



Reforming the airport regulatory regime

A REPORT PREPARED FOR EASYJET

June 2009

Reforming the airport regulatory regime

Executive Summary	1
1 Introduction	5
2 Background and context	7
2.1 The current failures of regulation	7
2.2 Characteristics of airports	9
2.3 Implications for the regulatory regime	12
3 The need for airport regulation	13
3.1 Assessing market power	13
3.2 Who should administer the licensing regime?	19
3.3 Are tiered licensing arrangements appropriate?	20
4 Approaches to price regulation	31
4.1 Addressing under investment.....	31
4.2 Institutional design.....	32
4.3 Procedural requirements.....	33
4.4 Specifics of the regulatory approach.....	34
4.5 Maintaining the statutory duty of regulator to ‘users’ of airport services.....	37
4.6 Right to appeal price controls.....	42

Reforming the airport regulatory regime

Figure 1. Probability of choosing Stansted Airport for passengers flying to typical international destinations	16
Figure 2. A possible model for intra-airport competition	23
Figure 3. Pattern of unregulated prices with major investments in capacity	28
Table 1. Simulation of easyJet moving a service from Stansted to East Midlands	17

Executive Summary

At easyJet's request Frontier has given consideration to the future of airport regulation in order to contribute to the Department for Transport (DfT) review of the framework for the economics regulation of airports.

If it is to be effective, the future regulatory regime must bear in mind the challenges facing the industry and the regulatory regime which are many. The adequacy of the current regime has been called into question by a recent Office of Fair Trading (OFT) investigation and a Competition Commission (CC) market inquiry. In addition recent regulatory and policy decisions have cast doubt on the effectiveness of the current sector regulator, the Civil Aviation Authority (CAA), in both assessing airport market power and in facilitating efficient investment through the regulatory process.

In assessing a sector's regulatory regime, we also need to consider what has and has not worked in other sectors and whether the nature of the specific industry in question warrants deviation from the regulatory approach applied in other sectors. We consider airports to have a number of characteristics that must be reflected in how they are regulated. In particular the market for airport services is characterised by a strong spatial element to competition, extremely high barriers to entry, long investment cycles and capital intensive operations. In addition it must be remembered that airports are wholesalers in the supply chain that provides passenger services to passengers. The economics of airline operation limit the freedom of airlines to switch services readily between airports. This creates lock in conditions on airlines that act to the airport's advantage. Furthermore, it is important to note that airport charges are only a fraction of total ticket costs, which can magnify the extent of any airport market power.

The need for airport regulation

The outcome of these challenges and characteristics is that the competitive pressure faced by an airport is not obvious without detailed analysis. This implies that the regulatory process must commence with an assessment of which airports should be subject to which levels of regulation, a fact acknowledged by the DfT by virtue of its proposed tiered licence approach.

Ex ante regulation is an appropriate response where competition is ineffective in promoting efficient outcomes. The key characteristics of airports and the market for aeronautical services are such that it is not self evident that competition or de-regulation will lead to efficient outcomes. However, intrusive regulation is unlikely to be appropriate in all instances.

This implies that a decision on which airports should be subject to regulation should be supported by a thorough analysis of whether an airport is subject to competitive pressures. The process for assessing competitiveness is well

established in competition law and involves defining the market/s and assessing the relevant firm's market power in that market/s – a substantial market power (SMP) test.

However, the geographic and inter-temporal dimensions of defining markets for airport service and assessing the presence of SMP make the required analysis extremely complex in this case.

Experience suggests that the process of conducting these assessments in the airport sector has neither been systematic nor effective to date. Given the lack of an established methodology for assessing airport market power, in our view the DfT needs to be prescriptive about what factors should be investigated as part of an SMP test and how these assessments should be undertaken, so as to limit the risk of regulatory failure.

We also question whether the CAA is the appropriate body to undertake these SMP tests. Our view is that it may be more effective to make use of other agencies with existing expertise in assessing market power and SMP. Our reasoning behind this is as follows:

- The CAA's has a poor track record in undertaking these assessments.
- There is a strong rationale for maintaining the separation between the roles associated with determining 'when to regulate' and 'how to regulate', as this limits the extent to which the regulator is subject to conflicting incentives given the decisions impact on its own future work load.
- The CAA is a sectoral regulator with no powers in relation to competition law. Therefore it is not configured for conducting assessment of this form, has no significant in-house expertise in this area and may lack the ability to bring in this expertise in a cost effective manner.

The extent to which airports with different degrees of market power should be subject to regulation (i.e. light handed or intrusive) also needs further consideration and involves weighing up the costs, benefits and risks associated with different approaches. The DfT has proposed that a new tiered licence regime be introduced for the economic regulation of airports, in order to enable regulation to be targeted, proportionate and flexible. This approach has some clear advantages. That said, there are likely to be challenges associated with such an approach. While an SMP tests should form the foundation for establishing the extent of an airport's market power it will not aid in determining the extent and form of regulation that should apply following this assessment. Rather it provides a larger toolbox of regulatory approaches for the regulator.

Therefore, we make the following suggestions in relation to the implementation of a tiered licence regime:

- In order to limit uncertainty and its affect on investment the DfT should be prescriptive about what factors/assessment criteria (as a minimum) should be used in determining an airport's tier status.
- The potential costs for the wider economy of under-investment are more severe than those of over-investment, such that the regulator should err on the side of caution before considering moving an airport to a lower tier or indeed introducing lighter-handed regulation. Similarly, the regulator should not hesitate in moving airports into a higher tier where real concerns exist regarding an airport holding significant market power.
- Smaller regional airports should not be presumed to have less market power simply by virtue of being small.
- Price monitoring alone is unlikely to constrain an airport's pricing decisions given market power is difficult to assess ex post from pricing data.
- Careful consideration also needs to be given to the process for reviewing an airport operator's licence tier, given the potential impact of this process on investment decisions.

Approach to regulation

Assuming an airport has a degree of market power, the scale of airport investment and the relative importance of capacity investment (given its impact on market outcomes) means serious consideration needs to be given to how the specific approach to airport regulation facilitates airport investment.

Questions have been raised with the extent to which the current regulatory approach addresses concerns of under investment. We consider a long term regulatory commitment critical to addressing this issue. There are various mechanisms associated with the design of regulatory institutions and their approach to regulating which can and should be introduced to achieve long term regulatory commitment.

First, possible institutional re-design, should be considered including the introduction of clearer board-level responsibility for regulatory decisions.

Second, the Regulators' Compliance Code (or similar specific obligations) should be applied to the CAA's economic regulatory activities, to ensure that it is required to produce specific documents or guidelines relating to its activities.

Third, the regulator should be able to adopt appropriate long-term pricing approaches to financing long-term capital investment. This would include

addressing concerns associated with the CAA's current approach of allowing pre-financing of investments and tends to cause prices to rise in the short-run when new capacity is introduced, which is the opposite of the movement that would be expected in a competitive market.

To avoid these problems the regulatory regime needs to be configured to enable longer-term price commitments to be made. However, rather than lengthening the period between price reviews as proposed by the DfT, clear terms for 'paying back' capital should be defined including commitment by the regulator to:

- the process for determining what investment is 'approved';
- not to retrospectively expropriate previously approved investment; and
- the target period over which this capital would be paid back, through long-run assessment of returns and attention to the conditions under which this period may be lengthened (or shortened).

Fourth, the statutory duties and objectives of the regulator should be clearly defined and should include a primary duty to the users of airports (which would include both passengers and airlines). This is an approach which is consistent with the regulatory precedent overseas and in other industries.

Changing the CAA's duty to focus only on passenger, as proposed by the DfT, would, in our view, limit the effectiveness of the regulatory regime. It may well result in the CAA disregarding the role airlines' decisions play in determining outcomes for passengers. This is a problem that has led to many of the weaknesses in the CAA's approaches in the past. As knowledgeable customers airlines are best able to improve the effectiveness of regulation by:

- assisting in identifying the efficient scale and form of investment by overcoming information asymmetry issues between the airport and regulator; and
- addressing other problems associated with consulting with passengers groups, who may often be poorly informed or who may have diverse and conflicting interests.

Finally, a clear appeal process for all stakeholders should be set in place. Our view is that there would be benefits in the appeal process enabling all materially and directly affected parties to appeal all aspects of the economic regulatory decisions including both the quantum and form of any price controls. In order to limit frivolous claims the appeal's body should have the right to dismiss the appeal if they consider it to be immaterial, unmeritorious or to be made by a party that is not materially or directly affected by the relevant regulatory decision. We also consider the appeal body's costs should be covered by the appealing party.

1 Introduction

At easyJet's request Frontier has given consideration to the future of airport regulation in order to contribute to the Department for Transport (DfT) review of the framework for the economic regulation of airports. The DfT's consultation paper *Reforming the framework for the economic regulation of UK airports* was published in March 2009.

The analysis presented in this paper is based on Frontier's broader, cross-industry regulatory knowledge relating to the appropriate application of regulation and regulatory methodologies. We also draw on previous analysis conducted on behalf of easyJet in the context of the debate over the de-designation of Stansted Airport and the subsequent price review.

Given the particular features associated with the provision of Airport services, this paper considers both the need for airport regulation and the best approach to price regulation, should it be required.

2 Background and context

2.1 The current failures of regulation

If it is to be effective, the regulatory regime must reflect and accommodate the challenges facing the sector. In this regard the DfT's review of the economic regulatory framework for airports is timely. As noted by the sector regulator, the Civil Aviation Authority (CAA) "(t)he framework for the economic regulation of airports is...beginning to show its age"¹. We agree with this sentiment.

Certainly the existing regulatory framework in the UK is not performing as it should. In particular, since the present regime was introduced at the time BAA was privatised in 1986 the capacity of London's airports has failed to keep pace with the growing demand for their services, leading to increasing delays and service quality problems for airlines and passengers.

The adequacy of the current regulatory regime was called into question when the Office of Fair Trading (OFT) made reference to the Competition Commission (CC) for further investigation into the supply of airport services by BAA. In making its reference the OFT's expressed concern that various aspects of the sector were combining to prevent, restrict or distort competition, a view which echoed the concerns expressed to the OFT by interested parties, including many airlines. The OFT's preliminary view was consistent with the market inquiry conclusions of CC, which found there to be various aspects of the market which have adverse effects on competition².

In addition recent regulatory and policy decisions have cast doubt on the effectiveness of the current sector regulator in both assessing an airport's market power and in facilitating efficient investment through the regulatory process.

