



A response for BAA Limited to the
Department for Transport consultation:

‘Reforming the framework for the
economic regulation of UK airports’

BAA Limited
June 2009

[NOTE: BAA's response contains sections that are commercially confidential. These sections have been excised from this PUBLIC version and are marked with the symbol: ✂]

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Foreword

by Colin Matthews, CEO of BAA Limited

The review of UK airports' regulation is important, particularly in the context of the UK's ability to emerge from global recession with the infrastructure needed to compete internationally. There is widespread agreement that the system put together in the 1980s needs to be modernised.

BAA supports the three strategic themes emerging from the consultation process;

- A continuous drive to improve the customer experience;
- Facilitation of the right investment at the right time in airport infrastructure; and
- Coherence between aviation and other Government policies, especially environmental.

BAA agrees that the primary duty of the CAA should be to promote the interests of consumers, and supports the move to a licence-based form of regulation. To achieve the best outcomes for current and future passengers, the CAA must also discharge other duties, including encouraging investment in airports, aligned with the wider framework of Government policy. In particular, the new regime needs to be adequately stable and robust to confront important and controversial questions including the delivery of new runway capacity.

The Government's wish to ensure that passengers are not disrupted in the event that an airport encounters financial difficulty is understandable, but the benefits of introducing a new regime must outweigh its costs and we will be asking Government to ensure that regulated airports be allowed to recover any such costs.

Heathrow warrants particular focus because of its unique role as the UK's only hub airport. Regulation should recognise that to provide passengers starting or ending their journey in London with a diverse network of routes, Heathrow must win the competition with hub airports outside the UK for transfer traffic, without which most direct long haul destinations would not be economically viable.

We encourage the Department to press ahead with its plans to reform the regulatory regime as soon as possible. This will minimise the period of uncertainty that is associated with the current consultation and enable BAA to finance its on-going programme of investment efficiently and get on with the task of delivering real improvements for passengers.

Executive Summary

Introduction

1. BAA welcomes this opportunity to respond to the Department for Transport's March 2009 consultation 'Reforming the framework for the economic regulation of UK airports.' BAA's response builds on the company's previous responses to the Department in July and December 2008 and provides answers to the specific questions raised by the consultation document.
2. BAA welcomes many of the elements of the Department's proposed reforms. BAA broadly supports the proposed statutory remit for the CAA and welcomes the flexibility that moving to a well designed licence-based regime should offer. Together with the proposed tiered approach to regulation this will create greater flexibility and enable regulation to be aligned with the economic characteristics of airports.
3. At this stage, many of the details associated with the reforms have not been developed to a point where the expected costs and benefits of implementing them can be properly assessed. BAA's broad support for the key elements of the new regime is, therefore based on the assumption that the anticipated benefits of the proposals will be shown to be proportionate to their costs. Before policy decisions are taken it is critical that the Department develops its current analysis to establish the impacts of the proposed reforms and BAA would be prepared to assist the Department with further evidence and analysis in this respect.
4. There are a number of areas where BAA has carried out further work to assess the practical implications and likely costs associated with some of the proposals. In particular, we have worked closely with the ABI and other creditors to develop a workable alternative to the Special Administration regime proposed in the consultation document.
5. This alternative, which BAA sets out in Annex C, is designed to achieve the Department's policy objective of ensuring that key airports remain open in the event of financial difficulties. It does so in a manner that is more likely to be compatible with BAA's existing secured financing structure and capable of being implemented at an acceptable cost and without further undue disruption to operators' financing and investment plans. However, it will be important for the Department to reach a view on whether intervention in this area is necessary given the likely balance of costs and benefits associated with potential reforms.

Understanding the costs and benefits of the proposed reforms

6. In considering the potential package of reforms, the Department needs to reflect the principles of 'better regulation' and implement reforms only where there is clear evidence identifying an expected net positive benefit. The process of implementing the new regulatory regime could lead to significant transitional costs and costs associated with the on-going operation of the new regime, and the Department will need to do further work to develop its understanding of these costs before ministerial approval for the proposed reforms is granted.

7. Recognising that these costs may need to be incurred to achieve the benefits for consumers expected from the reforms, the Department should direct the CAA to allow airports to recover – in full – the additional costs associated with implementing and operating the new regime through airport charges. It would not be appropriate for the Department to leave such decisions to the CAA, since the CAA may take a different view from the Department of the benefits to passengers of implementing the reforms, and may therefore not, unless directed by Department to do so, allow the full additional costs to be passed on to consumers.

Implementing the reforms

8. The initial market reaction to the Department's consultation document has reinforced the need for the Department (and subsequently the CAA) to provide clarity of the overall direction of its thinking on key issues, including the commitment to avoiding costly impacts on BAA's existing financing structure and the need for airports to be able to finance their regulated activities.
9. To mitigate the potential impact of a new regime, BAA expects the Department to minimise the uncertainties that are associated with implementing the new framework by providing clear guidance to the CAA on how the new framework should operate and taking an active role in the development and introduction of the new framework.
10. This will be particularly important given the significant role that the CAA will have in implementing the changes once the Department has enacted primary legislation. The proposed reforms would significantly increase the CAA's powers and the Department must ensure that the CAA is demonstrably ready and capable of discharging these powers. The Department will also need to consider how best to implement the regulatory reforms given the recommendations from Sir Joseph Pilling's recent strategic review of the CAA.
11. To maintain effective governance, the Department's responsibility for designing and implementing the new regulatory framework must be separated from the CAA's responsibility for operating the new framework. The Department must continue to provide sustained leadership and control of key policy issues throughout the implementation and transition phases, including the drafting of initial licences in the way that it did for NATS privatisation.
12. The Department must take into account the interaction between this review and the implementation of the provisions from the EU Airport Charges Directive. BAA agrees with the Department's proposal to implement the Directive through the introduction of a licence for all UK airports with a throughput of more than five million passengers a year. BAA will provide detailed comments on the Department's proposals to implement the Directive through the separate consultation which is planned by the Department for later this year.
13. In launching the Review, the then Secretary of State identified three main objectives for a new regulatory framework:
 - improve passenger experience;
 - encourage appropriate and timely investment in additional airport capacity; and
 - address the wider environmental impacts of aviation and airport development

14. The following sections assess the extent to which the Department's proposed reforms will achieve these three objectives, and consider a number of further issues raised by the consultation.

Improving passenger experience

15. BAA supports the Department's objective to improve the passenger experience as part of the review of the regulatory framework. In recent years, BAA's focus on passenger service has sharpened considerably. At Heathrow alone BAA has hired more than 1600 new security staff and added new security capacity (32 new lanes) and world leading technology and equipment to reduce queue times and improve security standards. BAA is also investing more than £4 billion at Heathrow to create new facilities and refurbish existing terminals, underlining the company's renewed commitment to delivering a culture of continuous improvement.
16. The proposed primary duty for the CAA to promote the interests of current and future consumers will ensure that it focuses on establishing the outcomes that best serve passengers' interests. It is right that in doing this, the CAA and airports place reliance on the views of airlines, as in most cases these views will be closely aligned with passengers' interests.
17. Achieving a clear appreciation of what outcomes would be in consumers' interest will require the CAA to develop an understanding of passengers' willingness to pay for service improvements and investment in new capacity. Of particular importance will be the CAA's recognition that the amount passengers are willing to pay for different outputs will vary significantly between airports. For example, passengers at Heathrow attach significant value to the network of long haul routes provided by the airport and the transfer opportunities that are available. To deliver the best outcomes for passengers, the CAA will need to make sure that the significant differences between the characteristics of each airport are reflected in the way it operates the new regime.
18. BAA supports the proposal to establish a primary duty to consumers supported by a number of further duties. To reinforce the importance of each of the duties, the Department should make clear through legislation that achieving the further duties will be an integral part of discharging the primary duty.
19. Giving the CAA a statutory remit to intervene to improve the passenger experience will improve coordination between the different parties involved in delivering services to passengers. The effectiveness of the CAA's role would be significantly enhanced by increasing transparency around the performance of all parties involved in delivering the end-to-end experience. These include the airport operator, airlines, handling agents and Government agencies such as the Border and Immigration Agency. Collecting and publishing performance data from these parties will generate strong incentives to improve performance by creating visibility of good and bad performance, and informing customer choice. At Heathrow, the ability to drive performance improvements will be of particular value in enhancing the airport's competitive position relative to other European hubs.
20. The CAA's statutory remit to intervene to improve service quality can be expected to enhance outcomes for passengers. However, the current proposals would mean that the CAA would only have powers to take enforcement action against the airport. While airport operators should take

responsibility for the overall reputation of the airport, they should not be made liable for the poor performance of other parties. Although some of these parties operate in generally competitive markets, it would be appropriate to give the CAA enforcement powers to be able to require these other parties to improve the level of service quality.

21. BAA supports the measures designed to enhance consumer representation within the regulatory framework. Passenger Focus should provide an effective voice for passenger interests, and will be in a position to work constructively with those responsible for providing services to passengers to improve the end-to-end experience. BAA also expects local passenger groups at some large airports will also make an important contribution to improving passenger experience.

Investment in new capacity

22. BAA agrees with the Department that one of the key objectives for the Review should be to ensure that the regulatory framework creates the right incentives for appropriate and timely investment in the delivery of new capacity. Airport capacity is a strategic issue for the UK economy: a new runway will enable Heathrow to compete with other European hubs and maintain a strong network of long haul services that connect the UK to all parts of the globe, and a new runway at Stansted will provide important capacity to meet demand for air travel.
23. The policy framework for the delivery of new airport capacity was clearly set out by the Government in 2003 in the Future of Air Transport White Paper. This looked ahead over the period to 2030 and concluded that there was a clear need for two new runways in the South East. Airports will need to invest considerable financial resources to deliver these projects, and the incentives and support provided by the regulatory framework will be a key factor for investors when assessing the case for investing in new runway capacity.
24. The existence of a Regulatory Asset Base (RAB) gives investors confidence in their long-term ability to secure a reasonable return on invested capital, and the approach has successfully underpinned significant investment (including Terminal 5) at BAA's London airports. However, a new runway will commit investors to substantial one-off capital investment in a single project. Any new regime will need to allow for the CAA to give investors adequate assurance that investment in large infrastructure projects – that have pay back periods over two or more quinquennia – will not be stranded and will earn a reasonable and predictable return.
25. It is right, therefore, that the Department should be considering the need for reforms to the existing regulatory framework to support the delivery of the new runway capacity set out in the 2003 White Paper. BAA believes that a clear regulatory commitment to the RAB, combined with a financing duty in the form outlined in Section 1.4 will be important elements in any such reforms but may not, on their own, be sufficient to deliver best value without additional bespoke arrangements with regard to risk allocation and long-term returns.
26. In this respect, the new statutory remit for the CAA and the introduction of a licence-based regime of regulation will generally enhance the delivery of new capacity:

- a primary duty to consumers will require the CAA to identify the outcomes that are in the interests of current and future consumers, and take steps to ensure those outcomes are achieved;
 - a duty to secure that demand is met will require the CAA to determine how much capacity should be provided in consumers' interests, and then establish appropriate incentives to ensure that it is delivered;
 - a duty on the CAA to assist the delivery of Government air transport policy will improve the overall coherence of the policy and regulatory framework relating to the delivery of new capacity;
 - a duty on the CAA to ensure that regulated airports can finance their functions and earn a reasonable return on investment will enhance investor confidence in regulated airports which will reduce the costs to passengers of new capacity; and
 - the introduction of a licence-based framework has the potential to create opportunities for the CAA to adopt a more flexible approach to regulation, and implement where appropriate bespoke regulatory solutions to secure the delivery of new capacity.
27. Whilst BAA is broadly supportive of the proposed primary duty and the further duties designed to promote appropriate and timely investment, it will be critical for the CAA in implementing the new framework to take a fresh approach to the issue of capacity development. The proposed regime will enable the CAA to explore new approaches to regulating investment in new capacity, which will be of particular importance with respect to BAA's investment in the delivery of a third runway at Heathrow and a second runway at Stansted. BAA would particularly encourage the CAA to use the flexibility provided by the framework to mitigate the risks associated with major investments, for example, by extending the duration of the price control period beyond the current five-year maximum and exploring the potential for market-based solutions to mitigate long-term demand risk.
28. At Heathrow, there will be an opportunity to adapt regulation to reflect the airport's clear position as the UK's only hub airport. Heathrow's market position can be seen in the context of two inter-dependent markets. The first is Heathrow's leading position in the market for direct long-haul services, which it is likely to retain for the foreseeable future. To maintain this network of long-haul services, Heathrow needs to compete intensively in a second market with other European hubs for transfer passengers. These two markets are part of a single economic system and thus cannot be treated separately for regulatory purposes. The CAA therefore needs to be concerned to promote the success of Heathrow in its competition with other hubs in order to fulfil its duty to achieve the best outcome for passengers.
29. At Gatwick and Stansted, where passenger demand is predominantly for point-to-point services, it would be appropriate for the CAA to adapt the regulatory regime to reflect the airports' particular economic characteristics. This may allow the CAA to promote consumers interests by taking steps to introduce a looser form of economic regulation, and potentially removing price-cap regulation altogether in the longer-term.

Addressing environmental impacts

30. BAA has long recognised the importance of responsible airport growth, and the need for airports and airlines to address local impacts and influence the collective international response to climate change. Only by effectively addressing these important issues will aviation be afforded opportunities to grow.
31. BAA supports the Department's objective to address the environmental impacts of airport development and the proposal to establish a duty for the CAA with respect to the impacts that airports have on the environment. However, the scope of the proposed duty would create an environmental remit for the CAA that would extend significantly beyond the recognised role of an economic regulator, into areas that are already the responsibility of other Government Departments and agencies. To address this, BAA is proposing that the environmental duty is revised to focus on the CAA's remit as an economic regulator and make clear that the CAA would be under a duty to assist regulated airports in their efforts to meet established environmental limits and agreed targets.

