



NON - CONFIDENTIAL

Response for BAA Limited

Response to CC paper on 'Assessment
of LRAIC-based Price Cap'

BAA/CC2008/1120

BAA Limited
August 2008

1. Introduction

- 1.1. In its reference to the Competition Commission (CC) in April, the CAA proposed two options - market-led price cap (MLPC) and precautionary price cap (PPC) - for the regulation of airport charges at Stansted Airport in Q5, which were based on the concept of long-run average incremental cost (LRAIC).¹ On July 21st, the CC issued a working paper entitled 'Assessment of LRAIC-based Price Cap within the Q5 Stansted Inquiry', which explains why it does not consider either of the LRAIC-based options to price regulation to be viable options for the Q5 control period.
- 1.2. This note is a response to the CC's working paper. It reviews the CC's reasons for rejecting the use of LRAIC-based approaches. BAA accepts that the introduction of LRAIC-based pricing is unlikely to be practical for Q5, not least because of the limited time available to the CC for modelling and consultation ahead of its statutory deadline for reporting to the CAA of October 29th 2008. BAA has however agreed to work with either the CC or the CAA if either decided such a proposal needed working up into a possible cap for Stansted.
- 1.3. However, it is also understood that the CC has effectively rejected LRAIC-based options for reasons that are specific to the setting of the price cap for Stansted during Q5, and therefore the rejection is not of the principles of LRIAC-based approaches per se. LRAIC-based approaches should be considered for future price reviews, subject to the practicality constraints identified in the CC's working paper being satisfactorily addressed.

2. Comments on the CC's reasons for rejecting LRAIC

- 2.1. The CC identifies six broad problems with the application of LRAIC-based pricing in this case. These relate to:
 - regulatory commitment;
 - competitive constraints;
 - establishing an efficient benchmark;
 - timescales;
 - data requirements; and
 - consistency of approach.

BAA's comments on each of these issues are set out below.

¹ CAA (2008), 'Airport Regulation Price Control Review—CAA reference to the Competition Commission for Stansted Airport'.

Regulatory commitment

- 2.2. An effective LRAIC-based price cap needs the support of regulators that spans multiple regulatory control periods, as per CC's comments. This can be problematic in an environment in which regulators cannot commit beyond one quinquennium.
- 2.3. The Oxera report on LRAIC pricing noted some of consequences of this lack of commitment.² These include the undesirable incentive effects that would arise were Stansted charges to be set on the basis of LRAIC during Q5, and then subsequently 're-regulated' with a RAB/WACC approach in Q6.
- 2.4. LRAIC is intended to deliver long-term signals, and cannot be expected to operate appropriately in an environment in which regulators retain discretion to change the regulatory framework at subsequent reviews. This will increase the risk of asset-stranding, which will raise the cost of funding those assets.
- 2.5. The CAA's proposals also lack clarity on the critical issue of how the LRAIC would be increased over time, as noted in the CAA's reference document:

In the CAA's view, when using LRAIC to inform the setting of the level of the price cap it is important to ensure that the estimate used does not vary significantly over time and, in particular, does not artificially depress airport charges following a major investment, as to do so might discourage economic and efficient investment.³

- 2.6. This could lead to a risk that historical investment might not be reflected in future prices, as investment triggered by a higher price cap might then become unprofitable if the price cap were to be reduced in the following regulatory period. It would be important to ensure that changes to the LRAIC charges at periodic regulatory reviews respect the principles of the methodology and do not discourage efficient investment.
- 2.7. The CC also notes that the credibility of commitments to LRAIC-based charges is likely to be affected by the DfT review of economic regulation and the CC's market inquiry. While this is true, these reviews might be seen as an opportunity for the issue of regulatory commitment to be addressed in the context of overall reforms to the regulatory structure. Mitigating the problem of regulatory commitment could reduce the inefficient distortions and perverse incentives that are created. Consequently, it is possible that regulatory credibility will be less of an issue for future applications of LRAIC-based charges, and therefore LRAIC approaches should be kept under review by regulators.