There are a number of clear examples of the current ineffectiveness. First the constructive engagement process promoted by the CAA at Heathrow, Gatwick and Stansted to develop the forward looking capex programmes has also been heavily criticised by the CC (and airlines). The CC noted that the process "excluded genuine two-way dialogue and exchange of views"³. They cite a lack of responsiveness to users as evidenced in the apparent unwillingness of the airport operator (BAA) to consider options of separate terminal development, co-

¹ CAA (2008), "The Government's review of regulation of UK airports, The Civil Aviation Authority's response to the call for evidence", p7.

² CC (2009) "BAA airports market investigation, a report on the supply of airport services by BAA in the UK"

³ Competition Commission (2009), "BAA airports market investigation, A report on the supply of airport services by BAA in the UK".

investment or longer-term contracts and a failure to market test some key activities. These problems relate in the first instance to BAA, but it is clear that the regulator has shown little appetite to engage properly with this issue despite repeated expressions of concern from airline operators. This fact was starkly emphasised in the CC's review of Stansted's price cap. During that short review the CC was able to bring BAA and the airlines to agreement over a capex plan at the airport; something the CAA had conspicuously failed to do in the preceding years. Moreover this plan showed substantial efficiency savings relative to the level that the CAA appeared willing to accept.

The regulator has also shown a propensity to side-step its responsibilities as an economic regulator, despite evidence that need for action is becoming more rather than less pressing.

For example, in 2007, the CAA recommended to the DfT that Stansted and Manchester be de-designated on the basis that charges at both airports are effectively constrained by competitive pressure from rivals⁴. Frontier's analysis at the time provided evidence of the strength of passengers' preference for local airports. We highlighted extensive weaknesses in the CAA's approach to assessing the competitive constraints on Stansted and demonstrated that it was simply not possible to draw any inferences about Stansted's market power from the simplistic approach that the CAA had adopted⁵. The Secretary of State for Transport ultimately rejected the CAA's advice in relation to Stansted, which clearly implied that she and the Department were not convinced by the CAA's analysis. This position was confirmed by the CC in its subsequent quinquennial price review of Stansted, which found that in the short term the actual competition faced by Stansted over the next pricing period was not strong enough to represent an effective constraint on airport charges, particularly given capacity constraints at nearby airports⁶.

Yet despite this setback, and also receiving significant criticism from the CC, the CAA appears to remain defiantly at odds with the higher competition authorities. This is best illustrated by its response to the CC's provisional remedies on BAA.⁷ This paper praises the likely benefits that will be created by the separation of ownership of Heathrow, Gatwick and Stansted and queries the likely additional benefits of further regulatory intervention. The credibility of the CAA's response is somewhat undermined however by the lack of any evidence to support its

⁴ CAA (2007), "De-designation of Manchester and Stansted airports for price control regulation - The CAA's advice to the Secretary of State".

⁵ Frontier Economics (2007), "The De-designation of Stansted Airport, A Report for easyJet".

⁶ CC (2008) "Stansted Airport Ltd - Q5 price control review", presented to the CAA 23 October 2008

⁷ CAA (2009), "The Competition Commission's Market Investigation of BAA Limited: The Civil Aviation Authority's Response To The Provisional Decision On Remedies."

views on the relative merits of different remedies. Moreover it is curious that the CAA should be so adamant about the virtues of structural separation in early 2009 when not long before its recommendation to the Secretary of State for de-designation of Stansted was framed without a single reference to the common ownership of the London airports. This is not indicative of a regulator with a clear evidence-based approach to policy making or that has a coherent understanding of the strengths and weaknesses of inter-airport competition.

This attitude of defiance of the opinions of the higher competition body, following on from what are perceived to be poorly-handled price reviews at the London airports has contributed to the crisis of confidence in the ability of the regulator to cope effectively with the challenges of the airport sector.

2.2 Characteristics of airports

Reviewing and comparing the regulatory approaches adopted across sectors can undoubtedly provide valuable insights for improving a regulatory framework. From this it is tempting to assume that one ideal regulatory regime exists that could be considered best practice.

However, this is a trap. In assessing a sector's regulatory regime, consideration needs to be given to what has and has not worked in other sectors; and whether the nature of the specific industry in question warrants deviation from the regulatory approach applied in other sectors.

Airports in particular have a number of key characteristics that must be reflected in how they are regulated and which are present in a unique combination unlike that found in other price-regulated sectors. In particular the market for airport services is characterised by spatial competition with extremely high barriers to entry, long investment cycles and capital intensive operations. In addition it must be remembered that airports are wholesalers in the supply chain that provides passenger services to passengers. Airport charges are only a fraction of total ticket costs, which magnifies the extent of airports' market power. Furthermore the economics of airline operation limit the freedom of airlines to switch services readily between airports. This creates additional lock in conditions on airlines that act to the airport's advantage.

2.2.1 Spatial competition and barriers to entry

The case for regulation of airports (in general) is not as clear as in some other network utilities where, upon privatisation, independent regulation was clearly essential due to the absence of competitive retail markets.

Airports have some natural monopolies characteristic which they share with other regulated network industries:

- Airport assets are effectively sunk — for the most part, under license terms, most of the assets used to deliver aeronautical services cannot be redeployed into alternate uses.
- Economies of scale and scope— up to a certain point, particularly in relation to runways, one airport is likely to be able to provide aeronautical services at lower cost than two.
- Network benefits — the development of hubs, enables network benefits to be generated for both airlines and passengers (particularly in relation to international and long haul flights).

These characteristics enable larger airports to deliver aeronautical services more efficiently, but they also limit the scope for competition. However, other unique features of the industry are often identified as balancing these characteristics including:

- The possible countervailing power of airlines.
- The balancing commercial incentives of airports whereby ‘non-aeronautical’ income can be increased by promoting passenger traffic rather than restricting demand.
- Modal substitution.

A vital question, which more than twenty years after airport privatisation has still not been adequately answered is: to what extent do adjacent airports actually compete with each other?

Competition in the market for aeronautical services is largely spatial in that different airports are geographically spread and can be considered to provide differentiated offerings based on this spread.

Competition will only put pressure on airport charges if the number of passengers prepared to switch to an adjacent airport is sufficient to persuade airlines to relocate services, and if the airlines can find enough capacity at rival airports to do so. Frontier has shown through previous analysis that customers for point-to-point services consider their location relative to an airport as very significant in determining the choice of their departure airport. We also identified that existing capacity constraints in the London area deprived point-to-point airlines of realistic alternatives when deciding from where to operate their services. The CC evidently agreed with this view in its decision on BAA.

Another key constraint on airport competition is arises from the significant effect airports can have on both the local environment and infrastructure. Hence significant expansions are subjected to a protracted planning process. The cost

and time involved in obtaining planning permission are an unavoidable feature of the sector, which further acts as a significant barrier to entry or expansion.

Spatial competition in the industry combined with the virtual impossibility of entering the airport market (especially in congested regions such as London) suggests that many airports may have a significant degree of market power that could allow them to maintain prices above the competitive level.

However, the extent of an airport's market power will depend heavily on the specifics of its circumstance. Hence assessing the level of competition between airports requires a robust analysis of the strength of local preference and its impact on competition between airports whose catchment areas may seem to overlap on superficial examination.

2.2.2 The nature of investment

Airport investment is often only economically viable in large and indivisible tranches. While this is similar to the larger resource investment schemes in the water industry, the degree of indivisibility and lumpiness of this investment relative to the regulated asset base (RAB) is far greater. For example Heathrow has a 2006/07 closing RAB of £8.4bn and investment at T5 cost around £4.2bn, which represents 50% of the RAB. This proportion is significantly smaller in the water industry as a whole where the regulatory capital value for 2006/07 was £43.8bn and average annual capital investment was £3.9bn, comprising many different individual schemes.

As with other network utilities the average rate of price increases will depend on the investment programme at the margin, but not to anything like the same degree as is the case with airport investment. As a result decisions over the efficient scale of investment and its costs are particularly contentious.

In addition investment in airport capacity, once determined, is particularly difficult to change in the short to medium term. The fact that this is true for rival airports as well is likely to be a key factor influencing the way airports choose their expansion path.

Airports can be expected to choose their profit maximising level of capacity, knowing that, once capacity is fixed, their rivals may not be able to increase profits by reducing prices, as capacity restrictions would mean that they could be unable to take advantage of any increase in demand created by a price reduction.

Therefore, the equilibrium level of capacity in the industry is likely to be above that provided by a monopolist, but less than the socially efficient level. In other words the nature of capacity investment is such that there is a material risk that airports will strategically exploit the lumpiness of the investment decisions of their rivals so as to reduce the intensity of competition between them.

2.3 Implications for the regulatory regime

If it is to be effective the regulatory regime must bear in mind the challenges facing the industry and the nature and characteristics of airports. So what are the implications of these factors for the airport economic regulatory regime?

First, the competitive pressure faced by an airport is not obvious without analysis. This implies that the regulatory process must commence with an assessment of whether airports should be subject to regulation (see section 3).

For some airports the question of whether or not they should be subject to economic regulation has been recently considered. However, numerous issues have been raised with the CAA's approach to undertaking these assessments. This suggests that serious thought should be given to by whom and how this task of assessing market power is undertaken in the future (see section 3.1 & 3.2).

Once it is clear which airports have market power and therefore should be subject to regulation, the extent of this regulation needs to be considered (i.e. 'light handed' monitoring or intrusive *ex ante* intervention). Furthermore, there is a potential for market power to change over time, which implies some flexibility should exist in the regime (see section 3.3).

Second, assuming an airport has a degree of market power, the lumpiness of airport investment and the relative importance of capacity investment (given its impact on market outcomes) means serious consideration needs to be given to how the specific approach to airport regulation facilitates airport investment (see section 4).

Again issues have been raised with the extent to which the current regulatory approach addresses concerns of under investment. Hence, serious consideration should be given to how investment is promoted through the specifics of the regulatory regime adopted.

3 The need for airport regulation

Ex ante regulation is an appropriate response where competition is ineffective in promoting efficient outcomes. This implies that a decision on whether to regulate hinges on considerations regarding the current and prospective efficiency of the markets for airport services.

Fundamentally, the DfT is proposing that the regulatory process should commence with an assessment of:

- which airports have significant market power, and
- the extent to which these airports should be subject to regulation.

Experience suggests that the process of identifying markets and assessing market power has not been conducted systematically or effectively, in the airport sector, to date. Given the lack of an established methodology for assessing airport market power the DfT needs to be prescriptive about what factors should be investigated as part of an SMP test and how these assessments should be undertaken to limit the risk of regulatory failure (see Section 3.1).

Furthermore, we question whether the CAA is the appropriate body to undertake this assessment (see section 3.2).