Measures intended to improve financial resilience

32. BAA supports the Department's objective of improving the financial resilience of regulated airports. The financing duty and "substantial effect" clauses which are features of other regulatory regimes are particularly appropriate for airport operators who face a level of demand risk that is greater than that faced in the water, rail and energy distribution sectors.
33. The feedback from banks and bondholders with regard to some of the Department's proposed other financial measures has, however, been less positive. There appears to be a broadly consistent view amongst creditors that the Department's proposals for Special Administration and the restriction of creditors' security rights are inconsistent with their existing rights and would, as a result, impair rather than improve financial resilience. Therefore they would not achieve the best outcomes for consumers, and it will be important for the Department to identify an alternative approach to ensuring its objectives are met.
34. BAA would, therefore, support the introduction of those aspects of the proposed financial ring-fencing conditions – for instance the restrictions on cross-subsidy – that reinforce resilience and which could be introduced without disrupting BAA's existing financing arrangements. However, BAA opposes the introduction of those elements of the financial ring-fencing conditions that would be incompatible with BAA's existing financing arrangements, such as the proposal to restrict the security that an airport company can give.
35. Financial resilience would also be enhanced by the inclusion within the regime of an appropriate "substantial effects" clause to provide a mechanism for re-opening price control settlements to take account of material changes in circumstance.

Mitigating the impact of the proposed reforms

36. The existing regulatory framework has provided a relatively stable environment for BAA's debt and equity investors over the period since privatisation, and they have been able to make clear assessments of the risks associated with investing in regulated airports. This stability has benefited

consumers by enabling BAA to raise funds for investment at a lower cost than would have been the case in a more volatile regulatory environment.

37. If the Department is to achieve the desired policy objective of establishing a framework to support long-term investment in the UK's airports it will need to have proper regard, in considering any reforms, to the value that BAA's investors attach to the regulatory stability that has been provided by the Airports Act. The current financial structure was put in place under the current regulatory framework, and the cost of capital borne by customers under existing arrangements is lower than would arise under a less stable regulatory environment.
38. Creditors have indicated that certain of the reforms would, if implemented in their current form, adversely affect their existing rights and materially shift the balance of risk and reward from the basis upon which they invested. These are, as a result, likely to introduce additional risks and uncertainties for investors relating to the future operation of the new framework and increase the costs to BAA of financing its on-going investment programme. Indeed, the uncertainty created as a result of the consultation is already having an impact on BAA's credit rating and its ability to raise funds for new investment. To minimise the period of uncertainty the Department should move as quickly as possible to confirm its plans for reforming the regulatory framework.
39. In proposing a Special Administration regime, the Department's objective is to ensure that major airports will continue to operate effectively during periods of financial distress to avoid disruption to passengers. BAA considers that the inherent risk of disruption resulting from insolvency is extremely low given the fundamental economic characteristics of airports. This risk would be further mitigated by the introduction of certain aspects of the proposed new regulatory regime and the Department will need to do further work to examine whether intervention in this area is necessary given the balance of likely costs and benefits of such action.
40. BAA nevertheless recognises the Department's policy objective. BAA has therefore worked closely with the ABI and others to develop a practical alternative to the Special Administration regime proposed in the consultation document. The alternative which is set out in Annex C is designed to implement the Department's policy objective of ensuring that key airports remain open in the event of financial difficulties. It does so, however, in a manner that is more likely to be compatible with BAA's existing secured financing structure and capable of being implemented at an acceptable cost and without further undue disruption to operators' financing and investment plans.
41. BAA welcomes the Department's willingness to consider feedback on how changes to the regulatory framework should be designed and implemented. BAA attaches significant weight to the Department's recognition that the reforms should only be introduced when market conditions make it efficient to do so and that it may be appropriate to introduce only limited parts of the reforms to minimise disruption to existing financial arrangements.
42. Further detailed work is required by the Department, BAA and its creditors to develop the alternatives put forward in response to the consultation to enable the Department to understand the costs and benefits of a range of different options. Only once this work has been completed will the Department be in a position to establish the most appropriate way forward.

Improving regulatory accountability

43. BAA agrees that increasing regulatory accountability is likely to improve outcomes for consumers. In reforming the appeals process the Department will need to strike a balance between holding the CAA to account for its decisions and ensuring that the structure of appeals does not encourage unmerited and opportunistic appeals of its decisions.
44. BAA supports the proposal to bring to an end the current practice of an automatic reference of price control decisions to the Competition Commission. In the new regime, it is BAA's view that the Competition Commission should be given the role of handling all appeals of CAA decisions, both relating to assessments of market power and licence modification decisions.
45. BAA supports giving rights of appeal to all parties with a material interest in the CAA's decisions concerning whether an airport should have a Tier 1 licence. However, the right to appeal the CAA's decision on licence modifications should only be given to the licensee. This is because giving all parties the right to appeal would be likely to result in a high number of appeals to the Competition Commission and significant disruption to the regulatory process.

Conclusion

46. BAA supports many of the stated objectives of this review of economic regulation. If as an industry airports are to deliver the right facilities, at the right time and at the right cost then the future regulatory framework must have these objectives at its heart. It is also important that specific aspects of regulation, particularly those concerned with improving financial resilience, do not inadvertently impede the overall objective, which is to provide world-class airport services to consumers.

Introduction

1. BAA welcomes this opportunity to respond to the Department for Transport's March 2009 consultation 'Reforming the framework for the economic regulation of UK airports.' BAA's response builds on the company's previous responses to the Department in July and December 2008, and provides answers to the specific questions raised by the consultation document.
2. BAA's response is structured in three main parts which address the proposals set out in the Department's consultation document. Two annexes are also included in the response.
3. The parts of the document and the content of the annexes are as follows:
 - Part 1 focuses on the proposed changes to the statutory remit under which the CAA operates. BAA considers the Department's proposed duties for the CAA, and discusses the other proposals to improve financial resilience.
 - Part 2 focuses on issues associated with the Department's proposal to regulate airports through a licence-based regime and measures to improve accountability.
 - Part 3 focuses on the Department's proposals to put passengers' at the heart of the regulatory regime. BAA provides its views on the proposed measures designed to enhance consumer representation in this framework, measures to improve the passenger end-to-end experience and its views on how the consultative framework can be reformed.
 - Annex A provides BAA's response to the Department's Impact Assessment which was published alongside its consultation document.
 - Annex B provides answers to the specific questions raised by the Department in its consultation document in chapters six through to ten.
 - Annex C sets out an alternative to the Special Administration regime which has been developed jointly by BAA and the ABI.
4. BAA considers that there is a need for further work on many aspects of the proposals. In some cases, the proposals contained in the consultation document are not of a sufficient level of detail to allow a full response on the specific advantages and disadvantages of different elements of the reform package to be made. In other areas, the Department has explicitly recognised that further work is required. Once this work has reached an appropriate stage, the Department should consult further with stakeholders on the next iteration of the Impact Assessment.
5. BAA looks forward to fully participating in the Department's ongoing and future engagements with stakeholders on these and other issues, and can provide further evidence and analysis to support its views on request. In all cases, BAA welcomes the opportunity to take part in ongoing discussions. BAA will continue to be fully engaged with the review and responsive to the Department's requirements.

Part 1: The CAA's statutory remit

1.1 Structure of the CAA's duties

- 1.1.1. BAA supports the Department's proposal to establish a framework of duties for the CAA that places consumers at the centre of the regulatory regime, through the creation of a single primary duty to consumers. BAA considers that giving the CAA a primary duty to consumers would be an important step forward from the current framework established by the Airports Act 1986, which contains no such duty.
- 1.1.2. In addition to establishing a primary duty for the CAA, BAA agrees it will be important for primary legislation to set out the CAA's further duties. Although it might be possible to rely on a single duty to guide the CAA's work, this would be likely to have significant disadvantages compared with the Department's proposed approach. Prime amongst these would be a lack of clarity regarding the way in which the CAA should seek to achieve its single duty. Setting out the CAA's further duties in primary legislation will make clear how the regulator should go about achieving its primary duty to consumers.
- 1.1.3. The further duties need to be accorded a higher significance than 'factors' that the regulator should consider when undertaking its regulatory activities to promote the interests of consumers. BAA does not believe that it would be helpful or necessary for primary legislation to establish an order of priority in the CAA's duties beyond the identification of the primary duty. BAA believes that each of the CAA's further duties should be established as independent but mutually supportive of one another, with each intended to contribute to the achievement of the primary duty to consumers.
- 1.1.4. As such, primary legislation should make clear that the CAA would fail to discharge its primary duty if, at the same time, it failed to achieve any of its further duties. For example, the CAA would not discharge its primary duty to consumers if it failed to allow an airport to finance its functions, or if it failed to assist in the delivery of Government policy.
- 1.1.5. For clarity, and to assist the Department in considering responses to the consultation, BAA has proposed alternative or additional wording for the duties where appropriate. In this case, BAA proposes that the Department should adopt the following additional wording to establish and clarify the relationship between the CAA's primary and further duties:

"in discharging its primary duty to existing and future consumers of passenger and freight services, the CAA will be obliged to ensure that all further duties are respected and complied with."

1.2 Primary duty to consumers

- 1.2.1. BAA supports the Department's proposal to establish a single primary duty for the CAA to promote the interests of consumers. Improving passenger experience was one of the three key policy objectives established at the beginning of the review, and the creation of a primary duty will properly reflect the importance of consumers in airport regulation.
- 1.2.2. The Department also proposes a number of further measures which are intended to inform the CAA in discharging the primary duty, including setting out the role of consumer representation and measures intended to promote the role of airlines within the regulatory process. This section of BAA's response sets out views on how the CAA should interpret the primary duty. Part 3 of BAA's response considers how the primary duty should be incorporated into the consultative framework, in particular through Constructive Engagement, and provides suggestions on a number of specific ways for the regulatory framework to support improvements in the passenger experience.
- 1.2.3. BAA believes it is right that the CAA's principal focus should be on promoting the interests of consumers. Where competition between airports is not fully effective, it may not be appropriate to rely on market forces to promote consumers' interests, and some form of regulatory intervention may be necessary. It follows, therefore, that the CAA's primary duty should be to regulate airports in ways that will promote consumers' interests, and thereby replicate as closely as possible the outcomes associated with a competitive market environment.
- 1.2.4. Some airlines have argued that their interests are closely aligned with passengers' interests, and that the CAA's duties should make explicit reference to airlines as well as passengers. In most circumstances, BAA agrees that there will be alignment between consumer and airline interests, and that airport and regulatory decision making should generally be guided by airline views. However, where airline competition is not fully effective there may be differences between airline and passenger interests. It may also be possible to identify circumstances where the more short-term nature of airline interests would not adequately represent passengers' long-term interests.
- 1.2.5. Whenever the CAA has reasons to believe that there might be a difference between the interests of consumers and airlines it should seek to gather independent evidence to establish the outcomes that would be in the best interests of consumers. Where this is the case, it would be inappropriate for the CAA to strike a balance between the interests of consumers and airlines: the interests of consumers should always come first.
- 1.2.6. BAA supports the inclusion in the CAA's primary duty a requirement for the CAA to promote the interests of 'current and future users', and to do so by promoting effective competition wherever appropriate. However, competition between airports for airlines, and competition between airlines for passengers, will only be possible where there exists sufficient airport capacity. In this context, placing a duty on the CAA to promote the interests of current and future consumers will require the CAA to establish a clear view on the long-term demand for air travel.
- 1.2.7. Promoting the interests of future users will require the CAA to take an active role in the delivery of new airport capacity wherever it assesses this to be in consumers' interests. The critical role of

Government policy in the delivery of new airport capacity through the newly reformed planning process is also likely to mean that the CAA will have to be highly active in assisting in the delivery of that policy, where the CAA judges it to be consistent with promoting the interests of consumers.

1.3 Financing Issues - Overview

[✂]

1.4 Financing Duty

[✂]

1.5 Special Administration regime and the prohibition on security

[✂]

1.6 The proposal to introduce financial ring-fencing

[✂]

1.7 Duties to encourage appropriate and timely investment

Overview

- 1.7.1. This section sets out BAA's understanding of how the new regime will fulfil this objective. BAA believes that a coherent overall framework that prioritises consumer needs will be a critical factor in ensuring the delivery of appropriate and timely investment.
- 1.7.2. The overall framework should respect Government policy, and require the regulator to assist in the delivery of that policy. The needs of current and future consumers should be the guiding principle for investment within the overall framework, and this will require the CAA to take an active role in working with airports, passenger groups and other stakeholders to identify projects that support the primary duty and for which there is a robust commercial business case that can be delivered by airport operators.
- 1.7.3. To ensure that consumer needs are fulfilled, it will be important that the overall framework, and the CAA's interpretation of its duties, does not increase avoidable regulatory risk and works to efficiently mitigate commercial risks to help support the delivery of those investments for which there is willingness to pay on the part of consumers.

Introduction

- 1.7.4. BAA agrees with the Department that one of the key objectives for the Review should be to ensure that the regulatory framework creates the right incentives to encourage appropriate and timely investment in the delivery of new capacity.
- 1.7.5. The current regulatory framework has been successful in delivering significant investment over the past twenty years and BAA alone has invested over £12 billion at Heathrow, Gatwick and Stansted since the company was privatised in 1987.
- 1.7.6. Looking to the future, airports will need to commit significant financial resources to deliver new runway capacity, and regulation will have a fundamental impact on commercial decisions concerning investments in these projects. It is for this reason that the new framework needs to provide the necessary stability and clarity to underpin investment in new airport capacity.
- 1.7.7. To ensure this objective is met, BAA agrees that it is appropriate for the Department to consider how the new regulatory framework should be reformed to ensure that it provides the most effective support for the delivery of new capacity, in line with Government policy. It would also be appropriate for the Department to consider giving guidance on the way the CAA should approach the task of regulating the delivery of new capacity under the new framework.
- 1.7.8. The section starts by examining how the Department's proposed reform of the CAA's duties will contribute to the achievement of its objective of encouraging appropriate and timely investment in additional capacity. Subsequent sections then consider further issues that the CAA will need to address in regulating airports under the new framework to encourage investment in new capacity.

