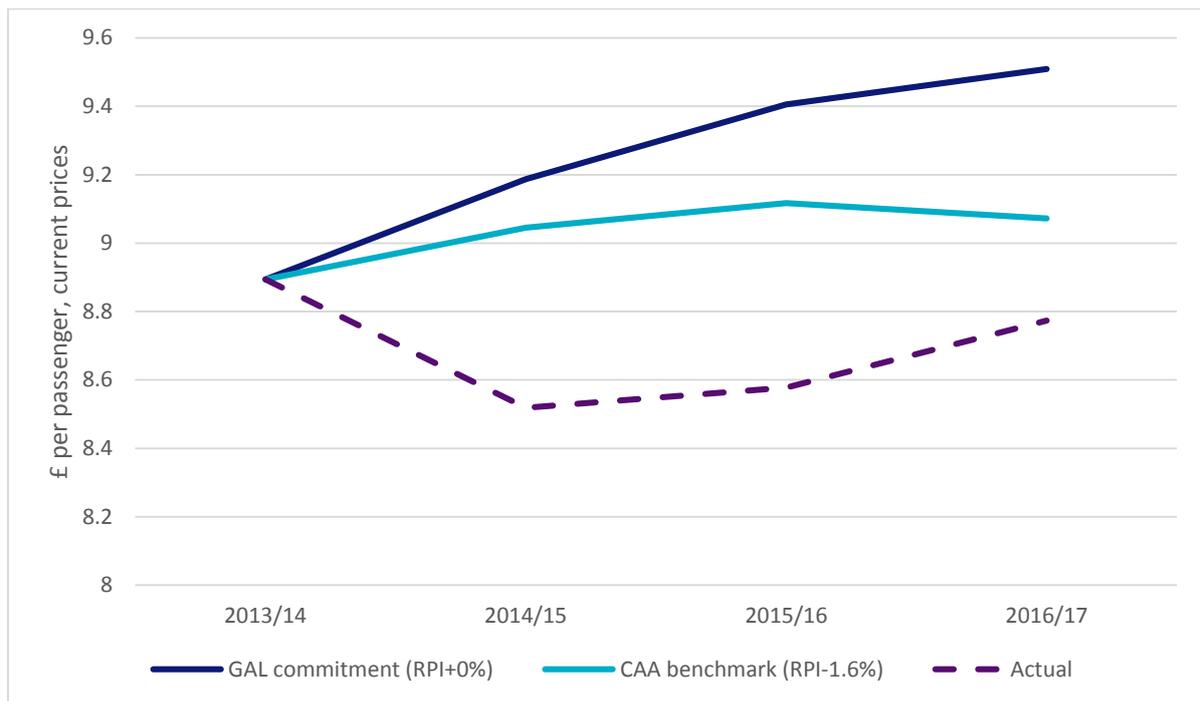
Figure 7: GAL's average airport charges

£ current prices	2014/15	2015/16	2016/17 (forecast)
<b>Core Yield (£ per passenger, based on applying published tariffs)</b>			
Commitments price path (RPI+1%)	9.28	9.59	9.79
Actual	9.04	9.16	9.45
<b>Blended Yield (£ per passenger, after discounts and marketing support)</b>			
Commitments price path (RPI+0%)	9.19	9.41	9.51
CAA fair price benchmark (RPI-1.6%)	9.05	9.12	9.07
Actual	8.52	8.58	8.77
<b>Cumulative revenue difference (£ million)</b>			
Core Yield vs GAL commitment (RPI+1%)	-9.0	-26.1	-40.9
Blended Yield vs GAL commitment (RPI+0%)	-25.8	-59.2	-91.5
Blended Yield vs CAA fair price (RPI-1.6%)	-20.3	-41.8	-54.9

Source: GAL

5.8 Figure 8 compares GAL's average charge after allowing for discounts and marketing support with GAL's RPI+0% price commitment and our fair price benchmark. Over the three years as a whole, its revenues have been more than £90 million lower than if it had set its charges in line with its Blended Yield price path, and more than £50 million lower than if it had set its charges in line with our fair price benchmark.

**Figure 8: GAL's average charge per passenger (after discounts and marketing support)**



5.9 GAL has now issued its proposed charges for 2017/18 for consultation with airlines. It is proposing an increase of 2.7 per cent in its average published charge per passenger, equivalent to an increase of RPI+0.9%. The estimated impact of this will be to increase the cumulative revenue difference between the Blended Yield and GAL's RPI+0% commitment to £121 million, and to increase the cumulative revenue difference between the Blended Yield and our fair price benchmark to around £58 million.