The extent to which airports with different degrees of market power should be subject to regulation (i.e. light handed or intrusive) needs further consideration and involves weighing up the costs, benefits and risks associated with different approaches. The DfT has proposed that a new tiered licence regime be introduced for the economic regulation of airports, in order to enable regulation to be targeted, proportionate and flexible. This approach has some clear advantages, but as requested by the DfT we have given consideration to how this regime will operate in practice (see section 3.3).

The key characteristics of airports and the market for aeronautical services are such that it is not self evident that competition or de-regulation will lead to efficient outcomes. However, intrusive regulation is unlikely to be appropriate in all instances.

3.1 Assessing market power

A decision on which airports should be subject to regulation should be supported by thorough analysis of whether the airport is subject to competitive pressures.

The process for assessing competitiveness is well established in competition law and involves:

- defining the market/s (see section 3.1.1),

- assessing the relevant firm's market power in that market/s— a substantial market power (SMP) test (see section 3.1.2).

The various matters associated with the geographic and inter-temporal dimensions of defining the market and assessing the presence of SMP make the required analysis extremely complex, but necessary.

We have concerns regarding whether the CAA has conducted this process of identifying markets and assessing market power systematically or effectively to date. Given this, in our view the DfT needs to be prescriptive about what factors should be investigated as part of an SMP test and how these assessments should be undertaken to limit the risk of regulatory failure. Further discussion of issues surrounding these assessments is presented in the following sections.

3.1.1 Market definition

Market assessment requires consideration of all the separate markets served by airports, considering each of the geographical, product/services (supply and demand side substitution) and functional dimensions.

In the airport context this issue is extremely complex, as a single airport serves many different markets. There are some similarities to the telecommunications industry, where a common network infrastructure supports a series of separate economic markets. Furthermore, the definition of the market may differ depending on which service is being considered. These may include:

- Point-to-point;
- Long haul;
- Hub operations;
- Transit passengers;
- Ancillary services to airlines; and,
- Non-aeronautical services; which may also consist of a number of separate markets.

To date the analysis of competition between airports has relied heavily on examining the overlap of arbitrarily-defined catchment areas in order to define the number of airports in within a certain drive-time. However, this approach does not permit the significance these overlaps to be quantified. What we need to know is: if a passenger is 45 minutes drive time from airport A and one and a half hours from airport B:

- how likely are they to choose A over B; and
- what role do relative prices play in influencing that decision?

Rather than using arbitrary catchments comparisons, the geographic market should be defined using the conventional SSNIP framework which involves considering whether it would be profitable to increase airport charges at an airport by 5-10% above the competitive level, taking into account the competitive constraints provided by other airports.

This necessarily involves consideration of:

- the share of airport charges in typical ticket prices;
- the extent to which these increases are passed through to passengers by airlines;
- the likely response of passengers (inbound and outbound) to these increase in charges; and
- the impact this passenger behaviour might have on airline switching airports⁸.

Although much of the passenger airline sector is highly competitive, in particular the point-to-point markets, it is evident that changes in underlying costs feed through imperfectly and slowly into ticket prices. This is demonstrated by the impact that increased fuel prices have had on airline profits, notwithstanding the fact that a simple economic analysis might conclude that a competitive market would simply pass through fuel cost increases in higher ticket prices.

This should not be a surprise given an understanding of the airline business model. Prices are demand driven, not administratively set, while airlines are under strong incentives to keep their planes fully utilised. This means that cost increases are only likely to feed through to higher ticket prices slowly as airline schedules are adjusted to reduce unprofitable services.

This dynamic increases the ability of an airport to exploit any market power that it may have.

In the case of point-to-point services the distance of a passenger's ultimate origin (or destination) from an airport is significant in determining the passenger choice between airline services. Frontier's analysis⁹ has shown that:

- presented with a choice of origin the propensity to take an air service from a given airport declines sharply as distance from that airport to the passengers point of origin increases; and

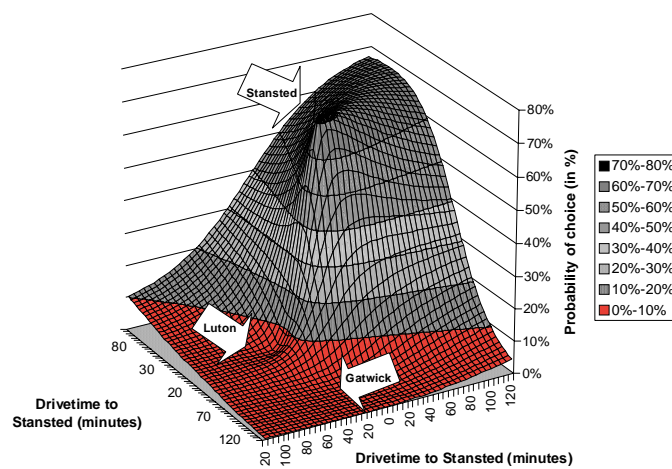
⁸ No consideration of these issues was present in the CAA's analysis in relation to the de-designation of Stansted airport.

⁹ Frontier Economics (2007), "The De-designation of Stansted Airport, A Report for easyJet".

- this propensity also tends to decline sharply as the passenger's point of origin approaches an alternative airport offering a competing service.

Passengers' preference for travelling from the closest airport is extremely strong. Frontier's analysis shows that for every 1% increase in distance, the likelihood of a passenger flying from that airport declines on average by 4%. This local preference is illustrated in Figure 1 which predicts the likelihood of a passenger choosing Stansted based on their location relative to other airports.

Figure 1. Probability of choosing Stansted Airport for passengers flying to typical international destinations



Source: Frontier analysis on behalf of easyJet

The strength of this local preference makes it extremely unlikely that they would relocate services, such that this threat is not often likely to represent a viable constraint on airport pricing. By way of example, our analysis showed that the effect on demand of easyJet moving an existing service currently operating out of Stansted to East Midlands Airport (which was previously considered by the CAA to have an overlapping catchment with Stansted Airport) can be simulated using a passenger choice model. The results of this simulation show that easyJet's loss in passengers from such a move, while holding prices constant, would be very significant, as shown in the Table below.

Table 1. Simulation of easyJet moving a service from Stansted to East Midlands

	% loss in passengers
International flights	30-50%
Domestic flights	60-70%

Source: Frontier Economics

Frontier's analysis shows that a simple drive-time market definition analysis is misleading. In fact the likelihood of a passenger choosing to switch between a close and a distant airport (assuming they have a choice) as a result of a change in airport charges is negligible; making it extremely unlikely that airlines would relocate the bulk of their service capacity. As a result this threat is not often likely to represent a viable constraint on airport pricing. The CAA's conventional analysis of competition between airports has relied heavily on examining the overlap of arbitrarily-defined catchment areas in order to define the market. However, this approach is insufficient and does not take into account the significance of airlines' responses and passengers' actual choices in defining the market.

Market definition is undoubtedly complex. Adding to the complexity is that for long-haul and transit passenger the geographical definition of the market may be very different. In the case of transit passengers airports could be considered to compete against widely spread airports as hubs for airline networks. However, in considering transit and long-haul passengers other considerations may also be relevant, such as route and travel time, which may restrict the extent to which hub competition could be considered to act as a constraint on aeronautical prices.

This complexity is highlighted merely to illustrate how involved the market definition process is. However, this analysis is necessary and hence serious consideration is required of who should undertake this task and how it should be undertaken.

3.1.2 Market power

A test for SMP involves consideration of a number of factors. In particular the following issues relating to market structure and conduct are likely to be relevant in the case of aeronautical services:

- existence of viable competitors and the market share of the airport in the relevant markets – once that market has been properly defined;
- barriers to entry;

- barriers to expansion;
- vertical and horizontal integration;
- dynamics of market;
- degree of and opportunities for modal substitution;
- product diversification or ‘non-aeronautical’ income;
- presence of countervailing buying power of airlines; and
- market behaviour and outcomes.

The extent to which other airports will act as a competitive constraint on the airport in question depends upon whether the alternative airports have spare capacity such that they can be considered a viable competitor. This issue is compounded by barriers to entry and expansion. Constraints on expansion mean that rival airports can easily predict the capacity that each other can offer, both currently and for the foreseeable future. This situation exacerbates the risk that airports will choose to under-provide capacity in the knowledge that rivals airports cannot offer a viable alternative to their airline customers.

Barriers to entry and expansion are primarily determined by planning legislation but also crucially by the time delay between planning and implementation. As noted in section 2.2.1 these characteristic undoubtedly explain why many aspects of aeronautical services are likely to remain uncompetitive into the future.

Concerns regarding horizontal integration were voiced in relation to BAA in the CC’s recent decision to require BAA to divest certain assets¹⁰. However, the decision to break up BAA in London may serve to enhance competition somewhat, but cannot be assumed to have removed the market power of these airports. While these divestments will affect the extent of horizontal integration in the London market, it will not affect the other factors which may give an airport SMP. As a result, without further assessment divestment alone cannot immediately be considered sufficient to reduce an airports market power. Frontier’s previous studies suggest that even if all three London airports were in separate ownership, competition could be limited – especially with respect to point-to-point air travel (see section 3.1.1).

Internationally, recent analysis by the Australian Productivity Commission (PC) suggests that some of the market constraints on airports behaviour that are often highlighted are predominately at the margin and are not as strong as was originally envisaged¹¹. The PC notes that “airlines generally have only modest

¹⁰ Competition Commission (2009), “BAA airports market investigation, A report on the supply of airport services by BAA in the UK”.

¹¹ Productivity Commission (2006) “Review of price regulation of airport services”.

countervailing power in dealing with the major airports. Also, it suggests that the negative impact of higher charges for aeronautical services on passenger traffic, and hence on airports' non-aeronautical revenues, does not appear to be a significant constraint. That said, the strength of these market constraints appeared to vary from airport to airport.

The conclusion that the extent of airline countervailing power is likely to vary from airport to airport is not surprising as it is likely to be based on the scope for the airlines to withdraw their services. In addition, as highlighted in our previous report, airlines may experience significant switching costs which create lock in effects, limiting their countervailing power.

Frontier's previous analysis has indicated that the key facts determining the strength of inter-airport competition will be geographical proximity of airports, the extent to which airport capacity is fixed in the short to medium term and the presence or otherwise of switching costs for airlines, that may create lock-in effects. These factors enable airport operators to behave strategically to restrict capacity, further increasing their market power (see section 2.2.2).

Therefore, the geographic and inter-temporal dimensions of defining the market and assessing the presence of SMP make the required analysis extremely complex. However, given the importance of a robust SMP test it should be fundamental to determining an airport's licence tier and therefore the form of regulation that will be applied to an airport.

The SMP test should be applied on a consistent basis to ensure competitive neutrality and avoid the regulatory regime affecting the efficiency of market outcomes. It should be noted that this does not imply the same outcome for all airports, just that the same test should be applied.