A coherent framework for airport development

- 1.7.9. In 2003 the Government set out the policy framework for the delivery of new airport capacity in the 'Future of Air Transport White Paper'. The 2003 White Paper looked ahead to 2030 and identified a clear need for two new runways in the South East during the period. Importantly, the White Paper specified Heathrow and Stansted as the locations where Government would support development of new runways.
- 1.7.10. The Government considered that in public policy terms it was appropriate to identify the locations where new runway capacity should be supported, having taken account of the economic, social and environmental impacts associated with airport development. The Government made clear that it attached significant value in planning terms to the added certainty that this location-specific approach would create.
- 1.7.11. In a recent submission to the Competition Commission the Government reaffirmed its commitment to the policy approach set out in the 2003 White Paper. The Government has also stated that the location-specific approach to airports policy will be a key feature in the forthcoming National Policy Statement (NPS) on Airports that will guide the decision making of the Infrastructure Planning Commission (IPC).

- 1.7.12. This approach to capacity development has been questioned by the CAA and the Competition Commission, both of whom have argued that the delivery of new capacity would be enhanced by the Government taking a different approach to air transport policy. In particular, the CAA and the Competition Commission have argued that the Government should place greater weight in developing airports policy on the benefits of competition.
- 1.7.13. This misalignment between Government policy and the preferred approach of BAA's regulators has the potential, if not addressed, to undermine the delivery of new runway capacity. To address this risk, BAA supports the Department in taking steps to align the CAA's objectives with the policy framework established by Government for airport development.
- 1.7.14. BAA therefore supports the Department's proposal to create a duty for the CAA to assist in the delivery of the Government air transport policy. This further duty would be entirely consistent with the CAA's primary duty to promote the interests of current and future consumers, in view of the importance of Government policy support in securing permission for new runway capacity.
- 1.7.15. The Department has proposed that the CAA should have a duty to assist in the delivery of the NPS for airports. The NPS will provide the policy framework for the IPC to consider proposals for major airport developments. However, it is not yet clear to what extent the NPS will be suitable for guiding the regulatory decision making by the CAA. Adopting a more general definition of Government policy with respect to the airport development would create useful flexibility for airports and the CAA in interpreting the duty to assist, and it would maintain a degree of separation between regulatory and planning processes.
- 1.7.16. The Department should set out the nature of the guidance that the Secretary of State will provide to the CAA under the new framework, and the weight that the CAA will be expected to give to such guidance. Amongst other things, the guidance will need to establish what would constitute a "compelling reason" for the CAA not to assist in the delivery of airport infrastructure set out in Government policy. It may also be appropriate for the Department to establish a requirement on the CAA to report periodically on the steps it has taken to assist in the delivery of Government policy as it applies to airport development.
- 1.7.17. To accommodate the possibility of changes to the Government policy, the regulatory framework will need to provide for the treatment of development costs that airports incur in bringing proposals forward. The financing duty will play an important role in ensuring recovery of investment that is efficiently incurred in bringing forward proposals for new capacity, but the regulatory framework should allow for the possibility of other mechanisms being made available to the regulator to ensure that the airport can continue to fulfil its obligations under the licence and avoid undue risk of asset stranding.

Assessing the needs of future consumers

- 1.7.18. The CAA's primary duty will require the regulator to identify the outcomes (in terms of airport capacity) that it considers would be in the interests of current and future consumers. The CAA will then be under a duty to take positive steps to promote the achievement of those outcomes. As such, the CAA's primary duty can be expected to provide general support for the delivery of new

capacity, and should be interpreted as a significant strengthening of the CAA's current duties which only require it to '*encourage investment in new facilities in time to meet anticipated demands*'.

- 1.7.19. To establish the interests of future consumers, the CAA will need to take a long term view of the future demand for air travel, and consider issues such as passengers' willingness to pay for new capacity and enhancements in service quality and resilience. This will allow the CAA to determine whether the projects proposed by airport operators are likely to be in consumers' interests, in terms of the timing, specification and cost of the proposals. Once the CAA is satisfied that a project is in consumers' interests, it would be for the CAA to develop and maintain appropriate incentives to encourage investment, including ensuring that the airport operator is able to earn a reasonable return on investment.
- 1.7.20. The primary duty, taken together with the further duties, will make the CAA directly accountable for ensuring that airports are given appropriate incentives to bring forward and deliver investment in new capacity, consistent with consumers' interests. BAA considers that this would represent an improvement to the current regulatory framework, and will lead the CAA to be more directly engaged in developing the regulatory framework to ensure that capacity projects supported by Government policy are brought to fruition.
- 1.7.21. The Department identifies that in some circumstances there might be "compelling reasons" for the CAA not to assist in the delivery of developments supported by Government policy. However, the CAA will need to have regard to the fact that future capacity development is most likely to be determined by Government policy. In this context, the primary duty to promote consumers' interests is likely to require the CAA to take an active and supportive role in the delivery of the Government's airports policy.

A duty to secure that 'reasonable demand' are met efficiently

- 1.7.22. A duty to secure that reasonable demands are met is common in other regulated sectors. Regulators tend to discharge this duty through setting outputs to be achieved in price controls, which are then reflected in licence conditions that hold companies to account for the investments it forecasts are necessary to meet a duty to supply to customers. Ultimately, through this process, it is for regulators to assure themselves that reasonable demands are being met.
- 1.7.23. The Department is proposing to introduce a duty on the CAA to ensure that all reasonable demands for airport services are met efficiently, subject to it being economical to meet them. The consultation document places significant emphasis on the importance of airports meeting the demand for airport services as efficiently as possible, and states that the duty is intended to build on the CAA's existing duties.
- 1.7.24. BAA accepts that it may be appropriate for the CAA to have a duty to ensure that outputs produced by airports are delivered efficiently. This further duty would be consistent with the CAA's primary duty to promote the interests of current and future consumers, and could be introduced separately from any duty on the CAA to secure that all reasonable demands are met.

- 1.7.25. However, BAA considers that the interpretation and application of the concept of reasonable demand will need careful consideration to be workable in the context of airport regulation. The definition and interpretation of reasonable demand varies significantly between regulated sectors, and there is no clear model for the Department to adopt for use in regulating airports. To be effective and workable, any definition of reasonable demand for airports would need to reflect the economic characteristics of the airport sector, which are significantly different to those in other regulated sectors. BAA would welcome further discussion with the Department on these issues.
- 1.7.26. BAA welcomes the Department's recognition that airports face greater risks than most regulated sectors, and that as a result operators will only be expected to bring forward investments which they consider to be commercially viable. This would be consistent with the proposed wording of the duty which would ensure that reasonable demands are met "so far as it is economical to meet them."
- 1.7.27. There are a number of further issues the Department would have to address in considering the introduction of the concept of reasonable demand, including the following:
- *Government policy*: how would the CAA interpret the concept of reasonable demand for regulated airports when Government policy effectively determines where demand for airport capacity should be met within the London system?
 - *Capacity constraints*: how would the CAA interpret the concept of reasonable demand when Government policy does not support the development of additional capacity at some airports?
 - *Competition*: how would the CAA interpret the concept of reasonable demand in circumstances when a regulated airport is competing with another airport to attract demand?
 - *Other airports*: how would the CAA take into account the capacity that is provided by other airports (such as Luton) in seeking to establish reasonable demand for regulated airports?
 - *Outputs*: for which outputs should the CAA seek to establish a reasonable demand, and to what extent should there be discretion for airports to invest in other outputs?

The CAA's implementation of the new regulatory framework

- 1.7.28. The new framework of CAA duties should in principle provide general encouragement for investment in new runway capacity. More generally, it should improve on the level of support currently provided by the CAA's current duties. However, a revised set of duties for the CAA will not be sufficient to address some of the issues that are inherent with the current regulatory framework. The success of the new framework will depend to a large extent on the way in which the CAA interprets and implements the licence-based regulatory framework. The Department and CAA should consider issuing guidance on how the CAA will appropriately interpret its duties and the approach it should take to regulating the delivery of new capacity.
- 1.7.29. There are a number of issues that are inherent with the current regulatory regime as it applies to incentivising investment that will need to be addressed by the CAA in its implementation of the new framework to serve the Department's overall objective of encouraging timely and appropriate investment in the delivery of new capacity. To achieve this objective, the CAA will need to take advantage of the opportunities that the new regulatory regime will create to take a fresh approach

to the issue of delivering new runway capacity. In particular, the CAA will need to address two particular issues with the current framework:

- the ability of the CAA to mitigate the regulatory risks associated with major infrastructure projects; and
- the ability of the CAA to mitigate commercial risks associated with major infrastructure projects.

Mitigating regulatory risk

- 1.7.30. The Department proposes that it will be for the CAA to consider its approach to setting price caps for airports in Tier 1 and that it may be appropriate to consider alternatives to price control, in lieu of more competitive pressures at some airports.
- 1.7.31. BAA considers that the current regulatory framework is relatively inflexible and until very recently it has been applied in a uniform way at each of the designated airports. In comparison with other regulated sectors, the CAA has fewer powers to intervene between reviews, and less ability to 'flex' the regulatory framework to address specific issues.
- 1.7.32. The Department's proposals will create additional flexibility for the CAA in the way that it regulates airports. For instance, there will be no commitment to maintaining a five-year price control period under the new regime. This will provide the CAA with the ability, for example, to extend the length of the existing price control periods where it is considered to be appropriate, or to allow for the higher marginal cost of financing major new build projects compared to renewal of existing capacity. This flexibility could be beneficial in some circumstances where increased regulatory commitment would reduce the risks associated with investment in delivering new capacity.
- 1.7.33. BAA welcomes the Department's proposal to make the Competition Commission an appellate body in the price control process, in line with other regulated sectors. BAA considers this will be an important aspect in improving regulatory accountability and reducing regulatory risk. It will also offer the potential for airports to achieve increased regulatory commitment from the CAA, given that it will have sole accountability for setting prices under the new framework. As outlined in section 1.4 the proposal to introduce a financing duty will also reduce the regulatory risks associated with investments in major infrastructure projects.

Mitigating commercial risks

- 1.7.34. Using the increased flexibility provided by the new regime, the CAA should consider new and alternative approaches to regulation that will give airports further ways of mitigating the demand risks that are inherent in investment in major infrastructure projects.
- 1.7.35. Demand risk refers to the uncertainty of demand and the ability of a producer to accurately forecast demand into the future. In its previous submissions¹ BAA has demonstrated that in comparison with other regulated sectors such as water and energy, its airports have faced relatively more demand uncertainty. BAA considers that such higher demand risks faced by

¹ BAA/RER/2008/002.

airports need to be sufficiently reflected within the regulatory framework. A failure to recognise this in the regulatory framework could have an impact on the delivery of new capacity. This is because major infrastructure projects such as runways, may require some additional means of allocating risk over and above the standard form of regulation. There are a number of mechanisms which could, in principal, be used in order to mitigate such risks. As part of this review, and in the context of delivering projects such as the third runway at Heathrow, further work is required to develop efficient and economic ways to mitigate these risks.

- 1.7.36. The five-year cycle of regulatory reviews is mandated by the Airports Act. This means that the remuneration of assets whose economic life far exceeds five years is subject to uncertainty, since regulators cannot secure commitment beyond the current regulatory control period. This has created uncertainty for designated airports (and investors) concerning their ability to ensure adequate recovery of capital expenditure. This issue is particularly relevant for incentivising major, one-off investments where airports are dependent on long-term cash flows to remunerate investments.
- 1.7.37. The current framework has not allowed for different types of regulation for different types of assets through the price control. For instance, the conventional RPI-X approach has been applied to the spectrum of projects ranging from Terminal 5 through to refurbishments and capital maintenance projects. BAA considers that there may be a need for different regulatory approaches to be applied to different types of assets, and the regulatory regime should be designed so as to afford the CAA the opportunity to introduce asset-specific regulation where appropriate.
- 1.7.38. The regime may not be best placed through the 'one size fits all' regulatory approach to adequately recognise the challenges in delivering major projects. Indeed, the Department's terms of reference recognises that the current framework "*did not consider how major expansions in airport capacity should be financed and delivered.*" In particular, there is no clarity as to how expenditures incurred, for example, bringing forward proposals in support of Government policy, should be treated in the regulatory framework. On this basis, the current framework may not provide sufficient support to properly incentivise an airport to deliver the best outcomes in each of these areas.
- 1.7.39. Another inflexible characteristic of the current model is the fact that the current statutory remit under which the CAA operates allows for little distinction for different types of regulation to be applied to different economic characteristics which an airport may possess. For instance, under the current framework, airports are designated or not, through the application of designation criteria. Aside from this, there has been no meaningful recognition of the differences in the economic characteristics of airports. BAA considers that airports characteristics, and the changing nature of these, should be reflected in a more flexible approach to regulation.

1.8 An environmental duty

- 1.8.1. BAA supports the Department's proposal to establish a duty for the CAA with respect to the impacts that airports have on the environment and local communities. This is in line with one of

the Department's policy objectives for the review, which was to address the wider environmental impacts of aviation from airport development.