5.10 GAL has also offered 'enhanced pricing guidance' which states that it currently intends to price to a level no higher than CAA's fair price benchmark of RPI-1.6% for the Blended Yield over the seven years of the commitments period.<sup>16</sup> This offer is based on a comparison of the net present value (discounted at a real pre-tax WACC of 5.7 per cent) of different revenue streams over the seven years of the current commitments period, rather than the cumulative revenue differences shown in Figure 7. GAL has calculated that one possible price profile that would not be inconsistent with this pricing policy would be annual tariff

<sup>16</sup> GAL has reserved the right to revise this guidance to reflect any material changes in market conditions or outlook.

increases of RPI+2.0% in each of the last three years of the current period.<sup>17</sup>

## Our assessment

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- 5.11 We welcome GAL's decision to hold its charges below our fair price benchmark during the early years of the commitments period. And we also welcome GAL's offer to airlines that, over the seven year period as a whole, it intends to price to a level no higher than CAA's fair price benchmark. Even though this offer is not legally binding on GAL, it represents a strong statement of intent and a decision to renege on this offer (without a strong justification) would be likely to have a significant adverse impact on both GAL's relationships with airlines and also our view of the most suitable form of regulation for GAL.
- 5.12 We currently consider our fair price benchmark to be the maximum level of charges that GAL could justify charging over the current regulatory period. GAL has already benefited from traffic volumes being significantly higher than the forecasts we adopted during the Q6 review. We made it clear in 2014 that we would not view stronger than expected traffic growth as a reason for requiring GAL to price below our fair price benchmark. But the fact that traffic growth has been strong reinforces our view that our fair price benchmark is the highest level of charges that GAL should levy over the current regulatory period.
- 5.13 We also stated in 2014 that capital expenditure would be the main variable that we would take into consideration when assessing the level of prices. Even though GAL's capital expenditure during the early years of the commitments period has been close to or higher than the forecasts that underpinned our fair price calculation, much of this expenditure has been on terminal facilities, baggage systems and security processing. In Chapter 3, moreover, we report potential concerns about the progress of

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<sup>17</sup> If the comparison with our fair price benchmark was based instead on calculating the cumulative revenue difference (similar to GAL's commitments on the Core and Blended Yields), then the equivalent price path would be RPI+1.1%.

airfield investment projects. This situation reinforces our view that GAL's charges should not exceed our fair price benchmark.

- 5.14 However, since GAL has previously set its charges below our fair price benchmark, this means that it now has scope to increase its charges during the remainder of the commitments period without breaching its offer to airlines. Such increases would be consistent with the overall regulatory package that we accepted in 2014, so there would be no justification at present for us to seek to prevent GAL from charging up to our fair price benchmark over the regulatory period as a whole.
- 5.15 Allowing GAL to recover the revenue lost from charging under the cap in earlier years is also consistent with the previous regulatory framework for GAL and the framework that still applies to charges at Heathrow. GAL's previous price cap included a 'correction factor' that, in the event that GAL undershot (or exceeded) the price cap in any one year, would allow it to exceed (or require it to remain below) the price cap in a later year in order to make up the difference.<sup>18</sup>
- 5.16 Such correction factors are often included in price caps. While they may be intended mainly for the case where a firm undershoots or overshoots a cap because of forecasting errors, there may be nothing to prevent them applying equally to cases where a firm deliberately chooses a different time profile of prices within the regulatory period. This is also consistent with the flexible way that GAL's price commitments are specified, simply stating that the cumulative revenue difference will not be higher than zero by the end of the seven year period.
- 5.17 Nevertheless, the current situation does create some uncertainty for airlines. GAL has said that, following its proposed charges for 2017/18, a pricing profile of RPI+2% for the remaining three years would be consistent with its offer to price no higher than our fair price benchmark. But if GAL does not increase its charges by this amount in 2018/19 and/or

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<sup>18</sup> The amount of any under-recovery would be uplifted by applying the UK Treasury Bill Discount Rate published by the Bank of England. Any over-recovery would be uplifted by this rate plus three percentage points.