3.2 Who should administer the licensing regime?

The success of the licence regime proposed by the DfT will also hinge on its specific features and how it is administered.

The DfT envisages that the CAA will be responsible for identifying which licence tier is appropriate for each airport and then, where applicable, determining the maximum airports charges. In our view this proposed arrangement raises some serious concerns.

In the case of airports there would appear to be a strong rationale for maintaining the separation between the roles associated with determining 'when to regulate' and 'how to regulate'.

First, this separation would limit the extent to which the regulator is subject to conflicting incentives. For example, where the CAA is responsible for undertaking both roles, a decision on whether or not to regulate would impact on

its own future work load, possibly leading to inefficient levels of regulation (either too much or too little).

This is much more than just a theoretical concern. As we have already noted, the current crisis of confidence in airport regulation stems from the inadequate way in CAA has approached the assessment of market power at Stansted and the price regulation of the three London airports. In its position on Stansted and its response to the CC's conclusions on BAA, the CAA has failed to show a balanced approach to the assessment of airport market power. Against this backdrop, proposing to hand over the assessment of which airports should be regulated to the CAA could exacerbate rather than address the fundamental concerns that have provoked the current review of regulation. This problem would, we fear, be even greater if the DfT were to leave open the terms under which the CAA would be expected to make its assessment.

Furthermore, in our view the expertise required to undertake the two roles proposed by the DfT is very different.

With due respect to the CAA it is not configured as an organisation for the assessment of competition law issues such as the assessment of SMP. Rather it is a sectoral regulator with no powers in relation to competition law. Therefore the CAA lacks experience and in-house expertise in defining the market and assessing SMP. Nor would it be straightforward for the CAA to bring such expertise in house, because the competition assessments envisaged under the DfT's proposals would be occasional, rather than continually on-going. It is unclear how the CAA could maintain a staff with the expertise to carry out such assessments, especially as we have made clear, such assessments are likely to be extremely complex.

Our view is therefore that it may be more effective to make use of other agencies with existing expertise in assessing market power and SMP to undertake this role of determining who should be regulated.

3.3 Are tiered licensing arrangements appropriate?

The DfT proposes the introduction of a new tiered licence regime as a means of ensuring that regulation of the sector is flexible and proportionate. Tier 1 airports¹² would be subject to some form of price and/or service control; tier 2 to

¹² The DfT is proposing that tier 1 airports with SMP would be subject to some form of price and/or service control. This would include the three currently designated airports — Heathrow, Gatwick and Stansted — plus, in the future, any airports the regulator deems appropriate.

requirements in terms of consultation and information provision and tier 3¹³ to other forms of special conditions.

Economic regulation can be considered to exist along a spectrum from 'light-handed' (ex post) to intrusive (ex ante) regulation.

Ex ante regulation anticipates or presumes market failures and takes pre-emptive action to prevent these failures. Price cap regulation fits within this category.

Ex post regulations address misconduct after it has occurred through the imposition of penalties, in order to discourage this conduct. In relation to airports this would include the application of competition law provisions relating to abuse of a dominant position.

These two approaches largely align with the DfT proposed licence tiers 1 and 3. Meanwhile tier 2 represents an intermediary regulatory form which involves standard competition regulation with an associated monitoring regime which would attempt to identify whether there may be anti competitive conduct.

The DfT proposal has some clear advantages in that it may enable regulation to be targeted, proportionate and flexible. That said there are likely to be challenges associated with a tiered licence approach. While an SMP tests should form the foundation for establishing an airport's extent of market power it will not aid in determining the extent and form of regulation that should apply based on this assessment. Rather it provides a larger toolbox of regulatory approaches for the regulator.

Therefore, while we see value in the tiered licence approach, we make the following suggestions in relation to its implementation:

- In order to limit uncertainty and its affect on investment the DfT should be prescriptive about what factors/assessment criteria (as a minimum) should be used in determining an airport's tier status.
- The dangers of under-investment are more severe than those of over-investment, such that the regulator should err on the side of caution before considering moving an airport to a lower tier or indeed introducing lighter-handed regulation. Similarly, the regulator should not hesitate in moving airports into a higher tier where real concerns exist regarding an airport holding significant market power.
- Smaller regional airports should not be presumed to have less market power simply by virtue of being small.

¹³ The DfT proposals include giving the CAA powers to introduce licences which impose some conditions on airports serving less than 5 million passengers, if justified by good cause such as material complaints from airlines or passengers.

- Price monitoring is unlikely to constrain an airport's pricing decisions given market power is difficult to assess ex post from pricing data.
- Careful consideration also needs to be given to the process for reviewing an airport operator's licence tier, given the potential impact of this process on investment decisions.

Further discussion of the advantages and disadvantages of the tiered licence approach and recommendations on how this approach should be practically implemented follows.

3.3.1 Advantages of the DfT's proposed approach

Promotes a proportionate regulatory response

The use of tiered licences could certainly facilitate a proportionate response by enabling the costs and benefits of regulation to be weighed against each other. The extent to which the various UK airports have market power will vary, suggesting that the benefits generated from regulating these airports will also vary.

Furthermore, regulation is not costless and so for some airports the costs of regulation may exceed the benefits, suggesting a light handed approach may be appropriate. This may justify lighter-handed regulation for some smaller airports. Conversely, the greater an airport's market power, the greater the potential efficiency loss from its use and the greater the likelihood that more intrusive forms of regulation will improve market outcomes.

Thus the DfT's approach may allow lighter handed regulation of smaller airports in relevant circumstances, but it should not be presumed that smaller airports cannot fall within tier 1.

Flexible and targeted which may facilitate competition where possible

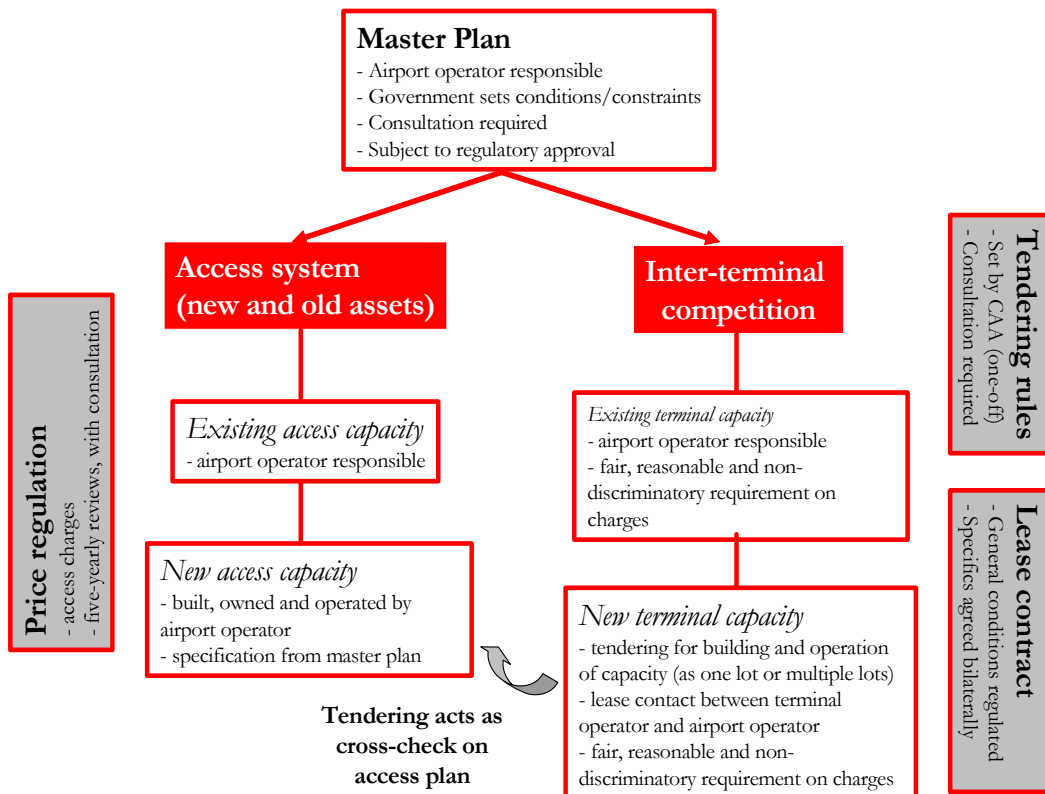
The DfT suggests that the proposed licence structure will enable the regulatory regime to be flexible enough to deal with issues associated with future changes to the structure of the industry. These changes could include new market entry, possibly by making greater use of existing but currently unused or underused airfields, or by separation of the contestable components of the supply chain, i.e. separating terminal operations from that of runways and other access facilities.

A licensing regime may facilitate this by limiting the need for legislative change (which can be laborious) when sector developments indicate the extent or form of regulation should be revisited.

This may be relevant in relation to the provision and operation of terminal facilities. We see no reason why these services cannot in principle be separated

from the monopoly access services. In fact there are many examples of airports, particularly in the US, where terminal facilities are separated from other airport facilities and operated by third parties under lease arrangements. **Figure 2** below summaries a basic structure for how such an arrangement could work.

Figure 2. A possible model for intra-airport competition



Source: Frontier Economics¹⁴

In instances where terminal competition occurs it should be possible to roll back regulation through a licence modification to cover just those parts of the airport that truly are natural monopolies— its “access” facilities, runways and surface access. Removing the need to monitor terminal costs would be a significant benefit, since regulators have struggled to identify the efficient cost of building and operating terminals. These are so diverse in their design and size that benchmarking has proved exceedingly difficult.

In addition, inter-terminal competition could lead these costs to become even more diverse. BAA’s current approach is to design all terminal facilities to meet

¹⁴ Frontier Economics (2008), “Regulation of capacity investment at Stansted Airport”

the needs of a standard full-service carrier. But airlines' requirements vary, even within the similar groups such as low-cost carriers (LCCs). For example, Ryanair may take very different view from other LCCs as to the terminal facilities they need, a point stressed in the debates about the specification for the proposed T2 at Dublin Airport.

Finally, introducing competition into the provision of new terminal facilities may make it possible to “market test” the demand for new runway capacity. If the associated terminal investment is put out to competitive tender, but no independent operator is willing to tender, this is a clear indication that demand is currently insufficient to justify the runway development.

Future regulation of the industry should anticipate these changes in the structure of the industry by taking into account contestable components of the supply chain and maintaining flexibility in these areas. A licensing regime can represent an effective mechanism for achieving this. But it is essential that the provisions of the licence are drafted in a sufficiently flexible way to permit the separation of contestable assets from the regulated airport operator.