- 1.8.2. BAA believes that the duty should be worded so that it is focused on ensuring that the CAA assists airports in their efforts to meet established environmental targets and planning obligations that are to a large extent established by third parties (i.e. parties other than the CAA).

The Department's proposals

- 1.8.3. The consultation document proposes the following further duty on the CAA:
'to have regard to the effect on the environment and on local communities of activities connected with the provision of airport services'
- 1.8.4. The Department also notes that an additional consultation will take place in 2009 which will consider how best to put into force the Pilling recommendation that the CAA should be given a statutory environmental duty.
- 1.8.5. The Department proposes that licence conditions will apply for airports in Tier 1 or Tier 2 that will require airports to publish on a yearly basis reports that set out their environmental performance, what the likely environmental consequences of their Master Plans are, and what further steps they intend to take to mitigate environmental damage. The CAA will also be empowered to impose additional environmental obligations by changing licence conditions if it deems it necessary to better fulfil its duties. The Department notes that they are aware that a number of airports currently produce these reports as part of their overall corporate social responsibility strategy and that the purpose of the licence conditions is to improve transparency and accountability.

BAA's response to the proposed environmental duty

- 1.8.6. BAA considers that it is important to ensure that the economic regulation of airports works consistently within the existing framework of environmental regulations, as set out in its previous response.² As the consultation document notes, there is an extensive regulatory framework - including EU and national policy, and local planning requirements - that impacts on the development of airports. In summary, the ways in which the environment is treated under the current framework can be described as follows:

- the Government takes account of environmental impacts when setting policy, and compares and contrasts these with the economic and social benefits;
- airports assess the likely effects of their development proposals as part of the planning process and they generally aim to minimise and mitigate these effects where possible, and finally seek to compensate for any residual effects;
- local planning authorities and statutory environmental bodies such as the Environment Agency evaluate the airport developers' proposals which are approved or refused through the planning process (sometimes involving a planning inquiry); and

² BAA-RER-2008-002

- when planning approval is granted with conditions or with planning obligations these are subject to on-going monitoring in association with the planning authority.
- 1.8.7. The primary environmental issues covered by the national policy and regulatory framework include:
- air quality (including emissions standards);
 - noise;
 - surface access to airports;
 - climate change & energy;
 - waste handling, management and disposal;
 - soil and water pollution; and
 - surface water drainage & flooding.
- 1.8.8. Currently, the planning system encourages developers to deliver good environmental performance across a range of local environmental issues. For other global environmental challenges such as climate change, the Government takes account of whether its policies are consistent with its aviation policies.
- 1.8.9. The current framework for economic regulation has allowed for costs of meeting environmental obligations to be taken into account by the CAA in setting the airport charges. BAA considers that there is a good case for airport operators to be provided with further incentives in this regard, especially considering the environmental challenges associated with the delivery of a third runway and additional terminal capacity at Heathrow and the delivery of a second runway at Stansted.
- 1.8.10. In response to the Department's 'Request for Views', BAA suggested that it would be possible for an environmental duty to be incorporated within a secondary duty on the CAA to assist in delivery of Government policy. Consistent with this, BAA supports the Department's proposal to give the CAA a further duty to assist in the delivery of Government policy.
- 1.8.11. The Department's proposed duty for the CAA to assist in the delivery of Government policy could, for example, encapsulate clear direction from Government about core environmental priorities.
- 1.8.12. The Department's proposed duty would require the CAA to 'have regard' to environmental impacts and local communities. BAA considers that the further duty should focus explicitly on the CAA's role in supporting the delivery of the Government's environmental policy priorities at airports with Tier 1 licences. The wording of the duty proposed in the consultation document is excessively broad and BAA considers that it would not provide sufficient clarity over the respective roles of the Government and the CAA and might lead to undesired duplication.
- 1.8.13. To avoid duplication, the environmental duty on the regulator should not overlap with the roles of Government as the policy maker, or the planning authorities and the statutory environmental bodies. Instead, BAA proposes that the duty should be directed towards requiring the CAA to provide support to airports in seeking to meet established environmental targets and obligations, and to provide support for airports' efforts to deliver better environmental performance.

1.8 14. Further, BAA does not believe that there is a case for requiring the CAA to intervene in the operation and development of airports outside Tier 1, including the various aspects of airports' environmental performance.

Proposed publication obligation

1.8 15. The Department proposes a reporting requirement in relation to environmental issues. BAA recognises the important role of environmental reports in providing a transparent account of an airport's performance, and in providing a basis for on-going discussions with stakeholders and the local community.

1.8 16. BAA has been reporting on its airports' environmental performance since the 1990s. The current suite of publications sets out environmental performance, what the likely environmental consequences of the Master Plans are, and what further steps BAA intends to take to mitigate environmental impacts.³

1.8 17. The Department's consultation document rightly notes that building trust over time is essential if an airport is to further develop and promote the interests of its passengers. BAA believes that this driver is already likely to provide sufficient incentive to Tier 1 and Tier 2 airports to report on their performance on issues of most interest to their stakeholders.

1.8 18. Before introducing a publication obligation as part of licence conditions, BAA recommends that the Department should carry out a review of current public reporting by Tier 1 and Tier 2 airports to identify whether regulation in this area would promote additional disclosure that would be of value to the CAA in fulfilling its new duties, and in particular its primary duty to passengers, as part of the overall package of reforms.

1.8 19. If a publication obligation is introduced, BAA considers further thought must be given to:

- What the reports would be expected to contain?
- How the regulator could be expected to react to the reports?
- What scope would the regulator have for associated changes in licence conditions?

1.8 20. BAA considers that it will be important to ensure that any future requirements are aligned with existing voluntary reporting guidelines, such as the Global Reporting Initiative, which is in the process of developing sectoral guidance on sustainability reporting for airports.

BAA's proposed wording for an environmental duty

1.8 21. BAA suggests the following form of words for the CAA's environmental duty:

“to assist airports in their efforts to achieve established environmental targets and obligations.”

³ BAA's latest public reports are publicly available at: www.baa.com/corporateresponsibility.

1.9 A duty to ensure best regulatory practice

The Department's proposals

1.9.1. The Department has proposed the following further duty:

"to have regard to the principles of Better Regulation and any other principles appearing to represent best regulatory practice, and to consult with stakeholders, including airlines."

BAA's views

1.9.2. BAA considers it appropriate for the CAA to have a duty to promote best practice in regulation. This will ensure that decisions are made according to the principles of Better Regulation or other best regulatory practice. Airport stakeholders will therefore be entitled to expect regulation that is proportionate, accountable, consistent, transparent and targeted.

1.9.3. The proposed duty also includes a reference to consultation with stakeholders. BAA is not clear that this will add clarity to the intention of the duty, which BAA understands is to ensure best regulatory practice is followed. BAA considers that in discharging its primary duty to promote the interests of existing and future consumers, the CAA will have to give sufficient regard and give appropriate weight to consumers' interests. BAA therefore considers that it is within the primary duty that due regard is given to stakeholder's views as a means to ensure consumers' interests are promoted. BAA expects that the CAA would consult extensively with stakeholders, including airlines, in pursuit of the primary duty.

1.9.4. Airport operators may then be subject to obligations to consult airlines under licence conditions. This is currently achieved through Annexes to the price control determinations. Part 3 of this response discusses further how consultation with stakeholders might operate in the context of the proposed duties.

BAA's proposed wording for a duty to ensure best regulatory practice

1.9.5. BAA suggests the following form of words for the duty to ensure best regulatory practice. The alternative wording should simplify, and clarify, the meaning of the duty:

"to take account of the principles of best regulatory practice."

Part 2: The Licence-based regime

2.1 The introduction and initial allocation of licences

- 2.1.1. BAA supports the principle of moving towards a more flexible regulatory framework, including the adoption of licence-based regulation. This section sets out BAA's views on the introduction of licences and the process so far on their initial allocation.
- 2.1.2. The introduction of licences needs to be based on the costs of moving towards such a regime bearing a reasonable and proportionate relationship to expected benefits. Annex A responds to the Department's initial Impact Assessment (IA) regarding costs and benefits of the proposals.
- 2.1.3. Depending on the final terms of the licensing regime there may be aspects for which BAA will require consent from its creditors, including provisions relating to termination of the licence and sanctions (see sections 1.5-1.6 and Annex A). Gaining consent may prove costly, although it is difficult to assess the likely costs and likelihood of requiring consent until the proposals are specified in more detail. At this point the Department should engage in further consultation with stakeholders on its IA prior to making policy decisions.

The Department's proposals

- 2.1.4. The Department proposes to regulate airport operators through a licence-based regime. The Department plans to work with the CAA to develop draft initial licences, with input from key stakeholders. The draft licences will be published for substantive consultation with stakeholders before ultimately being issued by the Secretary of State.
- 2.1.5. The Department's IA identifies the main benefits of a licensing regime that it expects to arise from its flexibility. With regards to costs, the Department considers these to be 'negligible since the CAA will be leading this work'. It is expected however that the industry will face some one-off costs related to developing and implementing the new licence regime. The Department have not quantified fully the costs and benefits of introducing the proposed licence regime in its IA. The Department are seeking estimates of these through the consultation and it is not clear, at this stage, whether the benefits of introducing licences exceed the costs. BAA responds to these points in Annex A where it addresses the costs and benefits of the proposals. Although BAA notes here that the Department's assessment of costs is incomplete and does not provide a reliable guide to support decision making.

BAA's response

- 2.1.6. BAA welcomes the additional flexibility that, in principle, a well-designed licence regime may bring. However, BAA has also noted that any such licensing regime should not lead to additional costs that do not result in any material benefit for end users.
- 2.1.7. The consultation document leaves a number of elements of the introduction and allocation of licences unclear. In particular, those airports currently permitted to levy airport charges under the Airports Act 1986 should automatically receive a licence appropriate to the tier in which the airport

is placed. The practical details of how these licences will be conveyed to airports have not been clarified and BAA would welcome further discussion with the Department on these issues.

- 2.1.8. BAA agrees that the initial licences should be issued by the Secretary of State. As part of the consultation process it will be important for BAA and other airport stakeholders to be given a full opportunity to contribute to the work undertaken by the Department and the CAA. The consultation on the drafting and allocation of initial licences needs to be of sufficient length to allow all parties an appropriate opportunity to respond.
- 2.1.9. The Department's IA identifies a number of benefits from the licensing regime, although this position has been reached on the basis of relatively little formal cost-benefit analysis. BAA believes that the costs of introducing a licence-based regime could be material and provides more detailed analysis in Annex A as part of its response to the IA.
- 2.1.10. As a matter of principle, BAA should be permitted to recover all of the implementation costs arising from changes to the system of regulation through its airport charges, including its charges at currently designated airports. This recovery of implementation costs should be allowed on the basis that the costs are being incurred to achieve the benefits for consumers. It will also be important to take appropriate steps to mitigate these costs wherever possible to ensure the transition to a new regime is as effective as possible from consumers' point of view.

2.2 The high level terms of the licence

- 2.2.1. This section sets out BAA's views on the structure of the proposed licence and BAA's views on key elements of the licence including: duration, grounds for revocation, sanctions and the possibility of fractional licences.
- 2.2.2. A number of features in this section will have a critical impact on the fulfilment of the Department's objectives, especially with respect to the proposed emphasis on passengers' interests. It is therefore essential that the Department's final proposals have close regard to how these licence elements are introduced, and subsequently interpreted and fulfilled.

The Department's proposals

- 2.2.3. The Department's consultation document does not contain a firm proposal concerning the duration of the licence. With respect to revocation provisions, the Department states these will be used only as a 'last resort'. It is proposed that these provisions 'follow closely the provisions in other regulated licences,' although no specific proposals are put forward for consultation.
- 2.2.4. The Department notes that sanctions will be available to the CAA in the new regulatory framework. The principal motivation for these sanctions will be to promote compliance with regulatory decisions and with the licence conditions. It is proposed that the sanctions regime will be set out in legislation, although some details may appear in the licence.

2.2.5. The Department also recommends the new regulatory regime should accommodate the possibility of terminal development tendering being introduced, allowing 'fractional' licences and accommodating such arrangements in the price control process.

2.2.6. The Department also proposes that the CAA be given concurrent powers with respect to competition law and that these would be set out in legislation rather than the licences per se.

BAA's response

Duration of licences

2.2.7. Consistent with practice in other regulated sectors, BAA considers that licences should be of a continuing nature, and should not have attached to them a specific deadline for expiry. For example, the wording that applies to the National Grid licence is as follows.

*'This licence, unless revoked in accordance with Schedule 2, shall continue until determined by not less than 25 years notice in writing given by Authority to the licensee.'*⁴

2.2.8. Similar wording appears in the licences of companies in other regulated sectors. BAA proposes that, as in other sectors the licence should have no specific expiry date, and continue indefinitely unless:

- the licence is revoked for specified grounds; and
- notice is given, such notice not to be less than ten years, and in any event not to be given for twenty five years after the introduction of the licence.

2.2.9. A notice period, and any initial period within which notice may not be given, requires careful consideration. Given the economic life of assets such as runways and terminal buildings, and the demand risk to which these assets are subject, there would not appear to be a strong case for not having a notice period, or at least a very long notice period should exist. The combination of long asset lives with volatile demand is typically not observed in utility sectors where the wording identified above for National Grid is representative. It is therefore important that airport investors are not deprived of the opportunity to recover projected returns on investments before, hypothetically, notice is given to revoke. The rate at which airport capacity requires renewal means that, at any point in time, the unrecovered part of sunk investment will require a further number of years to be recovered by investors, and therefore revocation without cause should not be able to take effect for at least the period that remains for the remaining portion of sunk investment to be recovered. Therefore, any notice period must reflect the basis on which existing investors have committed to invest in the airport.