2019/20, then airlines could find themselves facing a risk of more significant increases in subsequent years. For example, if GAL simply held its charges constant in real terms in 2018/19 and 2019/20, then a real increase of more than 12 per cent would be possible in 2020/21 without GAL breaching the terms of its offer.<sup>19</sup>

- 5.18 If this scale of uncertainty remains as the end of the commitments period approaches, there is a risk that airlines could be discouraged from investing in new or improved services at Gatwick. We therefore encourage GAL in future consultations to provide further guidance to airlines about its pricing intentions during the remainder of the commitments period, as well as re-confirming its intention to honour its current offer.

## Conclusion

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- 5.19 We welcome the fact that GAL has set charges below our fair price benchmark during the early years of the commitments period, and that it has provided 'enhanced pricing guidance' to airlines that it intends to price to a level no higher than our fair price benchmark over the seven year period as a whole.
- 5.20 During the remaining years of the commitments period, GAL is entitled to recover the revenue impact of this underpricing compared with our fair price benchmark. However, the fact that GAL has benefited from stronger than expected traffic growth, and our potential concerns about the progress of airfield investment projects, reinforces our view that GAL's charges should not exceed our fair price benchmark when considered over the period as a whole.
- 5.21 At present, there is no formal legal barrier to GAL pricing above our fair price benchmark. In the event that GAL decided to increase charges so

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<sup>19</sup> If, instead, the comparison with our fair price benchmark is based on the cumulative revenue difference (i.e. with the balance each year uplifted in line with UK Treasury Bill Discount Rates rather than a real WACC of 5.7 per cent), then GAL would still be able to increase its charges in 2020/21 by more than 6 per cent.

that it would exceed the fair price benchmark over the commitments period, we would need to consider the most appropriate regulatory response. And we would be likely to take this behaviour into account when considering the most appropriate form of regulation for GAL after the end of the current commitments period.

5.22 We encourage GAL in future consultations on airport charges to provide further guidance to airlines about its pricing intentions during the remainder of the commitments period. And we will be asking GAL to include a calculation of the cumulative revenue difference compared with our fair price benchmark in the annual monitoring reports that it provides to us and to airlines.<sup>20</sup> This should provide some additional transparency for airlines about the extent to which charges could increase during the remainder of the commitments period without GAL exceeding our fair price benchmark.

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<sup>20</sup> This should be calculated using the same methodology as the cumulative gross and net revenue differences that GAL already calculates.

## Chapter 6

## Conclusions

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### **Our conclusions on how well the commitments framework is working**

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- 6.1 Overall, the commitments framework appears to have worked well during its first two and a half years. This was a consistent view we heard from both airlines and passenger representatives, and none of the stakeholders we spoke to argued for a return to the previous form of regulation.
- 6.2 There have been a number of positive outcomes for passengers and airlines at Gatwick since 2014. More passengers than ever are now using the airport, overall passenger satisfaction has increased, GAL has met most of its service quality targets, it has agreed bilateral contracts with most of its largest airline customers, and it has held its charges below the fair price benchmark we calculated in 2014.
- 6.3 There have been some good examples of GAL working with airlines to improve services, including the planned terminal moves which will allow easyJet to consolidate its services in a single terminal. GAL has carried out significant investment in terminal facilities, baggage systems and security processing. And it has been proactive in some areas in taking measures to deliver better services for passengers.
- 6.4 However, in addition to these apparent successes, our review has identified two main potential concerns that, if not addressed, could have an adverse impact on passengers' interests in the future. And we heard a strong message from airlines that we should not scale back our monitoring of GAL's performance under the commitments framework.
- 6.5 The first potential concern is about the progress of airfield investment projects. As described in Chapter 3, though GAL is now discussing with airlines its revised proposals to provide additional pier capacity, we have

some concerns about the time taken for GAL to bring forward plans for additional airfield capacity in response to stronger than expected traffic growth. If shortages do occur in future, this could lead to a deterioration in the service quality delivered to passengers, for example because a higher proportion might need to be served from remote stands and therefore face a bus transfer to or from the terminal.

6.6 There may be a link between potential concerns about the progress of airfield investment projects and the commitments framework. GAL now has a general obligation to maintain and develop the infrastructure of the airport to enable its service quality targets to be met and has committed to invest a minimum of £700 million over the seven year period. But it does not face direct financial incentives similar to the investment ‘triggers’ in its previous price cap. Neither is it subject to the enhanced governance arrangements that now apply to Heathrow Airport Limited’s investment. The extra flexibility that GAL now enjoys could allow it to change its investment programme to meet the emerging needs of airlines and passengers or to respond to changing circumstances. But it could also increase the risk that investment required to maintain service standards will be delivered late or not at all.