² Oxera (2008). 'How LRAIC Might Work Differently in Airports Compared with Other Industries', BAA/CC2008/1008.

³ CAA (2008), 'Airport Regulation Price Control Review—CAA Reference to the Competition Commission for Stansted Airport', April.

- 2.8. Another analysis of the feasibility of regulatory commitment can be found in the CC's Q4 report on Heathrow, Gatwick and Stansted. The CC highlights its own analysis in that report citing credibility as a drawback of the "price path commitment" that had been proposed by the CAA. It is interesting that the CC cites possible alternatives to the PPC to provide incentives to invest, namely the use of AICC, "thereby reducing reliance on future larger increases in prices, in which BAA could have no confidence"⁴. The fact that the CC is now considering replacing AICC with AIO amply demonstrates the problems of regulators giving commitment.
- 2.9. When considering the ability to give commitment, BAA faces the unique challenge of relying on two regulators. In Q4, the CAA proposed the dual till and the PPC. The CC recommended the single till and no PPC. In Q5, we have the CC and the CAA duelling in public about the extent of Stansted's market power with direct implications for the form of the price cap that will be put in place at Stansted⁵. In this light, the issue of regulatory commitment seems difficult to address.

Competitive Constraints

- 2.10. The CC's provisional view concerning the degree of competition faced by Stansted is that the airport has market power⁶. The CC concludes that it would not be appropriate to set LRAIC-based prices that allow for mark-ups, since this may mean that prices at Stansted could be maintained above the price that would be expected in a well-functioning market. (We however note that the CAA is not of this view).
- 2.11. At the same time, the presence of market power of some form has not been an impediment to the introduction of LRAIC-based approaches in other regulated sectors such as water, telecommunications and energy. Therefore, LRAIC-based methodologies could be deployed to regulate airport charges in forms other than those proposed by the CAA in its reference. This suggests that the desirable properties of LRAIC could be demonstrated in alternative methodologies that reflect the specific circumstances and market environment of the airport that exist at the time of future regulatory reviews. The CC states that a correctly applied LRAIC model with sufficient accurate information:

*would be expected to result in prices closer to the level which would be expected in the long run in a well-functioning market than may be expected under a RAB-based approach. Under these circumstances a LRAIC approach would be expected to provide the correct signals to foster efficient entry, investment and innovation.*⁷

⁴ "BAA plc, A report on the economic regulation of the London Airport Companies", CC, October 2002

⁵ The latest instalment of this exchange has been published by the CAA on its website on 8 August 2008

⁶ BAA's views on market power at Stansted have been summarised in submissions BAA/CC2008/1080.

⁷ Competition Commission (2008) 'Assessment of LRAIC-based Price Cap within the Q5 Stansted Inquiry', para. 89.

- 2.12. These types of considerations suggest that the possibility of LRAIC-based approaches should be retained for consideration in future regulatory reviews, and that the presence of market power need not be a barrier to their use.

Establishing an efficient benchmark

- 2.13. The CC concludes that it is not clear whether it will be possible to find appropriate comparators and develop an efficient investment benchmark for Stansted capacity expansion. LRAIC can be calculated using a bottom-up or top-down approach. In a bottom-up approach, a hypothetical comparator (or network) is created by defining an efficient comparator capable of serving the observed demand by using engineering, economic and accounting principles. In a top-down approach, costs actually incurred by the operator are the starting point. The CC states that, in practice, the calculation of the LRAIC is likely to involve a combination of the bottom-up and top-down approaches with a view to reconciling the results. Ofcom has used such a combination in its so-called 'hybrid' approach.⁸ Whatever the nature of the calculation actually used, the exercise will require careful analysis, and it may not be practical to complete this analysis in the time available to the CC before the submission of its report to the CAA.
- 2.14. A more detailed feasibility exercise is likely to resolve some or all of the uncertainties and practical difficulties identified in the CC's paper. Given the potential advantages of LRAIC-based approaches to the regulation of airport charges, there would appear to be merit in undertaking a scoping exercise to assess the feasibility of determining efficient benchmarks for future regulatory reviews.