2.2.10. Stipulating a notice period and an initial grace period would create uncertainty for investors, which would be passed through to consumers in terms of higher financing costs. BAA is therefore

⁴ 'Scheme made pursuant to Paragraph 18 of Schedule 7 to the Utilities Act 2000 in respect of the Transmission Licence granted to the National Grid Company plc under Section 6(1)(b) of the Electricity Act 1989, Part I' Terms of the licence, p.4. http://epr.ofgem.gov.uk/document_fetch.php?documentid=11339

proposing that the licence should have not specific expiry date and may only be withdrawn on the basis of clearly defined revocation provisions, the basis for which is suggested below.

Revocation

2.2.11. In order to make the new regime consistent with practice in the licensed utility sectors, it will be necessary to establish the grounds on which licences may be revoked. It is critical that revocation should only occur for specific, defined, and transparent grounds, and that the revocation provisions should apply only in a very limited and tightly defined set of circumstances.

2.2.12. With these two principles in mind, and taking into account practice in other sectors, BAA proposes that the following grounds for revocation form the basis for the proposed regime:

- agreement between the licensee and the CAA to terminate the licence;
- repeated failure to comply with enforcement orders and statutory orders (subject to appeal); and
- non-payment of fees, and of financial penalties.

2.2.13. The Department requested responses as to whether there are features of the airport market that would suggest approaches to revocation in other sectors should be varied. It is worth noting that the grounds for revocation vary between sectors. Failure to start supply, or the cessation of supply, is a provision that appears in other sectors. This would be problematic in the context of airports, given that supply is sometimes subject to disruption due to external factors that are beyond the control of the airport concerned, and which by their nature cannot be anticipated as to their timing or extent.

Sanctions

2.2.14. BAA supports elements of the principles identified by the Department that are intended to shape the sanctions regime. In particular, in order for sanctions to be 'reasonable' - one of the guiding principles identified by the Department - it is important that any sanctions are:

- imposed only where there is clear and identifiable transgression that is attributable wholly and exclusively to the party on whom the sanction is levied;
- proportionate to the detriment arising;
- not likely to cause difficulties for the carrying out of licence obligations;
- appealable;
- levied in a consistent manner;
- supported by the proposed obligation on the regulator to give notice and publish a policy statement on the imposition of penalties and the determination of their amount; and
- consistent with the relevant principles of better regulation.

2.2.15. BAA recognises that a licensee must be accountable for any failure to discharge its duties or comply with its licence conditions, and that it is the responsibility of the licensee to do everything within its power to ensure compliance. These considerations suggest that licence conditions should be drafted so as to reflect those defined outcomes that are within the power of licensee to control. The principle of only imposing sanctions those parties specifically responsible for the

transgression is consistent with the principles of 'Better Regulation.' This would avoid situations whereby airports face sanctions or otherwise risks being in breach of licence conditions due to the actions of third parties that were not in the airports control. Relatedly, holding BAA responsible for the actions of third parties would appear to be unenforceable in the absence of formal regulation on these other parties. This point is further considered in Part 3 where BAA's response considers ways for regulation to contribute to improving the passenger experience.

2.2.16. BAA is concerned with the Department's proposition that the CAA should have the 'maximum amount' of flexibility in deciding what action is appropriate. While some degree of discretion may be advisable (including situations where mitigating circumstances would suggest some alteration of the quantum of any sanction would be merited), it would seem judicious for the Department to closely prescribe, the boundaries of the CAA's flexibility. This is because the new regulatory regime is intended to persist for a significant period of time, and clear guidance as to how a regulator should behave will support the fundamental principles intended to apply to the sanctions regime, most especially transparency, consistency, and proportionality. The CAA should be obliged to publish and comply with an Enforcement Policy that reflects the principles of regulatory best practice and includes its intended approach to fines. This policy should only be finalised or amended with the consent of the Secretary of State.

2.2.17. BAA agrees with the Department's proposals to impose a cap on the maximum size of sanctions. It is noted that the maximum penalties imposed in the water, gas, electricity and communications sectors are set in statute at 10% of the licensee's annual turnover. There appears to be no clear economic rationale for the 10% limit and, in setting any limit, a key practical consideration is the extent to which the magnitude of fines affects the airport's ability to carry out its other duties under the licence. BAA believes that, a statutory limit of significantly less than 10% would be advisable, and BAA therefore suggests a 5% cap may be appropriate. It is also important to recognise that maximum fine subject to a statutory cap of, for example, 5% would have significant implications for an airport operator, and therefore can be expected to have the same incentive implications to ensure compliance with relevant licence conditions and standards of conduct as sanctions imposed under a higher cap.

Concurrency

2.2.18. BAA supports the granting of concurrent powers to the CAA as part of the overall package of reforms.

Fractional licensing and terminal development tendering

2.2.19. BAA is opposed to provisions to allow for the introduction of inter-terminal competition on the grounds that they would be expected to have a negative impact on the interests of passengers. These negative impacts would be greatest at Heathrow, where the provision of customer service relies heavily on the integrated nature of the operations and the efficient use of scarce capacity. In any airport, but in particular at a hub airport, separating the operation and development of terminals is likely to complicate attempts to improve the overall end-to-end passenger experience.

2.2.20. The problem to which inter-terminal competition is the solution has not been defined. One motivation for making provisions for its introduction might be to allow for the delivery of timely and

appropriate investments. However, many other elements of the proposed reforms are also intended to achieve this objective, and it is not apparent that allowing for terminal tendering, in addition to other changes, is appropriate or feasible. Similarly, enabling airlines to tailor terminal services to their own need, could also be achieved by agreement with the airport operator through the enhanced consultative framework.

- 2.2.21. Instead, a more appropriate approach of supporting the primary duty to passengers in this context would be to identify the passenger detriment to which inter-terminal competition could be the solution, weighing the costs to the passenger of this change. This assessment would need to take into account the difficulties in providing a coordinated and integrated end-to-end experience and the possibility of exclusionary behaviour by airlines against any perceived benefits of the proposed measures. Further, care would need to be taken to identify those benefits that are not already delivered by other elements of the proposed reforms, such as the duty of the CAA to assist in the delivery of investment as a means of ensuring the timely provision of capacity.
- 2.2.22. Contrary to the expectation of some parties, fractional licences may, depending on their design and the manner in which they are implemented, increase the regulatory burden on airport operators, and ultimately there can be no assurance that they would succeed in supporting the interests of passengers.

2.3 The tiered approach

- 2.3.1. BAA broadly supports the Department's tiered approach to regulation. However, the Department's proposals raise a number of issues that need further consideration including the process for airports to move between tiers and the effect that this might have in airports' long term financing arrangements.

The Department's proposals

Entering and exiting Tier 1

- 2.3.2. The Department proposes that the regulator should be given the ability to bring an airport into Tier 1, subject to it meeting three key criteria:
- existence of significant market power
 - insufficiency of competition law alone to address market power
 - where the benefits of regulatory intervention outweigh the costs.
- 2.3.3. The Department recognises that the decision to bring an airport into (or taken out of) Tier 1 carries potentially significant commercial implications for the affected airport and other stakeholders. In this light, it is proposed that "materially affected" parties should be given the rights to appeal the decision.
- 2.3.4. The Department proposes that the CAA undertake periodic assessments of the status of Tier 1 airports to ascertain whether the scrutiny and control of a Tier 1 licence remains necessary. The frequency of these formal assessments should equate the period of price controls; the sunset

clause. If a Tier 1 airport is found to no longer meet the criteria for a Tier 1 licence, it would shift to Tier 2 status and the CAA would assess the proportionality of each licence clause to ensure no unnecessary burdens are placed on these airports.

Criteria for Tier 2 and Tier 3 licences

- 2.3.5. Airports with a throughput greater than five million passengers a year would have a Tier 2 licence, assuming they did not already have a Tier 1 licence. The CAA would have the ability to bring Tier 2 airports into Tier 1 as appropriate (using the criteria as outlined above).
- 2.3.6. Airports with fewer than five million passengers per year could be subject to a Tier 3 licence if the CAA had good cause to do so. The CAA's decision to impose a Tier 3 licence will be subject to appeal. The CAA would also have the ability to bring Tier 3 licensees into Tier 1, as appropriate (using the criteria as outlined above). This might arise for small geographically isolated airports with a degree of market power.

BAA's Response

Tier 1

- 2.3.7. BAA broadly supports the principle of a tiered approach, which recognises the difference in market position and degree of competitive pressure faced by airports. These can change over time in a manner not typically encountered in network monopoly sectors, and it is therefore right for the regime to apply differently to airports with different economic characteristics.
- 2.3.8. BAA agrees with the proposed tests for entry into Tier 1. The market power test should be based on, or the same as, that applied by the Office of Fair Trading. BAA also agrees with the inclusion of an impact assessment of the relative costs and benefits of the regulatory intervention as a means of qualifying the application of the Tier 1 licence.
- 2.3.9. It is worth noting the practice in other sectors for price controlled utilities in relation to periodic assessment of market power. Most regulated industries are natural monopolies and as such an ex ante test of market dominance is generally deemed to be unnecessary for what would be the corresponding entities in Tier 1. The absence of flexibility on this issue can support a stable financing regime, and therefore reduces the cost of capital in these sectors.
- 2.3.10. This presumption of persistent market power does not apply in the telecoms sector, where Ofcom regularly undertakes market reviews on retail products to assess whether any one provider retains Significant Market Power (SMP). If it is shown that SMP exists for a particular product, a price control may be selected as one remedy. Market opening has also taken place in sectors other than telecoms. For example, between 2002 and 2006, Ofgem and Postcomm removed retail price controls from a number of specific products. Removal of controls was primarily driven by a consideration by regulators that competition had developed sufficiently to rely on the market and on restrictions imposed by competition law and consumer protection rules. Furthermore, both Ofgem and Postcomm have a number of statutory objectives, one of which is to protect consumers through the introduction of competition, where appropriate.

2.3.11. As further discussed in Section 2.5, whilst BAA agrees with the provision of a sunset clause in Tier 1 airports to reflect the need for review of market power, BAA considers it would not be appropriate to establish the precise length (i.e. by specifying a number years) of review cycle for CAA assessments of market power, but rather the reviews should be carried out prior to the imposition of new price controls. For airports which are unlikely to have sustained market power, the CAA could review the market position more frequently. This would enable the CAA to pick up changes in actual or anticipated market power relatively quickly and amend the regulatory framework accordingly.

Tiers 2 and 3

2.3.12. The means by which airports might enter and exit these tiers requires further detailed work by the Department. For instance, the Department should clarify and establish how the threshold of five million passengers per year will operate, including the period over which the five million threshold will be defined, and what will happen if an airport falls below the threshold. The Department should also clarify the process for a Tier 3 licence to be withdrawn.

2.3.13. In principle, BAA does not see the need for the Department to establish powers for the CAA to be able to introduce Tier 3 licences for airports handling less than five millions passengers per annum. In most cases, these airports face competition from other airports (and other modes of transport), and any returns earned on assets will reflect success in meeting this competition through cost reduction and offering services of a level of quality demanded by users. This would appear to vitiate most grounds for regulatory intervention and challenge the rationale for using Tier 3 licence to address concerns over price and quality.

2.3.14. The consultation document outlines some of the grounds for an airport to be placed in Tier 3 including material complaints from passengers, freight users or airlines arising from poor performance. This would appear to present two principal issues in respect of the imposition of a Tier 3 licence by the CAA. The first being the formal means by which specific price or quality problems would be identified. In particular, this position would appear to presuppose the existence of airport data that will allow any complaints to be verified.

2.3.15. The Department has not provided any indication of the materiality threshold that would apply to passenger and airline complaints about an airports performance. BAA suggests that the threshold would need to be sufficiently high to prevent the CAA and airports being drawn into a continuous process of investigating complaints from these parties.

2.3.16. The relationship between Tier 2 and Tier 3 is not clear. For example, it is not clear how a specific airport in Tier 2 would be regulated if it was the subject of similar complaints that had led to an airport with less than five million passengers being given a Tier 3 licence. The enforcement provisions that might apply to both cases could perhaps form the basis for guidance from the Department to the CAA, or some other formal clarification.

2.3.17. From the above, it is clear to BAA that considerable further work is required by the Department to develop the concept of a Tier 3 licence. This should initially focus on establishing whether there is

a compelling rationale for introducing this form of regulation in what is considered to be a generally competitive market.

2.4 Initial terms of licence for each tier

2.4.1. This section sets out BAA's views on the initial terms of the licence for airports in each tier. With respect to Tier 1 airports, BAA agrees that some form of price control may be needed where there is evidence of Significant Market Power, although other approaches may also be possible. For airports in Tier 2, BAA supports the principle of the provisions associated with the Airport Charges Directive being introduced in this manner. BAA understands that Tier 3 will initially be empty and on this basis, the review should set out the principles by which the CAA should apply licences to airports in Tier 3.

The Department's proposals

Tier 1 Licence

2.4.2. Airports with a Tier 1 licence would be subject to the firmest and most stringent regulatory intervention across all tiers. They would all be subject to some sort of price regulation, ranging from ex ante RAB-WACC based regulation to ex post price surveillance. They would also face measures designed to enhance the airport operator's financial resilience, and would have to comply with obligations to consult with stakeholders related to the airport and report on environmental performance.

2.4.3. In addition, subject to a case-by-case determination, Tier 1 airports could face further obligations related to service quality standards, capacity utilisation limits, and the provision of regulatory accounting information.

Tier 2 and Tier 3 licences

2.4.4. It is proposed that airports with a Tier 2 licence will be subject to most of the provisions of the Airport Charges Directive (ACD) in addition to environmental reporting obligations faced by Tier 1 airports. The Department proposes that the content of the initial Tier 2 licences would be generic across the entire tier. However, the CAA would have the ability to modify licence conditions (subject to appeal) as appropriate to meet its duties.