6.7 We recognise that the situation has been complicated by airline opposition to GAL’s previous investment proposals, by the impact of next year’s terminal moves and by traffic growth being faster than GAL had expected. However, following several years of strong traffic growth, some of which may have been encouraged by GAL’s charging decisions and the incentives it offers airlines and facilitated by increases in the total number of slots available, it is disappointing that the continuation of strong traffic growth does not appear to have been anticipated by GAL, and that it has not yet expanded airfield capacity in response to stronger than expected traffic growth. GAL appears to have adopted an overly cautious approach to identifying the need for future investment and implementing plans to address this situation.

- 6.8 In addition to the direct impact on passengers, for example from any future shortage of pier-served stands, there is also a risk that future airfield capacity constraints will contribute to poor on-time performance at Gatwick. As described in Chapter 2, this is the problem that has had the most direct impact on passengers at Gatwick in recent years, and we heard different views from GAL and airlines about whether a shortage of stand and taxiway capacity has been a contributory factor.
- 6.9 The second main area of concern relates to GAL's relationships with airlines. While many airlines reported a good relationship at GAL at the commercial, strategic and financial level, there was much less positive feedback about relationships at the operating level. Airlines referred to GAL's withdrawal from AOC meetings, made a number of criticisms of the Operations Consultation Forum and reported cases where GAL responded defensively or abrasively when they attempted to raise issues. We also note the unresolved difference of views between GAL and airlines over the causes of poor on-time performance (which in turn leads to disagreements over the need for either additional airfield investment by GAL or changes to airlines' schedules and turnaround times) and cases where GAL has requested exclusions from service quality rebates that airlines do not feel are justified.
- 6.10 Overall, we are concerned at what appears to be a lack of genuine engagement in some of GAL's dealings with its airline customers at the operating level. While it is common for there to be commercial tension between suppliers and customers, there are two main reasons why we are concerned by this current state of affairs:
- GAL has substantial market power. This means that the balance of power between GAL and airlines is likely to be uneven. Airlines and passengers have limited ability to take their business elsewhere if they are unhappy with the way that GAL is treating them; and
  - GAL is subject to relatively light touch regulation. This means that we are less directly or intensively involved in detailed aspects of regulation than we are, for example, at Heathrow. It is important

therefore that airlines are able to raise issues directly with GAL, and that the parties then work constructively together to deliver better services for passengers.

- 6.11 To date, there is no clear evidence of a significant passenger detriment arising from this situation. But it is possible, for example, that disagreements over the causes of poor on-time performance are already preventing the parties from working together as effectively as they might do in order to improve the situation. And, over time, there will be a greater risk that emerging problems (or opportunities for improvement) will not be addressed and passengers' interests will be harmed.

## Our policy conclusions

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- 6.12 We are not proposing specific changes to the commitments framework at this stage. This reflects several different aspects of our findings, including that:
- overall, airlines and passenger representatives believe the new framework is working well, and none of the stakeholders we spoke to argued for a return to the previous form of regulation;
  - the commitments framework is still relatively new, so it is reasonable to expect that GAL and airlines will need some time to adjust to the new framework. There are signs of improvement in relation to some of our concerns; and
  - we have not found clear evidence of a significant passenger detriment from the operation of the commitments framework sufficient to justify making a material change to the regulatory framework only two and a half years into a seven year period.
- 6.13 Nevertheless, our primary statutory duty requires us to act in a manner that we consider will further the interests of passengers and cargo owners. And our clear conclusion from this review is that there are some aspects of the current situation that could risk harming passengers' interests in future unless addressed. We will therefore include both GAL's

planning and delivery of airfield investment projects and its relationships with airlines in our ongoing monitoring of GAL's performance under the commitments framework.