3.3.2 Recommendations for the implementation of a tiered licensing regime

Managing uncertainty

While the licensing regime provides benefits in terms of flexibility, this can lead to a level of uncertainty that can adversely affect airport investment (see section 4.1)

In order to limit the level of uncertainty and to ensure a consistent and thorough approach, the DfT should be prescriptive about what factors/assessment criteria (as a minimum) should be used as part of determining an airport's tier status. This could include:

- the criteria that should be met in order to categorise an airport;
- the degree of proof required (or criteria that should be met) in order to move away from the starting licence presumption; and
- the extent of regulation that should apply to airports in different tiers (NB: this should not include the specific regulatory approach) (see below).

Providing as much certainty as possible for airport operators about the regulatory environment, such that they are aware of where they are likely to stand now and in the future, should encourage investment. Furthermore, clearly defined tiers could potentially acts as a threat to discourage anti-competitive behaviour. However, for the threat of increased regulation to be effective there needs to be some facility for airport's tier status to be reviewed.

Extent of regulatory intervention required —ex ante vs. ex post

Reconsidering which airports will be subject to regulation necessarily involves reconsidering the extent of regulation (i.e. light handed or intrusive), weighing up the costs, benefits and risks associated with the different approaches.

The DfT, by remaining silent on the extent of economic regulation which would apply to tier 1 airports, could be taken to be proposing a move away from more intrusive regulation for the currently ‘designated’ airports. While intrusive regulation is difficult and therefore not favoured by the CAA, these reasons alone are insufficient to propose de-regulation.

In our view the risks of the existing ex ante, price cap regulation seem less severe than those that are presented by de-regulation. Indeed if the current system is refined and strengthened it can deliver benefits for passengers and airport operators.

Where passengers have such a strong preference for flying from their closest airport such that an increase in landing charges is unlikely to cause airlines to switch airports, airports already have market power. This combined with the risk that airports will behave strategically to restrict capacity, immediately suggests that some form of regulation is likely to be appropriate to correct market failures.

De-regulation of airports, under these market conditions may, in the long run, result in:

- Under investment — over-provision of capacity can cause landing charges to fall. Therefore, in making substantial long-term investments in runways and terminals, airports operators will have an incentive to allow capacity development to lag behind demand so as to limit their risk and enable them to exploit the resulting capacity constraints. When capacity is lumpy and not easily altered there is a material risk that airports will strategically restrict capacity in this way. This is a function of the fact that airports know that their rivals, as well as themselves, cannot readily alter capacity.
- Excessive prices — resulting from airports exploiting capacity constraints.
- Loss of wider societal benefits associated with airline travel — as a result of the demand for airline services reducing given excessive prices.

The benefits of reducing these impacts must be weighed against the risks and costs of regulation. Given the key characteristics of airports it makes some sense to start with the presumption of a sector prone to market failure. In which case, light handed forms of regulation may lead to significant competition problems remaining uncorrected.

While more intrusive forms of regulation (such as a RAB based approach) may run the theoretical risk of biasing towards over investment, an unregulated

airport sector runs a serious risk, as we have noted, of strategic under investment. Under-investment leads to excessive prices for airlines and passengers, and knock-on loss of the wider economic benefits generated by air travel.

By contrast, the risks of over-investment fall primarily on the airport operator. Excess capacity suppresses airport prices, as in order to maximise revenue the airport will lower prices to maximise demand, resulting in an operator being unable to recover the costs of its investment or raise prices to the level of the regulated cap.

Our view is that the dangers of under-investment are more severe than those of over-investment. While over investment can, in principle, lead to an overly high price cap, even under price regulation an airport with market power cannot make the market pay for excessive capacity (unless it is a pure monopolist).

It could be argued that competition law exists as a catch-all to reduce the risk of deregulation. However, relying on the ex-post application of competition law is likely to be inadequate as a means of curtailing an airport with SMP. While it may be possible to use competition law to rectify the negative effects of excessive pricing in the short run, it is unlikely to be sufficient to address the long-run structural bias towards under-investment. Moreover, if competition law is used too vigorously to control airport profits in the short run, when capacity is constrained, the effect may actually be to reduce further the incentive for airports to invest in appropriate levels of capacity.

In any case excessive pricing would be extremely difficult to prove given the nature of airport investment profiles.

International experience with de-regulation of airports is not persuasive on the merit of this approach. New Zealand is one of the few countries to have unregulated major airports. The Commerce Commission, New Zealand's competition regulator has raised concerns regarding the adequacy of this approach and in particular with the ability of the 'threat of regulation' to act as a deterrent to anti-competitive conduct¹⁵.

Given that it is airlines and their passengers that will bear the risks associated with a 'lighter handed' or de-regulated approach, the regulator should err on the side of caution before considering moving an airport to a lower tier or indeed introducing lighter handed price regulation for a tier 1 licence. Similarly, the regulator should not hesitate in moving airports into a higher tier where real concerns exist regarding an airport holding significant market power.

¹⁵ Commerce Commission (2002) "Final report Part IV inquiry into Airfield Activities at Auckland, Wellington and Christchurch International Airports"

Treatment of small regional airports

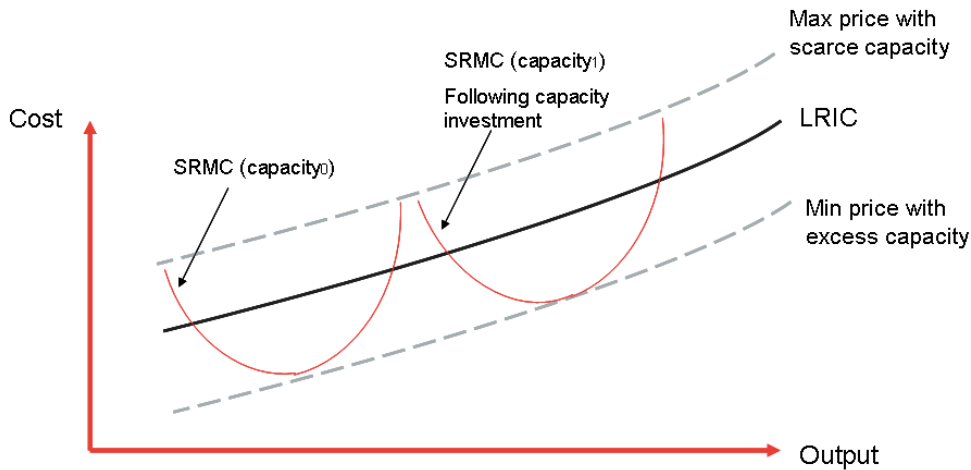
The DfT's proposed tiering arrangements also presume that smaller regional airports will have less market power simply by virtue of being small. This is not necessarily the case. This was recognised by the CC in its market investigation findings that, as well as the more high profile proposals for the London airports, imposed undertakings on Aberdeen airport. However, it should be noted that there is a lower chance of the benefits of using ex ante regulation outweighing the costs for these smaller airports. The DfT appears to have acknowledged this in stating that if a small airport was found to meet all the criteria for entry to Tier 1 including SMP, it could be placed into this tier. We agree with this proposition but feel the DfT should be unequivocal about the possibility of placing a small airport in tier 1, should it meet the relevant criteria.

Issues with using price monitoring

The proposed tier 2 licence will impose requirements on airport operators in relation to consultation and information provision. As a result the operator will be subject to what amounts to a monitoring regime as well as standard competition law.

While this provides the regulator with an additional tool, in our view it is not clear that it is a particularly useful one.

Where airport charges are not subject to regulatory determination, the pricing of services at any point in time will almost certainly be driven by issues associated with capacity. For example, when capacity is plentiful at the airport in question and at local rival airports, this may prevent the recovery of capital costs such that the price level is significantly below long run incremental cost (LRIC). Conversely, when capacity is scarce, short-run returns may appear "excessive" (i.e. above LRIC), as prices will rise to ration available capacity above this long run level. This is illustrated in **Figure 3** below. As a result there is no obvious point in time (or short run period of time) over which prices in this system will approximate either short run avoidable costs or LRIC.

Figure 3. Pattern of unregulated prices with major investments in capacity

Consequently, inferences regarding the misuse of market power will be heavily affected by the capacity investment cycle and can only be drawn from airport price data by considering additional information. This would include historic and forecast information covering the whole expected life of assets concerned. Existing and future capacity constraints at rival airports would also have to be taken into account.

As a result, short-run pricing data is such that market power may be very difficult to assess *ex post*, making such an approach a risky strategy.

Experience in Australia (see text box, below) raises issues with *ex post*, lighter handed regulation that should not be surprising, given the characteristics of the sector we have outlined. It is therefore not self evident that a price monitoring regime can result in an efficient outcome. This appears true even where monitoring is associated with the threat of the introduction of more stringent price cap regulation and an alternate dispute resolution procedure.

Australian evidence on the success of de-regulation and price monitoring of airports

Following a review in 2002, price regulation was eased for Australia's key privately owned, city airports. In its place a new 'light handed' approach was introduced, which involved monitoring and benchmarking charges for aeronautical and related services.

Airports were also subject to the national access regime which provided airlines with a course of action if they considered airports to be misusing their market power. If an airport is deemed to be of national significance, the aeronautical charges set by an airport could be subject to arbitration by the Australian Competition and Consumer Commission in the event that parties were unable to agree on a suitable price. This process can be protracted and was considered likely to be an option of last resort.

This regulatory arrangement was reviewed in 2006 by the Productivity Commission¹⁶. The review noted the following:

- The behaviour of airports in regard to the determination of non-price terms and conditions — i.e. the allocation of gate and parking positions, and the right of an airport to vary its conditions of use— was considered unsatisfactory.
- Negotiations on both price and non-price matters were protracted, such that Virgin Blue had to resort to seeking arbitration for charges paid to Sydney Airport.
- Some of the market constraints on airport behaviour were not as strong as was previously envisaged. In particular it was noted that:
 - airlines generally have only modest countervailing power in dealing with the major airports, and
 - the negative impact of higher charges for aeronautical services on passenger traffic, and hence on airports' non-aeronautical revenues, did not appear to be significant.

The review concluded that “price monitoring and the threat of re-regulation must carry more of the burden in preventing misuse of market power” suggesting a forthcoming move back towards more intrusive regulation.

¹⁶ Productivity Commission (2006) “Review of price regulation of airport services”.

Reviewing an airports licence tiers

Given that the extent of an airport's market power may vary over time, some flexibility or regular review of the licence tier applied to an airport is clearly essential. However, in order to encourage appropriate levels of investment this will need to be balanced against the provision of certainty in regulatory arrangements.