2.4.5. All airports with less than five million passengers per year will not to be subject to an economic licence, unless the CAA introduces a Tier 3 licence. However, should they behave anti-competitively and subject to appeal, the CAA could introduce a Tier 3 economic licence. BAA understands these arrangements would replace the current obligation on airport operators to seek permission to levy airport charges when aeronautical revenue exceeds £1m per annum.

2.4.6. A company with a Tier 3 licence could be subject to any or all of the obligations imposed to Tier 2, except airlines' right of appeal and to the environmental reporting obligations. While Tier 3 licence conditions would be designed to address specific issues at small airports, they would stop short of

imposing a price control. These licences allow the regulator to impose firm licence obligations on small airports that have substantial market power or dominance.

BAA's Response

Tier 1 licence obligations

2.4.7. Significant further work is required in the development of obligations which Tier 1 airports may be required to meet. BAA's initial views are discussed below.

Price and service quality regulation

2.4.8. BAA agrees that some form of regulation should be applied where there is clear evidence of persistent significant market power, and that form of regulation should be specific to each particular airport. BAA believes that it would be appropriate to maintain a RAB-based approach to regulate Heathrow's current operations for a number of reasons: the regime has supported a significant investment since privatisation, is widely understood and valued by investors, and can be modified and adapted to meet specific regulatory objectives.

2.4.9. Consistency in the application of regulatory approaches is important. Investors and operators of airports cannot make long term planning decisions, and deliver major capital expenditure programmes when the form of price regulation changes between reviews without adequate notice and justification. It may be appropriate to introduce a form of commitment by the CAA to reduce the uncertainty associated with changes in the form of price regulation. This commitment could be for around five-years at some airports, and would in effect be a reassurance that the form of price cap would not change for the period of the commitment. However, should an airport deliver a new long term asset which involved high upfront costs which need to be remunerated over a longer period of time (such as a new runway) a longer term commitment and agreement may be appropriate.

2.4.10. The Department proposes that for airports in Tier 1 the form of price regulation may range, at the CAA's discretion, from ex ante RAB-WACC based regulation to ex post price surveillance. While a general approach of flexibility and adaptability to the specific circumstances of the airports concerned is a sensible general approach, it is less clear that this approach is internally consistent with the application of the proposed criteria for entry into Tier 1. A version of these criteria is currently used to determine whether airports should be deregulated for price control purposes. It is questionable whether they are the appropriate criteria for determining whether an airport should have a Tier 1 licence, when the spectrum of regulation envisaged is considerably wider than currently in force at designated airports.

2.4.11. The consultation document does not identify the grounds for which airports, that are adjudged to have persistent SMP, will be further differentiated. The key consideration that should guide any further deliberations about different types of regulation within Tier 1 is the extent to which these forms would be consistent with the CAA's statutory duties. For instance, it would appear somewhat difficult to reconcile a non-binding price cap or an ex post price surveillance system with the financing duty.

2.4.12. This suggests that, while some degree of flexibility in the form of price cap that might be applied is welcome and may be optimal from the perspective of consumer interests, this flexibility should be constrained by the extent to which the type of regulation is applied:

- can control significant market power;
- is consistent with the CAA's statutory duties; and
- is consistent with, and supportive of, other obligations faced by the airport under its licence.

2.4.13. The intention to allow for systems of regulation of varying degrees of stringency seems likely to lead, in effect, to additional sub-tiers in regulation beyond those envisaged and supported by the Department in the consultation document. A consistent and transparent approach to the type of regulation that will be applied to airports in Tier 1 will reduce uncertainty for airports subject to regulation (of one form or another) in this tier. These issues should be clarified before the new regime is given legislative effect.

Capacity utilisation limits

2.4.14. BAA does not support the Department's proposal to introduce capacity utilisation limits. BAA considers the objective of ensuring delays are kept to an efficient level is best dealt with through other fora.

2.4.15. As part of economic regulation, BAA believes that airports should have appropriate incentives to achieve incremental increases in capacity. The current regulatory structure at BAA's London airports provides a general incentive to this effect by giving airports an incentive to maximise traffic volumes within each five-year period. In other sectors, for example rail and energy networks, capacity optimisation is incentivised by separately incentivising capability (the amount of traffic that can in principle be carried in a given period of time), and availability (the amount of traffic that is actually carried in each such period of time).

2.4.16. BAA considers that setting such a capacity utilisation limit will be likely to produce a sub-optimal outcome by encouraging a risk-averse attitude to providing access and managing assets. It would seem preferable to incentivise capacity optimisation by a combination of market mechanisms to allocate capacity (providing revealed preference information about the value of capacity in differing time frames) and financial incentives to encourage maximal availability of installed capacity. It is important to note that any 'market-based' mechanisms for allocating capacity would have to comply with the existing slot allocation rules for allocating runway capacity under Regulation (EC) 95/93, which may limit the scope to rely on such mechanisms.

2.4.17. Given the collaborative nature of the way in which capacity is declared, BAA should work with other stakeholders involved in the process to achieve the best outcome. Where new capacity becomes available it should be for the airport to work with these stakeholders, within the framework of incentives provided by the CAA, to manage the introduction and utilisation of that capacity to achieve an optimal balance between capacity, resilience and delays.

2.4.18. BAA considers that this approach should be used to help shape future delay and capacity trade offs and has already set out its intention to establish specific punctuality targets, based on

discussions with airlines, passengers groups and business organisations.⁵ Accordingly, the Department should not pursue its proposal to introduce a power for the CAA to impose capacity utilisation limits. The goal of the regulatory framework should focus on ensuring that capacity development is supported where there is a robust commercial business case to support such investment. This would obviate the need for artificial and potentially arbitrary restrictions on capacity in the manner implied by utilisation limits.

2.4.19. The proposals do not set out the details underlying how the Department intends such limits to operate. However, issues which would need to be considered by the Department were this to be pursued is the impact on cost of air travel for consumers. Reductions in capacity would potentially increase the level of airport charges and airfares at each airport and reduce the scope for airline competition. Reductions of this type would also appear inconsistent with the duty to meet reasonable demand.

2.4.20. BAA's views on other aspects of the Department's proposed reforms which relate to Tier 1 airports are discussed elsewhere:

- the proposed measures to enhance the financial robustness and resilience of the operator are discussed in Sections 1.3-6;
- the obligation to consult with airlines and other stakeholders on future plans for investment in, and the operation of, the airport are discussed in Section 1.9 and Part 3 and
- the obligations to report on environmental performance in Section 1.8.

2.4.21. With regards to service quality regulation, BAA believes that well defined service quality standards that reflect the responsibility of the parties for delivering those services could support the regulator's primary duty to passengers.

Tier 2 licence obligations

2.4.22. BAA supports the proposal that Tier 2 licence obligations would relate to the requirements contained in the Airport Charges Directive (ACD) with one exception: BAA does not support the proposal to give airlines a right of appeal to the regulator on proposed changes to the structure or level of airport charges. BAA is opposed to the introduction of this measure because of the generally competitive environment in which these airports are expected to operate.

2.4.23. Implementing the ACD through the Tier 2 licence will avoid the need for separate arrangements for UK and EU based regulation, although it would be preferable for a parallel consultation. BAA understands, however, that owing to legislative constraints and the implementation deadline of spring 2011, a separate consultation and implementation of the ACD under the current regulatory framework will be required.

⁵http://www.heathrowairport.com/portal/page/Heathrow^General^Our%20business%20and%20community^Media%20centre^News%20releases^Results/eb30f72eb48dd110VgnVCM10000036821c0a____/a22889d8759a0010VgnVCM200000357e120a____/3

- 2.4.24. The consultation document does not detail the kind of licence conditions that will be necessary to give effect to the requirements of the ACD. However, it is likely that the type of licence conditions that may be necessary will depend on the level of detail with which the ACD requirements are drafted. BAA will respond separately in detail to the consultation on ACD, however, as a principle, the implementation of the ACD should reflect the spirit of the Directive, and should not be applied arbitrarily without regard to the specific circumstances of the airports concerned.
- 2.4.25. As discussed in section 1.8, BAA believes that since Tier 2 airports operate in a generally competitive market it would be inappropriate to require environmental reporting as part of the licence. These airports can be expected to operate and develop their businesses (including environmental reporting) in a manner that they judge best responds to the need to build trust with local communities and supports their efforts to develop new capacity.

Tier 3 licence obligations

- 2.4.26. As noted in Section 2.3, it is unclear which and in what ways Tier 2 licence conditions, and indeed any other licence conditions, will be applied to Tier 3.

2.5 Appeals of the CAA's decisions

- 2.5.1. This section provides BAA's views on the Department's proposed approaches for appeals of CAA decisions. BAA agrees that getting this right is important.
- 2.5.2. BAA's view is that there would be merit in giving a single body responsibility for handling all appeals of the CAA's decisions to ensure a joined up approach. On the basis that a single body would be responsible for all appeals BAA believes the Competition Commission would be best placed to handle both Tier 1 appeals and licence modification appeals.
- 2.5.3. BAA's view is that all parties with a "material interest" (as defined below) should have the ability to appeal CAA decisions regarding whether an airport should have a Tier 1 licence. With regard to licence modifications, the right to appeal the CAA's decisions should be limited to the relevant airport licensee. Giving these rights to other parties could result in a high number of appeals to licence modification decisions, which would cause significant and inefficient disruption to the regulatory process.

BAA's response

Periodic reviews of an airport's Tier 1 status

- 2.5.4. The Department has proposed that the CAA would be required to consider the regulatory status of a Tier 1 airport prior to the commencement of each price control period. This is consistent with Article 6(5)(b) of the EU Airport Charges Directive which anticipates that there will be a review of an airport's market power prior to the imposition of price control.
- 2.5.5. BAA supports the Department's proposal to require the CAA to review the regulatory status of Tier 1 airports at the end of each regulatory period. Since there would be no justification for price

control in the absence of “significant market power”, it must follow that a review of an airport’s market power should precede any imposition of price control by the CAA. The periodic review of market power should be established as good practice. This would be consistent with the principles said to be underlying the Department’s approach to regulation.

- 2.5.6. BAA welcomes the flexibility that would be created by the licence-based regime to extend the current five-year control period to a longer period, consistent with expectations about market power. As has been identified above, this flexibility will enable the regulator to address some of the commitment issues that are a feature of the current regime.
- 2.5.7. As such, it would not be appropriate to establish the precise length (i.e. by specifying a number years) of review cycle for CAA assessments of market power, but rather the reviews should be carried out prior to the imposition of new price controls.
- 2.5.8. For airports which are unlikely to have sustained market power, the CAA could review the market position more frequently. This would enable the CAA to pick up changes in actual or anticipated market power relatively quickly and amend the regulatory framework accordingly.
- 2.5.9. In practical terms, if the CAA determines that an airport should have a Tier 1 licence, it will (and should) go onto consider the relevant price control and other regulation it believes necessary. The determination of market power, the degree of that market power and the necessary regulation (as a function of that market power) are intrinsically linked and the regime should recognise that.
- 2.5.10. BAA recognises that making the decision on Tier 1 status prior to the price control process has the potential to save on costs and time. The risk of a “wasted” price control review for an airport which successfully appeals a CAA decision on Tier 1 regulation, is insignificant when compared to the costs and time status associated with separating the processes and making the Tier 1 decision a matter to be determined prior to the implementation of a price control review. Allowing for appeals associated with the determination of Tier 1 status before commencing a price control and then, subsequently, allowing for any appeals associated with the price control itself, results in the potential for a costly and lengthy process. Assuming that the determination of Tier 1 status would take six months, an appeal of that decision was decided in six months, the price control then took six months and the appeal of that decision required a further six months then this would amount to two years in time and resources.
- 2.5.11. It would be more efficient to wrap-up the appeal body’s review of market power within an overall review of the CAA’s decision, so that the questions ‘is there market power’ and ‘how should it be controlled’ would be dealt with in a single review-appeal cycle.
- 2.5.12. For appeals of the CAA’s decision concerning market power, the Competition Commission’s capability and experience in price control matters make it the most appropriate body for this exercise. How appeals of the CAA’s decisions would be handled is considered further below.

Appealing CAA decisions regarding an airport's Tier 1 status

- 2.5.13. The Department has proposed that CAA decisions regarding whether an airport should have a Tier 1 licence should be subject to a merits-based appeal to the CAT.
- 2.5.14. BAA agrees that it would be appropriate to have merits-based appeals of CAA decisions regarding whether an airport should have a Tier 1 licence. Judicial review would not be an adequate form of appeal for such decisions; as the Competition Commission has itself recognised.⁶
- 2.5.15. With regard to which body should handle the appeal, it is clear that both the Competition Commission and the CAT have the necessary capability and experience to handle merits-based appeals on issues associated with market power. However, the determination of market power of an airport and the appropriate form of regulation for the same airport are interdependent and, therefore, issues raised on appeal of such determinations are inherently linked.
- 2.5.16. Accordingly, making a single body responsible for appeals on both market power and the appropriate form of regulation has considerable merit not least because it promotes a consistent regulatory approach to considering the issues of market power. For example, the assessment of market power in an appeal on Tier 1 status would also be highly relevant in an appeal of a price control decision. Having two different bodies taking independent – and potentially different – views of an airport's market power in separate appeals introduces the risk of inconsistent views on the need for price control and the appropriate nature of that price control.
- 2.5.17. We do not believe the CAT would be a more appropriate body for these appeals most notably for the additional time that would likely be incurred. For example, in the H3G appeal over whether it had SMP over mobile termination charges the appeal to the CAT took from 4 August 2004 to 16 December 2005 (with the matter then remitted back to Ofcom for determination). Wrapping up the SMP review into a price control process with subsequent review in the event of appeal by the Competition Commission should be much quicker and lead to a more coherent framework with decisions on the degree of market power and its appropriate regulation appealable to one body.