- 6.14 In relation to airfield investment, we look to GAL to make good progress with its current initiatives to provide additional pier capacity and to accommodate passengers arriving in the South Terminal from the Common Travel Area (CTA). And it is important that GAL adopts a proactive approach to identifying future potential capacity constraints and takes action to address these before they start to affect the service provided to passengers.
- 6.15 We will monitor GAL's progress with its current investment proposals, and its ongoing approach to identifying and addressing future capacity constraints. We are not prescribing particular investment projects that GAL should undertake, indeed in some cases there may be alternative ways that potential constraints can be addressed (for example, changing the way that existing capacity is used). GAL will need to work constructively with relevant airlines to understand how they might use the airport in future, to identify possible future constraints and to develop an agreed approach to ensuring that sufficient airfield capacity is available.
- 6.16 We will discuss with GAL the most suitable way of including airfield capacity and investment issues in our monitoring framework. Some possible options include a new section in the monitoring report that GAL publishes each year or a separate paper distributed (at least) to us, airlines and the PAG. The contents could include a description of the airfield investment projects undertaken over the past year, GAL's assessment of future airfield investment requirements, its proposed approach to addressing these requirements, and details of how the views of airlines and other stakeholders have been taken into account.
- 6.17 If GAL does not make good progress with initiatives to address the potential shortage of pier-served stands and to accommodate CTA arrivals, or if it appears to be slow to address similar problems in future, then we may consider further measures. We may also revisit the question

of GAL's investment performance if there is evidence (from our wider work on operating resilience or elsewhere) that airfield capacity constraints are having (or likely to have) a material impact on on-time performance at Gatwick.

- 6.18 It is equally important that GAL establishes open and constructive relationships at all levels with the airlines using the airport. In the context of a lighter touch regulatory framework, airlines should not be discouraged (implicitly or explicitly) from discussing operational problems with GAL or coming forward with suggestions that could improve services for passengers. And GAL should respond constructively to suggestions, comments or complaints from airlines and other stakeholders. This requires a genuine willingness to listen to and respond constructively to airline views.
- 6.19 It is not possible to establish a check list of measures such that an organisation that takes these steps can say that it has established good relationships at all levels with its customers or other stakeholders. Our monitoring of GAL's progress will inevitably require a subjective assessment, based on inputs such as views expressed during our regular meetings with airlines and our own observations of how emerging issues at Gatwick are addressed (for example, whether through genuine collaboration and co-operation).
- 6.20 If it appears that GAL's relationships with airlines or other stakeholders are worsening, and especially if there is a risk that this situation will have a material adverse impact on passengers' interests, then we will consider whether further intervention might be required.
- 6.21 The quality of GAL's relationships with airlines and other stakeholders is also an important factor (along with others, including GAL's investment performance and any impact on on-time performance) that we will take into account in any future consideration of the need for and form of economic regulation at Gatwick. This includes:

- any future Market Power Determination that we may carry out in relation to Gatwick airport.<sup>21</sup> We could carry out a new Determination either because we consider it appropriate to do so or in response to a request from GAL (or from another party likely to be materially affected). However, we could also decline a request for a new Determination if we do not believe there has been a material change of circumstances since the previous Determination. We have already said that an airport operator's engagement with airlines is one of the possible indicators of substantial market power that we will look at, alongside other aspects of the operator's behaviour and performance;<sup>22</sup>
- any review of the form of economic regulation to apply at Gatwick after March 2021 (the end of the current regulatory period). When accepting GAL's proposed commitments as the basis for our economic regulation of GAL, we did not make any statements about the form of regulation that might apply beyond the current regulatory period. Light touch regulation is more likely to be considered a viable long-term option if GAL can establish open and constructive relationships with airlines and other stakeholders. In contrast, if relationships are poor, there will be a stronger argument for a more intrusive form of regulation.

6.22 If GAL makes good progress with the airfield investment projects currently under consideration and improves its operating level relationships with airlines, then our next review of the commitments framework is likely to form part of a wider programme of work that considers how GAL is regulated after March 2021. We are likely to need to start considering these issues within the next two to three years.

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<sup>21</sup> We completed a Determination in January 2014 (see [www.caa.co.uk/cap1134](http://www.caa.co.uk/cap1134)), concluding that GAL had met the requirements of Tests A-C under Section 6 of the Civil Aviation Act 2012. We noted (among many other factors) that GAL's engagement of its customers into its decision-making process confirmed rather than rebutted the presumption of substantial market power.

<sup>22</sup> See section 4 of our August 2016 guidance on how we intend to apply the market power test and make market power determinations, at [www.caa.co.uk/cap1433](http://www.caa.co.uk/cap1433).

6.23 However, if any serious problems arise, and especially if there is a risk of a material adverse impact on passengers' interests, we will consider whether earlier intervention is required. In addition, if we were to conclude in the light of further evidence, such as our wider work on the causes of delay at Gatwick, that an economic regulation remedy was necessary and proportionate, we would expect to discuss this with stakeholders within the current regulatory period.