As is discussed in section 4, appropriately designed regulatory 'contracts' between operators and regulators are critical for encouraging appropriate levels of investment. Where an airport operator is subject to price cap regulation the revenue generated from an investment could be affected by any change in the airport's tiering if this affects the form of regulation that is applied. Therefore, the frequency with which an airport's licence tier is reviewed could affect the perceived level of regulatory risk and hence investment levels.

Therefore, the frequency with which an airport's tier status is reviewed could depend on the licence tier being considered.

For airports subject to lighter handed regulation (i.e. airports in tiers 2 and 3) regulatory risk of this form may not be as relevant to their investment decisions and therefore these airports need not be subject to reviews at fixed intervals. Rather the review process could be subject to a trigger — such as in response to a formal complaint from airlines or passenger groups.

We consider the DfT needs to give careful consideration to the process for reviewing an airport operator's licence tier, particularly in relation to tier 1 airports, given its potential impact on investment.

4 Approaches to price regulation

The DfT's policy objectives for reforming the airports regulatory regime include encouraging appropriate and timely investment. A long term regulatory commitment is critical to achieving this objective.

Long term regulatory commitment can be achieved through careful design of the institutional and regulatory mechanisms for regulating airport charges. Our view is that this should be promoted through:

- Possible institutional re-design of the regulator, including the introduction of clearer board-level responsibility for regulatory decisions.
- Applying the Regulators' Compliance Code (or similar specific obligations) to the CAA's economic regulatory activities, to ensure that the CAA is required to produce specific documents or guidelines relating to its process and policies.
- Enabling the regulator to adopt appropriate pricing approaches to financing long-term capital investment. This would include addressing concerns associated with the pre-financing of investments and enabling longer-term price commitments to be made.
- Clearly defining the statutory duties and objectives of the regulator which should include a primary duty to the users of airports.
- Setting in place a clear appeal process for affected stakeholders.

The following sections provide an introduction to the problems of under investment followed by the subsequent discussion of the recommendation outlined above.

4.1 Addressing under investment

Under investment, particularly in relation to 'access' facilities at an airport — runways and surface access — can be a consequence of the regulatory regime adopted as well as use of market power.

The long term nature of investment in the industry increases the importance of clearly and publically articulating ex ante, long-term, regulatory commitments.

Airport capital expenditure often involves constructing infrastructure, which has little or no value for other uses, therefore the operator faces the risk that change to the regulatory regime or its application may make the investment retrospectively uneconomic.

In an unregulated market risk can be shared through long term contracts which limit the ability of customers to walk away from an arrangement once capital has been committed.

Where one party to a contract has market power the contract formed may not represent an efficient outcome, hence the possible need for regulation. However, in a regulatory setting making a long term commitment is difficult. The current airport regulatory regime attempts to provide some commitment through the use of a five-year regulatory review period during which time the CAA commits to a future price path.

However, this period of commitment is unlikely to be sufficient in relation to investment in airport access infrastructure such as runways.

Regulation, by virtue of the fact that it caps the future prices that can be charged, but does not place a floor on charges, may increase uncertainty and thus hold-up otherwise economically viable investments.

Possible approaches to managing regulatory risk and encouraging appropriate levels of investment include:

- careful consideration of the institutional design of the regulator;
- imposing explicit, statutory, procedural requirements on a regulator in relation to accountability, transparency and reporting;
- specifics of the regulatory approach or ‘contract’ between the airport operator and regulator which define the investment ‘pay back’ terms;
- defining the statutory objectives/duties of the regulator i.e. the matters that must be considered by the regulator in reaching a decision; and
- allowing for appropriate judicial or substantive appeal.

Consideration of these approaches follows below.

4.2 Institutional design

It is commonly held that for a regulator to be effective it must be independent, as this enables a regulator to:

- take a longer term view — given its autonomy from the political process and thus any political instability, thereby reducing regulatory risk and its impact on investment, and
- have some ability to adapt quickly and respond to changing conditions without having to engage in potentially lengthy political processes.

It is just as important that regulators are perceived by the industry to be independent for investment purposes. This implies that transparency and

accountability of the regulator are critical. The DfT's proposals in regard to introducing clearer board-level responsibility for regulatory decisions will assist in this regard.

4.3 Procedural requirements

Independence must be balanced with clearly identified procedural requirements for accountability, transparency, and reporting. Some level of accountability is provided by establishing the statutory objectives and duties of the regulator. However, this can be further supported by procedural requirements relating to:

- reporting to government, in order to provide some level of oversight;
- procedures for ensuring transparency i.e. relating to conducting, reporting and recording the outcomes of consultation, publishing the minutes of Authority meetings;
- obligations to comply with, or have regard to compliance codes; and
- publishing guidelines of the regulator's process and policies.

Although, the CAA currently has some requirements in respect of reporting to government, in an economic regulatory context it is not subject to any other procedural requirements relating to accountability and transparency.

The Legislative and Regulatory Reform Act 2006 requires regulators undertaking certain roles to have regard to the Regulators' Compliance Code when determining their policies. This includes ensuring that regulators':

- perform their duties in a way that does not impede business productivity;
- undertake risk assessments of all their activities;
- provide information such that businesses can understand what is required by law;
- collaborate with other regulators to share data;
- apply various compliance and enforcement actions in accordance with various principles; and,
- report on the outcomes, costs and perceptions of their approach in order to increase transparency.¹⁷

¹⁷ <http://www.berr.gov.uk/whatwedo/bre/inspection-enforcement/implementing-principles/regulatory-compliance-code/page44055.html> (accessed 13 May 2009)

However, the Regulators Compliance Code only applies to the safety and consumer protection regulatory functions of the CAA and not its economic regulatory activities.

The DfT is proposing to redress this by including within the statutory duties of the CAA a requirement to *have regard to the principles of Better Regulation and any other principles appearing to represent the best regulatory practice, and to consult with stakeholders, including airlines.*

Both Ofcom and Ofgem have a statutory duty to have regard to the five principles of Better Regulation of proportionality, accountability, consistency, transparency and targeting in carrying out their functions¹⁸. Ofcom considers that it addresses these principals by producing Statement of Charging Principles, Tariff Tables and Annual Plans, while Ofgem publishes minutes of its Authority meetings.

Certainly, any strengthened requirements in relation to accountability and transparency would be an improvement on the status quo. However, there would be benefit in going further than merely obliging the CAA to have regard to the principles of Better Regulation by obliging it to produce statements or guidelines relating to its procedures, policies and the principals it applies in reaching its decisions.

This could be achieved through requiring the CAA to have regard to the Regulators' Compliance Code, given its greater specificity (when compared to the Better Regulation principles) or by placing similar specific obligation of this form on the CAA. The more stakeholders understand the processes and matters considered by a regulator in reaching decisions, the more they will feel comfortable in predicting its decisions. Predictable regulators may encourage investment, by reducing uncertainty.

4.4 Specifics of the regulatory approach

The DfT in its consultation paper remained silent on the form of economic regulation that would be used in relation to tier 1 airports. The term 'price and/or service control' used by the DfT could be read to imply that aeronautical charges at these airports would merely be monitored instead of the current price cap approach. Setting price or revenue caps for an airport is undoubtedly a difficult task. But this reason alone is not sufficient to propose de-regulation. Indeed a first step should be consideration of whether changes can be made to the present system that would facilitate more efficient outcomes.

We consider that improvements can be made to the existing approach relating to removing the pre-financing of investments and more clearly defining the terms of

¹⁸ Better Regulation Executive, <http://www.cabinetoffice.gov.uk/REGULATION/>

the regulatory contract that would lead to more stable and predictable long run pricing and would encourage efficient investment.

In particular, aspects associated with the terms for ‘paying back’ capital are critical in encourage efficient levels of investment.

Specifically, a RAB-based approach can promote the inter-temporal continuity of pricing that underpins a regulator’s commitment to ensuring that efficiently-incurred investment is appropriately remunerated in the long run. However, RAB-based pricing can produce unsatisfactory results in the short-run when the increments to capacity are very large, and the approach to cost allocation is to recover too much of these costs over the initial regulatory period. This is how the present RAB-based approach has been applied, leading to the entire RAB-based approach being unnecessarily discredited.

The current application of RAB-based regulation has been further undermined by the treatment of asset pre-financing. Since the 1996 review the CAA, and the CC, have allowed for a full return to be earned on assets during construction. The rationale appears to be to lower the cost of financing through limiting regulatory risk associated with the large scale investments. Although trigger penalties exist, this arrangement may impact on airports incentives to actually deliver investments on time and within budget.

Allowing pre-financing in the airport’s RAB exacerbates any incentive airlines may have to resist plans for major expansion. Airlines may be reluctant to support investment on this basis because they are being asked to pay up front for the cost of facilities they are not able to use. This equates to an unacceptable shifting of financial risk for investment from the airport to the airlines.

The major alternative to RAB-based regulation is to adopt a long-run incremental cost (LRIC) approach, similar to that applied in telecommunications. While this has certain merits, in our view it will not adequately resolve the twin issues of price stability and investment incentives. The LRIC approach can prevent prices increasing significantly when new capacity is introduced, by spreading costs over the assets operational life. But a normal cycle of investment associated with capacity increases would usually involve prices being low during the initial period of excess capacity (leading to initial under recovery of revenue) and higher later, such that the total returns cover the total costs over the life of the asset. Where the regulatory approach caps prices at LRIC this approach could lead to failure to recover costs and so to under-investment. This is because regulation would prevent full cost recovery in the later phase. Furthermore, LRIC may be difficult to measure in relation to airport operations.

In our view, however, it is possible to reconcile the two approaches. By way of example, the Irish airport regulator, CAR, has adopted a twin approach. It has chosen to smooth some elements of the airport’s costs using long-term demand forecasts. In addition, as regards the major capital investment at T2 costs will be

admitted to the RAB in stages, the first tranche when the terminal becomes operational, and the remainder once demand rises above a pre-defined threshold.

This approach should ensure that the airport is able to recover its investment costs in the long run. In particular short-run downturns do not result in significant price increases as occurs under the approach previously adopted by the CAA. Rather an unexpected down turn should result in a lengthening of the period over which the airport recovers its investment.

In our view such an approach to ensuring long term regulatory stability is more appropriate than the DfT's proposal that there would no longer be a binding obligation on the CAA to follow a 5-year price review cycle. Regular price reviews are essential to balance the incentives on the regulated company to operate efficiently and to pass on the benefits of that efficiency to customers over a reasonable time frame. Furthermore, in terms of protecting the value of long-lived investments, increasing the period between price reviews may actually be counter-productive by exposing the airport to excessive risk of a long term downturn.

Rather than lengthening the period between price reviews, we believe that defining clear terms for 'paying back' capital is critical to encouraging efficient levels of investment. This would need to include commitment by the regulator to:

- the process for determining what investment is 'approved';
- not to retrospectively expropriate previously approved investment; and
- the target time period over which this capital would be paid back through regulatory returns and the terms under which this period may be lengthened (or shortened).