Parties who can appeal CAA decisions relating to an airport's Tier 1 status

- 2.5.18. The Department proposes that access to merits based appeal on the CAA's decision about whether an airport should have a Tier 1 status should be granted to all parties with a "material interest". The Department has also asked for views on the related issue of how frivolous or vexatious appeals should be deterred.
- 2.5.19. BAA agrees with the Department's proposal to give all parties with a "material interest" access to a merits-based appeal of the CAA's decisions regarding which airports should have Tier 1 status. However, consideration needs to be given to defining the threshold of parties with a "material interest" so as to make clear which parties can appeal the CAA's decisions on Tier 1 status.
- 2.5.20. In particular, it is necessary to determine when airlines with small numbers of passengers or annual aircraft movements should have the right to appeal a decision on Tier 1 status. It would be

⁶ Competition Commission; BAA Airports Market Investigation; 19 March 2009 paragraph 10.308

extraordinary if an airline with a small number of flights was able to appeal a decision notwithstanding that airport charges were material to its UK operations.

- 2.5.21. BAA therefore submits that a threshold must be set which establishes that an appeal on Tier 1 status can only be brought by a particular airline (or a group of airlines which jointly agree to bring the appeal) which individually (or together) represent at least 50% of either passenger volume, aircraft movements or cargo tonnage at the particular airport.
- 2.5.22. Frivolous or vexatious appeals would be deterred by confining the appeal rights in the manner set out above.

Licence modifications

- 2.5.23. The Department has asked for stakeholders' comments on how the right of appeal on licence condition changes should be framed, with reference to three specific options:

Option 1 – Rights to a merits-based appeal on all licence modifications granted to all parties with a material interest, including the licensee, airlines, specified consumer groups and other airport operators;

Option 2 – Rights to a merits-based appeal on all licence modifications granted to the licensee. A right of appeal for other parties with a material interest (including airlines, specified consumer groups and other airport operators) on a limited range of issues, including – but not limited to – the CAA's decision on whether an airport should be subject to a Tier 1 licence.

Option 3 – Rights to a merits-based appeal on all licence condition changes granted to the licensee. Other parties with a material interest (including airlines, specified consumer groups and other airport operators) granted access to a merit based appeal on the decision whether an airport should have a Tier 1 licence but not to licence modification decisions.

Option 3

- 2.5.24. BAA would favour Option 3, where the licensee would have rights to a merits-based appeal on all licence modifications, and other parties with a material interest would have access to a merits-based appeal on CAA decisions regarding Tier 1 status.
- 2.5.25. In considering its response to these options, BAA has been conscious of the way in which licence modifications (including price controls) have operated in other regulated sectors. In BAA's view the licence modification process has established a balance between the regulator and licensee, whereby the process encourages both parties to accept compromises to avoid unnecessary appeals being taken to the Competition Commission. This has been a key feature of utility regulation in the UK over the last decade or so and has achieved a reasonable balance of tough outcomes but relatively efficient processes.
- 2.5.26. Such a balance would be disturbed by giving appeal rights to third parties. These parties will not necessarily have any (or the same) concerns in relation to the delay and uncertainty created by an

appeal to the Competition Commission, will not bear any significant costs on an appeal and will be unlikely to be materially affected by the difference between the outcome proposed by the CAA, and the outcome reached following an appeal to the Competition Commission.

2.5.27. BAA believes that the balance between regulator and licensee is regarded as one that has worked well in other sectors. BAA does not consider that there are any reasons to believe that it would not also work well in the context of UK airports and therefore supports Option 3.

Option 1

2.5.28. For the reasons stated above, BAA would be opposed to 'Option 1' where appeal rights would be given to all parties with a material interest. The costs of launching an appeal would be relatively low for third parties (including airlines). Consequently, the likelihood of a third-party appeal of the CAA's final decision would be relatively high, creating significant disruption to the regulatory process.

2.5.29. Under the new framework, the Department proposes to provide additional rights to airlines within the regulatory process, in terms of consultation and information disclosure. The CAA will have the ability to take airlines' views into account in reaching its final decisions concerning licence modifications. If these parties are not satisfied with the way the process has been operated, then they will have recourse to Judicial Review to address any procedural irregularities.

Option 2

2.5.30. At a general level, BAA's view is that 'Option 2' is less objectionable than 'Option 1'. By narrowing the range of issues on which parties with a material interest could appeal, the scope for disruption to the regulatory process would be more limited. BAA agrees that the licensee should have rights to a merits based appeal on all licence modifications.

2.5.31. The Department identifies two sub-options relating to how appeal rights could be extended beyond the licensee. The first would be an appeal to the CAA's decision to endorse an airport operator's statement of charging principles setting out how a price control once set will be translated into the detail of airport charges. This right of appeal would not be necessary if the airport operator is subject to prohibitions of non-discrimination and a requirement to set cost reflective prices. In such circumstances, licence enforcement by the CAA should suffice, backed up the threat of Judicial Review from an affected party if the CAA manifestly fail to apply these rules in a manner beyond the margin of discretion to be accorded to it.

2.5.32. However, if third parties were granted the right of appeal in this area, it could be an area where the Competition Commission could take an adjudicative role (rather than an investigative role) in determining the appeal. This would accelerate the consideration of the appeal, and limit the Competition Commission's focus to establishing whether the CAA had got it demonstrably wrong.

2.5.33. The second sub-option concerns the right of appeal on a statement of principles by the CAA setting out the fundamental basis on which price control decisions are made. BAA recognises that there may be some benefit to separating the principles underlying the CAA's approach to setting a price control, from the detailed inputs that are used to determine the level of the price cap.

However, it seems potentially wasteful of public and private resources to anticipate appeals on points of principle when the financial consequences are not clear and as a result it may be difficult in practice to identify objections to the CAA's approach until the outcome of the latter stage is known.

2.5.34. In terms of practicalities, allowing sufficient time to enable parties to appeal 'prior matters' will significantly elongate the regulatory process and involve additional cost. Under the current model, the only decision that can be appealed is the CAA's final decision. Under the new framework, there could potentially be a series of CAA decisions and related appeals:

- CAA consultation on Tier 1 status, followed by a CAA decision, and a possible appeal;
- CAA consultation on high level principles, followed by a CAA decision and a possible appeal;
- CAA consultation on licence modifications, followed by a CAA decision and a possible appeal;
- and
- CAA consultation on charging statement, followed by CAA decision and a possible appeal.

2.5.35. Sufficient time would need to be allowed in the regulatory process for each of these issues to be resolved, in advance of setting prices for the start of the next price control period.

PART 3: Putting passengers first

3.1 Enhancing consumer representation

3.1.1. BAA supports the Department's proposal to establish Passenger Focus as the lead group responsible for representing air passenger interests at a national level. Responding to the Expert Panel's recommendation, BAA will work with Passenger Focus to establish a consumer panel at its airports. Both of these developments will benefit passengers by creating a clearer consumer voice in discussions concerning improvements to the end-to-end experience.

The Department's proposals

3.1.2. Reflecting the importance of passengers in airport regulation, the Department has proposed replacing the four duties of the CAA with a single primary duty. The Department has also presented a number of measures to enhance consumer representation.

3.1.3. The Department proposes that Passenger Focus be given responsibility for air passenger representation (currently with the Air Transport Users Council) and a complaints mediation role. It is envisaged that the CAA's Consumer Protection Group has an enhanced role, possibly serving as a 'critical friend' and adviser to the CAA's Economic Regulation Group as it discharges its duties.

3.1.4. The Department is also considering the Expert Panel's suggestion of expanding the use of airport passenger service committees as a means of collecting consumer intelligence about issues relating to each airport, in which Passenger Focus could take a role in developing and supporting a network of consumer panels at leading airports.

BAA's response

3.1.5. BAA supports the Department's proposal to establish Passenger Focus as the lead group responsible for representing air passenger interests at a national level. Passenger Focus will have a broader remit in representing passengers' interests which will enable it to take a positive and proactive role in driving improvements in the end-to-end experience across a range of different service providers.

3.1.6. With regards to complaints handling, BAA supports the Department's proposal for Passenger Focus to assume responsibility for complaints handling, which is consistent with BAA's view that there would be potential benefits from having a separate body from the CAA dealing with complaints handling.

3.1.7. Passenger Focus was established by Government to represent the views of rail passengers in Britain, and it will shortly take on the same responsibility for bus and coach passengers in England. To be effective in representing the views of air passengers, Passenger Focus will need to develop appropriate expertise in airport and airline operations, and an understanding of how these influence passenger experience. BAA is committed to providing Passenger Focus with the

necessary assistance to develop this understanding of airport operations to enable it to fulfil its remit effectively.

- 3.1.8. The Department is also considering the possibility of establishing a network of Passenger Focus panels at some airports to complement the work of Passenger Focus at a national level. BAA believes there would be value in establishing passenger groups locally at some airports to represent passengers' views. These groups would ensure that passengers have effective representation at both a local and national level. Care would need to be taken in setting up the group to ensure that its regular membership provided a representative picture of passengers' views.
- 3.1.9. BAA believes that local groups would usefully represent passengers' views on a variety of issues. One role for the group would be to monitor and provide feedback to the airport operator, airlines and other agencies on aspects of passengers' end-to-end experience. In support of this role, it would be appropriate for the local group to have access to the findings of passenger research carried out by BAA, and for airports to discuss future research projects with the group to help to help inform their views on specific topics.
- 3.1.10. BAA can also see considerable value in local passenger groups providing direct input and feedback concerning an airport's development programme, including the specification of current projects and the strategic options for the airport's long-term development. Feedback from the group on these issues would provide useful inputs to inform Constructive Engagement with airlines and discussion with the CAA.
- 3.1.11. BAA would like to press ahead to establish a local passenger group at Heathrow as soon as possible, and then apply the learning to setting up similar groups at other airports in due course. To support this, BAA would like to discuss with the Department and Passenger Focus the most appropriate arrangements for establishing local passenger groups at its airports. It will also be important to review the appropriate future role of Passenger Services Sub Committees within the context of the discussions regarding the role of Passenger Focus.

3.2 Improving the end-to-experience and extensions to the SQR regime

- 3.2.1. BAA welcomes the priority attached by the Department to improving passenger experience as part of the Review. BAA is committed to delivering better services for passengers. Achieving improvements in customer services at Heathrow is particularly important in view of its importance to the UK economy and the presence of strong competition from European hubs for transfer traffic.
- 3.2.2. An important step in improving the end-to-end experience will be creating transparency around the performance of all parties involved in delivering customer service to passengers. BAA proposes that airports should be empowered to collate and publish service performance data from the various parties involved. This increased transparency will drive improvements in passenger experience by highlighting aspects of good and poor performance, thereby informing passenger choice and improving competitive outcomes for passengers.

The Department's proposals

- 3.2.3. The Department recognises the importance of good quality information provision in ensuring that customer's interests are protected where airports hold significant market power. On this basis, it proposes that the CAA be given robust information-gathering powers, with the power to distribute this information to the airlines where appropriate.
- 3.2.4. The Department contemplates a number of changes to the service quality regime, including:
- an extension of service quality rebates (SQRs) beyond the operations controlled by the airport operator to include those parts of the wider end-to-end passenger experience;
 - a more targeted and appropriate service quality regime; and
 - improving the targeting and proportionality of the financial incentives relating to the SQR regime.
- 3.2.5. The consultation raises the possibility of airports and airlines viewing the passenger experience as a shared responsibility, with targets created to reflect passengers' entire end-to-end journey. Metrics might then be used as the basis for contractual obligations between the airport and airlines that affect the passengers' experience.

Creating transparency around service quality performance

- 3.2.6. Coordinating and raising the performance of different parties involved in delivering different stages of the passenger journey will be key to achieving consistently high standards of service. BAA's view is that substantial improvements in customer service could be achieved at some airports by creating transparency around the performance of all parties that have a role in providing services to passengers. Highlighting good and poor performance will inform passenger choice and create pressure on all parties to improve the end-to-end experience.
- 3.2.7. Such a scheme would only be necessary for some airports, but where it was judged appropriate; transparency could be achieved by collecting performance data from the airport, airlines, handling agents and other agencies, and publishing the results periodically. Recognising the airport's central role in delivering services to passengers, BAA would be willing to take the role of collecting, collating and publishing the service quality data for all parties. An alternative approach would be to give this role to a third party, such as the CAA.

Enforcing improvements in passenger experience

- 3.2.8. The Department has proposed giving the CAA a statutory remit to intervene to improve co-ordination between the different parties to improve the passenger experience. However, the Department's proposal would not give the CAA powers to require performance improvements from all the parties involved in delivering the end-to-end experience; the CAA would only have powers to regulate the airport company. Giving the CAA a co-ordination role may have some benefits, but the lack of enforcement powers over other parties would limit the CAA's ability to achieve improvements in the end-to-end experience for passengers.