Timescales

- 2.15. The time available for the CC to undertake the consultations and detailed modelling required for a LRAIC-based approach to be introduced for Q5 might be indeed insufficient.
- 2.16. The CC's recognition of the importance of undertaking modelling of the details of proposed regulatory options is welcomed. This principle should be applied to all of the options currently being considered by the CC for Q5, particularly concerning the investment and financeability implications of the CC's 'Option 1a' augmentation to the building-block approach to determining charges, which remunerates only assets in operation, rather than assets in the course of construction.

Data Requirements

- 2.17. The CC's recognition that robust and detailed modelling of the costs associated with the relevant increment is necessary in order to obtain a reliable and meaningful LRAIC estimate on which to base a regulatory control determination is welcomed. The data requirements can indeed be an obstacle to introducing LRAIC for Stansted in Q5.

⁸ Ofcom (2007), 'Mobile call termination statement', March 27th.

- 2.18. The CC compares the data requirements of LRAIC to the standard RAB/WACC building-block approach, and concludes that the data requirements under LRAIC are more onerous than the RAB/WACC model, at least for the initial introduction of LRAIC. It is worth considering whether, in future reviews, this objection could affect the merits of LRAIC-based approaches.
- 2.19. As the CC notes in para 69 of the working paper, the data requirements of LRAIC in subsequent reviews (ie, following a first review to 'set up' a LRAIC-based cap) would be less burdensome than a RAB/WACC approach, although some adjustments (to input costs, for the 'efficient comparator' and perhaps to correct for forecasting errors) would still be necessary at each review. This suggests that LRAIC may result in fewer data requirements overall, and result in a lower regulatory burden for BAA and its regulators. We note however the discussion between the CAA and the CC in the CAA's hearing as to whether in fact the information requirements remain broadly the same, since each regulatory review would provide an opportunity to "update" the LRAIC calculations.

Consistency of approach

- 2.20. BAA recognises that the consequences of applying different models of regulation to the south-east airports requires careful consideration. The CC suggests – but does not demonstrate - that BAA may have an incentive to prioritise investment at the RAB-regulated airports of Heathrow and Gatwick through the 'gold-plating' effect, and thereby neglect to undertake efficient investment at Stansted. In addition, the CC suggests that if prices are higher at Stansted than at the RAB-regulated airports (perhaps because prices at Heathrow and Gatwick are below the competitive level), users may be discouraged from using Stansted, thereby increasing congestion and capacity tightness at the other airports.
- 2.21. The CC's first argument concerning the inconsistency of the different models reflects a presumption that regulation cannot address the problems that the CC has identified. The solution to any perceived incentive towards 'gold-plating' at RAB/WACC-regulated airports would appear to be continued regulatory oversight.
- 2.22. The CC's second point, concerning the implications for the allocation of demand in the south-east, is a consequence of the market-led signals that would be provided by LRAIC. If the market does not constrain LRAIC prices to levels similar to those at Heathrow and Gatwick, the airport must face a clear signal to undertake efficient investment, for which there is an identifiable willingness to pay. It is questionable whether concern that demand may be misallocated under such a scenario is sufficient to overcome the public interest benefits of increased capacity and expansion that would be associated with the investment at Stansted.

3. Conclusion

BAA agrees with the CC's overall conclusion that practical constraints - particularly the time available to the Commission to undertake consultation and detailed modelling - mean that LRAIC-based charging caps do not appear to be feasible options for Stansted during Q5. However, the CC has identified a number of important potential advantages of the approach. These advantages suggest that the regulator should consider investigating the possible applications of LRAIC-based methodologies in future regulatory reviews.

We note that the DfT's review of economic regulation may well be an opportunity to fully consider the implications of moving to a LRAIC based approach.