It is important to clarify that, although we have made recommendations relating to improving the regulatory process, we do not consider that the specific regulatory form adopted should be defined in legislation. In many cases this could be counter productive as this may reduce the ability of the regulator to adapt to changing industry arrangements.

Ofwat has pointed to this problem in regard to 'the Costs Principle' contained in the Water Act 2003. Under the Costs Principle incumbent water companies (or Ofwat in the event of a dispute) must set common carriage and wholesale prices for water based on the prevailing retail price, less any ARROW expenses (expenses that they can be avoided, reduced or recovered in some other way), plus any additional expenses. This defines the method for determining access prices to a 'retail minus' approach. Ofwat believes that this unnecessarily

constrains the approach it must take¹⁹. Furthermore, recent independent reviews into competition in the water industry have also noted that the principle may constrain Ofwat's ability to introduce competition²⁰.

In our view defining the specific of the regulatory approach in legislation will only be appropriate where no circumstance can be envisaged under which the regulator would need to take a different approach. Given the changing nature of the industry, it is unlikely that this level of specificity would be appropriate.

4.5 Maintaining the statutory duty of regulator to 'users' of airport services

As previously discussed, regulatory accountability and therefore the perceived regulatory risk inherent in the industry can be improved by establishing legislation that sets explicit governing objectives and duties for the regulator.

The current statutory duties of the CAA under section 39(2) of the Airports Act and Airports (Northern Ireland) Order include furthering the reasonable interests of users of airports. The DfT, in line with the independent panel's recommendations, is currently proposing modifications to the CAA's duties which include replacing this duty to 'users of airports' with a primary duty to instead promote the interests of 'consumers of passenger and freight services' at UK airports, using competition where possible.

At first glance the DfT proposal is consistent with its policy objective of improving the passenger experience. However, airports are primarily wholesalers of their primary aeronautical services to airlines while being direct providers of non-aeronautical services to airline passengers. Therefore, airports essentially serve both these customers as users of airports. Thus under their current duties the CAA is required to consider the interests of both airlines (as their wholesale customers) and their passengers.

In our view removing the regulator's primary duty to airport users would limit the effectiveness of the regulatory regime.

First, it is the market interaction between airports and airlines which largely determines the outcome for passengers. This is acknowledged by the DfT who are proposing that the regulator should have powers to "intervene at airports to improve coordination between parties operating at the airport to improve passengers' end-to-end journey"²¹. Removing the CAA's duty to users of airports

¹⁹ Select Committee on Regulators First Report, Ofwat Q 158, (source: <http://www.parliament.the-stationery-office.co.uk/pa/ld200607/ldselect/ldrgltrs/189/18906.htm>)

²⁰ Cave, M. (2009) "Independent Review of Competition and Innovation in Water Markets: Final report"

²¹ DfT (2009) "Reforming the framework for the economic regulation of airports", p44.

and therefore airlines (as a class of user) is inconsistent with the DfT's own conclusions for redressing market power. Indeed it may result in the CAA ignoring the role the decisions of airlines play in determining outcomes for passengers.

In our view this excessive passenger focus led to many of the weaknesses in the CAA's approach when recommending to the DfT in 2007 that Stansted airport be de-designated. The CAA argued that charges at both airports were effectively constrained by competitive pressure from rivals based on examining the overlap of arbitrarily-defined catchment areas and the results of simplistic passenger surveys. However, this approach ignored the role of airlines in defining markets (see section 3.1.1) and the economics of airline operations in determining the extent to which airlines could feasibly respond to changes in airport pricing.

Second, requiring the regulator to consider the interest of airlines would ensure they have a seat at the consultation table. While the DfT is recommending that the statutory remit of the regulator be amended to have regard to the principles of better regulation through consulting with stakeholders including airlines, this does not equate to requiring the regulator to give due consideration to airlines views. As knowledgeable customers airlines are best able to improve the effectiveness of regulation by:

- assisting in identifying the efficient scale and form of investment by overcoming information asymmetry issues between the airport and regulator (see section 4.5.1); and
- addressing other problems associated with consulting with passengers groups, who may often be poorly informed or who may have diverse and conflicting interests (see section 4.5.2).

This proposed approach is also inconsistent with the regulatory precedent overseas and in other industries (see section 4.5.3).

While not explicitly stated, the proposed rephrasing of the primary duty may be an outcome of the DfT having concerns regarding airlines' and passengers' interests diverging (or indeed airlines' interests being divergent), making maintaining a duty to both parties unachievable. In our view, this is not a valid concern. Irrespective of how the primary duty is phrased the CAA will still be required to balance potentially divergent interests and protect the interests of passengers. In assessing the interests of all airport users, the regulator would be able to take into account, and discount, any proposals it was concerned could damage inter-airline competition or favour one group of airlines disproportionately at the expense of another group. Clearly such an outcome would not be desirable for passengers.

4.5.1 Identifying the efficient scale of investment

Given the large indivisible nature of much of the investment that occurs in relation to airports there are often particular difficulties associated with identifying the efficient level and form of that investment.

- As discussed previously the dynamic relationship between prices and capacity is more complex than in other network industries, given the interaction between capacity and market power.
- In addition benchmarking is problematic as there can be significant design variability between airports and comparable operators operate in different countries under different ownership and regulatory approaches.

Therefore, there is benefit in imposing a strong requirement for engagement with and due consideration of airlines views as the most knowledgeable customers, particularly for expenditure relating to expanding capacity.

Given that engagement with the airlines has not been effectively implemented in the past, and has been heavily criticised by the CC, relegating airlines to being a secondary duty of the CAA would, in our view, further weaken the effectiveness of the regulatory regime in identifying the efficient scale of investment necessary to meet the price and quality requirements of passengers.

While passenger consultative groups could be used for the purposes of ‘identifying efficient investment’, it is very unlikely that they would be in a position to be sufficiently knowledgeable about such matters. As a result a consultative process could be very involved in order to adequately inform these passenger groups. It is highly unlikely to improve engagement outcomes; rather it will delay the process.

4.5.2 Conflicting interests of passenger groups

The views of passengers obviously cannot be considered homogenous. This raises the question as to how the regulator would balance different and conflicting views. Arguably the airlines have a role to play in addressing problems associated with defining passengers’ interests given that these are likely to be diverse and conflicting. Airlines themselves will be seeking to balance the various passenger demands and offer commercially viable services that meet these demands as best they can. In this sense it is the airlines that have to “put their money where their mouth is” as regards what passengers actually want. In contrast direct consultation with passengers may not be constrained by what is commercially viable because individual passengers or passenger groups will not be commercially held to account for the consequences of their wishes.

Airlines can be considered to undertake the function of both collating the collective views and distilling the disparate views of their customers. Where there

is strong inter-airline competition there should be direct alignment between the interests of airlines and their passengers. Competitive markets are generally considered as leading not only to productive efficiency, but also allocative efficiency — where firms produce what is required by customers. Therefore, in a competitive market airlines can be considered to have a strong customer focus such that their interests will be aligned with their passengers.

Competition necessarily requires airlines to undertake a process of discovering the demands and tastes of their customers. Therefore, airlines can be considered to undertake this function, easing the need for the regulator to undertake this difficult task.

If there are concerns that airlines are acting in ways that are unrepresentative of their customers' needs, this is better dealt with through competition and fair trading legislation which exist for this purpose, as opposed to reducing their involvement in the regulatory process. We note that the DfT has itself stated that “(t)he regulatory framework for the aviation sector focuses on airports because the airline sector is seen to be competitive and therefore delivering good outcomes to passengers.”²² If this accepted then it should not be a matter of concern to include airlines (as a class of user) within the group to which the regulator's duty applies.

Second, as noted by the DfT, different users of airports are likely to have different requirements in terms of airport services and that these requirements may change in the future²³. For the most part it is unlikely that passengers will have the necessary information or ability to co-ordinate in order to present these sometime disparate views to a regulator.

Finally, it is likely that the regulator may have difficulty separating the interests expressed by passengers *as* travellers (on the appropriate price and service provided by airports) from their views as citizens (in relation to planning and environmental policy). This could reduce the effectiveness of passenger groups in any consultative process particularly in regard to new investment. It is very possible that some passengers will allow their views on appropriate levels and forms of investment to be clouded by broader policy concerns. These concerns are valid and should be addressed through the appropriate policy channels, but cannot and should not be addressed through the economic regulation of airport charges.

4.5.3 Regulatory precedent

Furthermore, it is wrong to conclude that replacing the CAA's current duty of considering the interests of users (including both airlines and their customers)

²² DfT (2009) paragraph 3.15.

²³ DfT (2009) paragraph 3.18, p 24.

with that of passengers represents best practice regulation. Indeed maintaining the status quo has precedent in regulation.

Airports are in many cases bottleneck infrastructure to which airlines require access in order to provide their services to passengers. Access regulation is typically used in such instances to promote competition and to encourage entrants into contestable parts of an industry.

To be effective an access regime must attempt to satisfy the demands of both the access seeker and the access provider's investors. A regulator with a role in determining the price and related conditions of access is a common feature of access regimes. The regulator is typically required to balance the needs of the entity seeking access to the infrastructure (airlines) and the incumbent operating this infrastructure (airport operators) and in many cases third parties (passengers).

Access is a feature of telecommunications industry where Ofcom has a duty in carrying out its regulatory functions (including in relation to access) "to further the interests of consumers in relevant markets, where appropriate by promoting competition"²⁴. If this was applied to aeronautical services the consumers in the relevant market would be both airlines who receive wholesale aeronautical services and passengers who use the airports land-side services, consistent with the CAA's current statutory obligation.

Similarly, the amended proposals of the EU for a common regulatory framework for communications networks and services currently includes a requirement for regulatory authorities to promote "market driven investment and innovation in new and enhanced infrastructures including by ensuring that the cost of access to facilities takes appropriate account of the risks incurred by the investors and those undertakings enjoying access to the new facilities"²⁵. In addition the Office of Rail Regulation (ORR) under its appeal role for disputes relating to access to the rail network²⁶ state that it's "approach [to determining access arrangements] is...designed to strike a balance between the interests of applicants and facility owners"²⁷.

International access regulation also takes this form. Australia has a non-industry specific national access regime for bottleneck infrastructure assets. Airports (deemed to be of national significance) can and have been subject to the regime

²⁴ Communication Act 2003, s(3)

²⁵ Article 8, paragraph 4a (new), Amended proposal for a Directive of the European Parliament and of the Council amending Directives 2002/21/EC on a common regulatory framework for electronic communications networks and services.

²⁶ Under the Railways Infrastructure (Access and Management) Regulations 2005.

²⁷ ORR (2006) Guidance on Appeals to ORR under the Railways Infrastructure (Access and Management) Regulations 2005, March 2006, para 2.7

which provides airlines with a course of action if they considered an airport to be misusing its market power. In 2007 Virgin Blue sought arbitration by the Australian Competition and Consumer Commission (ACCC) of the aeronautical charges set by Sydney Airport Corporation Limited. In making a determination regarding access the ACCC is required to take into account, amongst other things, the legitimate business interests of the provider and their investment in the facility, the public interest, and the interests of persons who have rights to use the service²⁸.

In summary all these regulatory arrangements require the regulator to balance the needs of the user(s) or access seeker(s) and the incumbent operator or their investors. These arrangements are consistent with the current statutory duties of the CAA which require them to balance to needs of users and airports.

4.6 Right to appeal price controls

The DfT is proposing that the CC's current automatic advisory role in relation to the CAA's price control decisions should be removed and replaced with a merit-based appeals process.

In considering possible reforms to the appeals process the DfT in its consultation report suggested that all parties with a material interest should have a right to appeal the regulator's decision with respect to an airport's licence tiering. This appears to be a reasonable approach to encourage accountability in relation to any decision on which airports should be subject to regulation.

However, alternate options were suggested in relation to the appeals process for a proposed licence modification (which appears to include the CAA pricing decisions). These options differed in their treatment of the following:

- the parties with the right to appeal — i.e. licensee or all parties with a material interest (see section 4.6.1); and
- the form of challenge or aspects of the regulatory regime that should be appealable — i.e. whether for parties other than the licensee it should relate to all aspects or be on a limited range of issues or principles (see section 4.6.2).

In addition the report gives some consideration to mechanisms which can be used for limiting frivolous claims (see section 4.6.3).

Appeals processes are a widely observed feature of economic regulation. The economic rationale for incorporating these processes into a regulatory regime relates to correcting errors associated with regulators often having imperfect

²⁸ Trade Practices Act (1974) Comm.. 44X(1)

information and ensuring regulators are held to account. Parties involved in a regulatory process will have private information in relation to what would represent a reasonable decision that balances the needs of the stakeholder's involved. The appeals process enables this private information, held by the appellant, relating to whether a flawed decision has been made, to be revealed.

Our view is that there would be benefits in the appeal process enabling *all* materially and directly affected parties to appeal all aspects of the economic regulatory decisions including both the quantum and form of any price controls.

We do not consider that placing specific limits on parties with a standing to appeal or on the matters that may be appealed would be beneficial in limiting frivolous claims. Rather it could lead to manifest injustices where a party with a legitimate appeal is prevented from expressing this. Instead we propose that the appeal's body should have the right to dismiss the appeal if they consider it to be immaterial, unmeritorious or to be made by a party that it considers is not materially or directly affected by the relevant regulatory decision. We also consider the appeal body's costs should be covered by the appealing party²⁹.

4.6.1 Who should have the standing to appeal?

As discussed in section 4.5.1 airlines have an important role to play in identifying the efficient scale and nature of investment by balancing the views of the airport licensee. In the same way that airports may have an incentive to overstate investment costs airlines may have an incentive to understate these in order to secure a lower price. Parties directly involved in a regulatory process will have:

- private information in relation to what would represent a reasonable decision that balances the needs of the stakeholder's involved; and,
- the incentive not to delay the outcome.

Therefore, there would be benefits in the appeal process enabling all materially and directly affected parties (including both airlines and airport operators), to appeal economic regulatory decisions.

We note that passenger groups do not pay aeronautical charges (directly) and, as such, the right to appeal price controls might seem unnecessary and potentially could lead to claims where passengers do not separate their concerns with an economic regulatory decision from wider concerns relating to planning or the environment. Although passengers may be indirectly affected by these charges, it is unclear why airlines would not represent passengers' best interests in these

²⁹ In many appeals processes the appellant is also required to cover the costs of the opposing party where there appeal is unsuccessful. However, this would be difficult in a regulatory setting where these costs would be extremely difficult to determine and it is the regulator's decision that is being apposed rather than another party.

circumstances. Similarly, airlines that do not use or pay airport charges would not be directly affected by the pricing decision and therefore may not be able to adequately judge whether the regulatory decision is flawed.

Certainly passenger groups may be more directly affected by aspects of the regulator's decisions that relate to the broader matters of service quality and hence passenger groups should be given the standing to appeal on the basis of errors of judgement in this area.

We note that the appeals process for pricing determination of the Commission for Aviation Regulation (CAR) in Ireland, enables airports, aviation authorities and any airport user (including airlines) who are affected by a determination to apply for appeal. Similarly, the EU telecommunication directives are consistent with this, whereby any user or provider who is affected by a decision of a national regulatory authority has the right of appeal against the decision to an independent appeals body³⁰.

4.6.2 What aspects should be appealable?

The DfT is proposing various options around the power of parties with a material interest having the right to appeal a licence modification or some specific aspects of a licence modification. These include the CAA's:

- decision to modify the licence;
- decision to endorse an airport operator's statement of charging principles; or
- statement of principles, setting out the fundamental basis on which price control decisions are made. This would include the high level pricing methodology used, but not the details of the technical calculations and assumptions.

The DfT is also proposing an option whereby licence modifications (which is understood to include price control decisions) are not appealable at all.

It is not clear why the DfT would attempt to limit appeal to particular aspects of CAA's economic regulatory decisions. An appeals process in relation to both the tiering and the pricing decisions of the regulator is likely to be beneficial, provided unmeritorious or immaterial appeals can be swiftly dealt with.

The current arrangements are such that the CC effectively reviews the whole pricing determination, including the technical aspects of the calculation. Limiting the appeal to only high level fundamentals may make the process faster, but it

³⁰ Directives 2002/21/EC on a common regulatory framework for electronic communications networks and services, Article 4, paragraph 1, (source:http://eur-lex.europa.eu/pri/en/oj/dat/2002/l_108/l_10820020424en00330050.pdf)

limits the effectiveness of an appeal process as a mechanism for holding the regulator to account.

While the appeals process adopted in other regulated network industries varies, it tends to facilitate merits-based appeals on both the form and the substance of a regulatory decision³¹. For example under the Energy Act 2004 the decisions of Ofgem may be appeal on one or more of the following:

- that regulator failed to have regard to the relevant matters;
- that regulator failed to have regard to the purposes for which the relevant condition has effect;
- that regulator failed to give the appropriate weight to one or more of those matters or purposes;
- the decision was based, wholly or partly, on an error of fact; or
- the decision was wrong in law.

This list of factors does not limit the appeal to the high level pricing methodology used, but also allows appeal of the technical details of the decision.

In addition the appeals process for pricing determination of the CAR in Ireland is understood not to limit what aspect of the price determination is subject to appeal.

4.6.3 Limiting frivolous claims

If an appellant faces no costs as a result of submitting to this process, then they may have an incentive to appeal irrespective of the correctness of the regulator's original decision. Where these 'frivolous claims' impose costs on other parties and the appellant is not required to provide recompense, an appeal process could be inefficient. Examples of such costs involved in an appeal process include:

- the costs of the opposing party;
- the direct costs of the appeal body;
- the opportunity costs associated with other parties potentially being unable to enter an appeal as a result of the appellants action; and

³¹ Other examples include the Water Industry Act 1991 requires Ofwat to refer any disputed determination of price limits to the CC for determination. Similarly decisions of Ofcom under Part 2 of the Communications Act 2003 may be appealed to the CAT. If the appeal raises a price control matter the CAT must refer that matter to the CC for determination. The CC also has appeal jurisdiction under section 173 of the Energy Act 2004 in relation to the regulatory decisions of Ofgem. Appeals to the ORR in relation to access disputes can be on both the quantum and process for determining charges.

- the costs of third parties such as other airlines whose operations may be affected by a change or delay in the final regulatory determination.

An appeals process can be structure in numerous ways in order to avoid or limit the extent of any frivolous claims and ensure a timely process.

The most efficient and commonly-used mechanism for limiting frivolous claims would be to pass the costs of the appeal process through to the appellant, such that they take account of these external costs when deciding whether to appeal. We consider these costs should include the appeal body's costs³².

This approach is likely to be effective in relation to commercial parties where the costs of an unsuccessful appeals process. However, it may not be as effective for 'not for profit' groups who are formed on a single-issue platform, for which the regulator's decision represents success or failure. In these cases it may be appropriate to directly limit the ability of these parties to appeal the decision or give the appeal body the power to dismiss the appeal if they consider it to be unmeritorious.

We consider that the appeals body should have the power to dismiss appeals by parties not materially or directly affected by the regulatory decision in order to limit frivolous claims. By way of example, environmental groups should be restricted from appealing an economic regulatory decision on the basis of dissatisfaction with a planning decision as this matter is unrelated to economic regulation and other appeal forums exist to manage such disputes.

The appeals body should also have a dismissal power relating to the merits of the appeal. This could be on the basis of a relatively low threshold such as 'reasonable suspicion' that the regulator has made an error of judgement, be based on the appellant's submitted statement of objection and potentially a very low level of investigation from the appeals body.

In addition an explicit time limit or 'best endeavours' clause could be added to the legislation that requires the appeal body to resolve or use their best endeavours to resolve an appeal within a certain time period. This is consistent with the approach contained in the EU telecommunication directives which require Member States to ensure that the merits of the case are taken into account, and that appeal proceedings are not unduly lengthy³³.

³² In many appeals processes the appellant is also required to cover the costs of the opposing party where there appeal is unsuccessful. However, this would be difficult in a regulatory setting where these costs would be extremely difficult to determine and it is the regulator's decision that is being apposed rather than another party.

³³ Directives 2002/21/EC on a common regulatory framework for electronic communications networks and services, Article 4, paragraph 1, (source:http://eur-lex.europa.eu/pri/en/oj/dat/2002/l_108/l_10820020424en00330050.pdf)

Frontier Economics Limited in Europe is a member of the Frontier Economics network, which consists of separate companies based in Europe (Brussels, Cologne, London & Madrid) and Australia (Brisbane, Melbourne & Sydney). The companies are independently owned, and legal commitments entered into by any one company do not impose any obligations on other companies in the network. All views expressed in this document are the views of Frontier Economics Limited.

FRONTIER ECONOMICS EUROPE

BRUSSELS | COLOGNE | LONDON | MADRID

Frontier Economics Ltd 71 High Holborn London WC1V 6DA
Tel. +44 (0)20 7031 7000 Fax. +44 (0)20 7031 7001 www.frontier-economics.com