- 3.2.9. If the Department's objective is to give the CAA the ability to drive performance improvements across the airport, then a range of alternative options will need to be considered. One approach would be to give the CAA powers to enforce performance improvements from all parties involved in delivering services to passengers.
- 3.2.10. An alternative approach considered by the Department would involve giving an airport, airlines and other parties a shared responsibility for delivering service quality using performance targets that reflected the end-to-end journey. The Department has suggested that such metrics could be used as the basis for contractual obligations between the airport and airlines that affect the passengers' experience.
- 3.2.11. It might also be possible to address this issue by establishing a system of contracting relationships between the parties involved in the end-to-end experience. This would be a complex task given the number of contracting parties, the variety of relevant performance standards and associated metrics, and the identification of a consistent and workable system of liquidated damages between the parties. There would be a risk that relying purely on a private contracting basis to maintain and improve passenger service standards would be unworkable in practice. With an appropriate legal framework this approach might be effective in driving significant performance improvements across the airport; however, this would require a body such as the regulatory authority to set the relevant standards across the end-to-end experience. It may then also be appropriate for that same regulatory authority to have the necessary powers to enforce these standards. A further alternative mechanism would be to appoint the airport operator as a coordinator between the parties involved in delivering services to passengers.
- 3.2.12. However, BAA believes that it would be most feasible for the airport operator (and potentially also for other parties) to collect and publish service performance data from the various parties involved in delivering the end-to-end experience. Whilst the publication of information would not be backed by any enforcement powers, creating visibility of performance would inform passenger choice and deliver the associated benefits to passengers. To fulfil this role, BAA may need to be given powers to require parties to disclose what may be considered to be commercially confidential information. BAA would welcome further discussion with the Department and the CAA to establish how this information disclosure could work in practice.

Coordination and extensions to the SQR regime

- 3.2.13. BAA supports the Department's emphasis on the end-to-end experience and the need to maintain a level of coordination to deliver positive outcomes. However, an important principle that should guide deliberations in this area is that penalties should only be imposed on parties that are directly responsible for the service issue that gives rise to the penalty. BAA should not face penalties as a result of non-performance of other parties, particularly given that BAA is likely to be subject to an economic licence while other parties will not be subject to the same types of obligations including, notably, formal permission from an economic regulator to operate their assets.

3.3 The consultative framework, Constructive Engagement and the use of willingness to pay analysis

- 3.3.1. BAA believes that Constructive Engagement has the potential to provide a good basis for reaching agreement on an airport's future development plans, but it will need to be restructured to enable passenger views to be appropriately represented in the consultation process, and for the CAA to be assured that the agreed plan represents the best outcome for consumers. Appropriately framed, analysis of consumers' willingness-to-pay and cost-benefit analyses also have the potential to help guide regulatory decision making in this area.

The Department's proposals

- 3.3.2. The Department's proposals identify reliance on an enhanced Constructive Engagement process as a means to align investment with the needs of consumers in Tier 1 airports. The Department further expects that the CAA will take a proactive role in intervening to improve information flows. The CAA will have discretion on how the conclusions of the Constructive Engagement process are used to set the price cap. However, the Department considers that regulated service outcomes developed in pursuit of securing reasonable demand would be based on a 'consideration' of consumers' willingness to pay for different price/quality combinations.

BAA's response

Background

- 3.3.3. Constructive Engagement has been an important step forward in the way airports engage and consult with airlines in the formulation of development plans. It provides a comprehensive platform for negotiation between airlines and the airport, supported by substantial information disclosure on the part of the airport. Although the Constructive Engagement process has not been without difficulty, in certain respects it has been successful in creating agreement between airports and airlines on future investment programmes.
- 3.3.4. Constructive Engagement requires consultation on a range of areas, including traffic forecasts, capacity requirements, the capital investment programme and the desired level of service quality. The objective has been to reach agreement on each of these areas, and to highlight for regulatory consideration those areas where agreement was not possible. The Constructive Engagement process also establishes those areas that, whilst influenced by outputs from airport/airline negotiation, require ultimate determination by the CAA.
- 3.3.5. It is timely for the Review to consider the Constructive Engagement process, and to address some of the lessons that have been learnt so far. More importantly, in putting passengers at the heart of the regulatory framework, the Department needs to be clear about how passengers' views should be considered as part of the consultative process to ensure that it delivers the best outcomes for consumers.

BAA's experience of Constructive Engagement

- 3.3.6. The process of Constructive Engagement has raised a number of issues which can usefully be considered by the Department in this review, as part of the process of identifying how passengers should be represented in the consultative process.

- 3.3.7. Airlines express views through Constructive Engagement in pursuit of their own commercial interests, which in most cases will align with the interests of passengers. However, the interests expressed by one airline or one airline group will not always be consistent or compatible with the commercial interests of other airlines operating at the airport. As a result, the views of different airlines may not converge, and it may not be possible for the airport to achieve a mutually acceptable outcome for all parties. Hence, it may not be possible for the airport to reach agreement with airlines through the Constructive Engagement process by virtue of the fact that airlines do not have a single common view.
- 3.3.8. BAA has had to balance the competing and conflicting requirements of different airlines that have emerged during the Constructive Engagement process. In constrained and complex operating environments like those at Heathrow and Gatwick, striking a balance between competing interests of airlines while at the same time not appearing to be unresponsive to airline requests has been difficult, and it is not surprising that some airlines have felt that the outcome of Constructive Engagement process has not fully reflected their demands.
- 3.3.9. The interests expressed by some airlines may not be consistent with promoting consumer interests, or compatible with the airport's overall development plan. Added to this, there has been no organisation with clear responsibility for representing passenger views, and there has been no natural focal point for passengers' views to be represented in the airport-airline consultation process. As a result, Constructive Engagement has focused on addressing airline requirements, without a direct reference to passengers' interests.
- 3.3.10. The disconnect between the consultation process and the regulatory process for setting airport charges means there is no clear relationship between the investment requested by each airline and the average price airlines pay to use the airport. One consequence of this arrangement is that airlines have incentives to submit bids for capital projects that they might not otherwise submit if they had to pay the full costs for the requested investment. In aggregate, this could create incentives for airlines to submit total bids for capital investment that are far in excess of an efficient level of investment.

Initial views on the way forward

- 3.3.11. Taking account of the issues above, BAA's initial views on possible reforms to the Constructive Engagement process include:
- The CAA should establish clear timetables and clear roles for the Constructive Engagement process. BAA considers that Constructive Engagement would benefit from the issuance by the CAA of appropriate guidance on timetables and requirements prior to the start of the process. The CAA could consult on these process issues, and then be responsible for overseeing their delivery.
 - The system would also benefit from increased clarity around the role of CAA within the process. There would be benefit in the CAA taking the role of independent chair for plenary meetings to ensure all views, including those of passengers, are represented in the Constructive Engagement process.

- The CAA should take on a role arbitrating on key aspects of the Constructive Engagement process where it is not possible for the airport to reach agreement with airlines. The CAA could be asked to take a view on the appropriate course of action in such circumstances, with reference to its primary duty to promote the interests of current and future consumers. This would help to prevent ‘deadlocks’ occurring in the consultation process, and would provide feedback to the airport, airlines and passenger groups on the appropriate interpretation of the primary duty.
- This would also mitigate the risk to airports of investments being excluded from the RAB because the CAA subsequently decides that the airport did not consult users properly before proceeding with an investment. In situations where there is a dispute between airlines and the airport on the appropriate course of action, the CAA would be in a position to provide immediate clarity on what it determines to be in consumers’ interests, having taken account of submissions from the airport, airlines and passenger groups;
- Measures need to be developed to ensure airlines do not approach the Constructive Engagement process with a ‘wish list’ of projects which does not take account of the price impacts. There may be a need to evaluate business cases of proposed capital expenditure through cost benefit analysis (CBA) and willingness to pay (WTP) analysis. This could include costing and valuation of the service levels implied by different options. It could also include, in principle, the introduction of some form of market mechanism whereby airlines reveal their true preferences in relation to capacity by making a financial commitment (subject to the slot allocation rules). A further discussion on WTP in passengers’ interests is provided in the next section; and
- The range of issues covered by Constructive Engagement should be reviewed to ensure that it covers passenger needs. BAA does not believe that merely relying upon enhancements to the Constructive Engagement process between airports and airlines will result in effective consumer representation (which is not meaningfully represented at present). BAA believes that direct passenger input would enrich Constructive Engagement and the wider consultative processes, and provide a practical means of supporting the regulator’s primary duty to passengers.

Passenger representation in the Constructive Engagement process

- 3.3.12. As highlighted above, it is critical that the consultation process is reformed to incorporate passengers’ views. BAA has not yet developed proposals on this issue, but one potential approach to reforming the consultative process to incorporate direct passenger representation might involve the airport operator establishing a baseline level of service for all passengers, based on its understanding of passenger requirements. The baseline level of service could be established through consultation between the airport operator, passengers, airlines and other stakeholders. These standards could then be endorsed by the CAA as the appropriate basis for developing the airport’s baseline capital plan.
- 3.3.13. At this initial stage, the airport operator could seek confirmation from the CAA that its proposed minimum standards were consistent with its duty to promote consumers’ interests. It would be for the CAA to decide having taken advice from passengers, the airport and airlines whether proposed standards were in fact consistent with the proposed primary duty. This would ensure that the airport operator, following consultation with airlines, passenger groups and the CAA, did not have

the discretion to establish service standards below those required by passengers, or compromise those standards in the design of airport facilities.

- 3.3.14. The airport would use these standards to develop capital investment proposals to achieve the baseline level of service. The CAA, airlines and passenger groups would then be in a position to assess whether the resulting investment plans achieved the baseline level of service. Through the process of Constructive Engagement it would be open for the airport and airlines to agree enhancements to the baseline plan to achieve higher levels of service, where it was considered appropriate.
- 3.3.15. At Heathrow, the baseline standards would need to reflect the hub-related nature of the airport, and would potentially be higher than baseline standards agreed at other airports. For example, the baseline level of service at Heathrow could include a requirement to provide for rapid transfer of passengers around the airport. Such facilities would be valued more highly by Heathrow's passengers than passengers at other airports given the relative significance of transfer traffic at Heathrow.
- 3.3.16. Alternative means of improving the representation of passenger interests may be appropriate and BAA is open to exploring with airlines, passenger groups and the CAA these alternatives. However, whatever form of consultation is ultimately adopted, it is important that the current consultation process through Constructive Engagement needs to be opened up to incorporate passenger views.

Annex A: Response to the Department's Impact Assessment

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Annex B: Answers to the Department's questions

This annex provides answers to the specific questions raised by the Department raised in Chapters six through to ten in its consultation document. The material in this annex is based largely on the views discussed in the remainder of the document.

6 Statutory remit for the economic regulation of airports

Q6.1 Does the proposed hierarchy of the duties – with a single primary duty supplemented by a set of further duties that the regulator should also consider when seeking to achieve its primary duty – provide sufficient certainty over the regulator's priorities? Are there alternative arrangements which would provide additional regulatory clarity?

A6.1.1 BAA supports the proposed structure of the CAA's duties and welcomes the additional clarity that will be created by setting out the CAA's further duties. The further duties should be accorded a higher degree of significance. BAA understands the structure of the duties to be independent but mutually supportive. This means that the CAA would fail to discharge its primary duty if, at the same time, it failed to achieve any of its further duties. It is appropriate for the legislation to make this clear and to reflect this BAA has suggested some wording of clarification in section 1.1.

A6.1.2 BAA considers that it is not necessary, in ensuring sufficient certainty for the CAA's duties, for the Department to set out an order of priority in legislation beyond that of the primary duty.

Q6.2 (a) Do you agree with the proposed primary duty? Do you have any comments on the drafting of the primary duty?

A6.2.1a BAA supports the proposed primary duty to consumers and the proposed drafting of this duty, as discussed in section 1.2. The CAA's principal focus should be to promote the interests of both current and future consumers. The CAA's primary duty should be to regulate airports in ways that will promote consumers' interests, and thereby replicate as closely as possible the outcomes associated with a competitive market environment. The primary duty should be accompanied by clear guidance on how the CAA should interpret the duty.

Q6.2 (b) Do you agree with the proposed approach of putting the passenger experience at the centre of the regulatory regime with additional rights for airlines and enhanced consumer representation?

A6.2.b1 BAA supports the proposed approach of putting the passenger experience at the heart of the regulatory regime. Whenever the CAA has reasons to believe that there might be a difference between the interests of consumers and airlines it should ensure that interests of consumers are put first. As discussed in Part 3, in discharging its primary duty the CAA will need to have a clear picture of passenger's interests on a wide variety of issues, ranging from short-term services issues through to the appropriateness of an airport's long term development plans.

A6.2.b2 BAA supports the proposals to enhance consumer representation, in particular the proposal for Passenger Focus to have a broad remit in representing passengers' interests. One role for Passenger Focus would be to monitor and provide feedback to the airport operator, airlines and other agencies on all aspects of passengers' end-to-end experience. BAA supports the proposal to establish passenger groups locally at some large airports to ensure passengers have effective representation at both a local and national level.

A6.2.b3 The proposal to put passengers at the heart of the regulatory regime will require the consultation process to be restructured to take account of consumer interests. This is likely to have ramifications for the Constructive Engagement process and it will be necessary in developing these reforms to take into account lessons learnt so far. In Part 3, BAA provides some initial views on the way forward including reformed roles and responsibilities for all of the parties involved in Constructive Engagement. BAA welcomes further work in this area in coming months.

Q6.2 **(c) Is promoting effective competition the best way to promote the interests of consumers of airport services?**

A6.2.c1 BAA believes that the promotion of effective competition is the best way to promote the interests of consumers of airport services, as discussed in Section 1.1. Effective competition between airports for airlines, and competition between airlines for passengers, will only be possible if sufficient airport capacity is available. Therefore, the CAA will need to establish a clear view on the long-term demand for air travel in discharging its primary duty to consumers.

A6.2.c2 It is important that competition is not promoted at any cost. In promoting "effective competition", therefore, the CAA needs to recognise this. For instance, attempts to promote competition should not be at the expense of efficiency/quality of service. Attempts to promote competition are limited in very constrained operating environments, where capacity is scarce and there is a high premium on coordination and integrated operation. Therefore at Heathrow, BAA considers terminal competition inappropriate.

A6.2.c3 BAA would be concerned if the duty were to lead to regulatory inhibitions on Heathrow in order to provide competitive assistance to other airports designed to artificially overcome Heathrow's advantages. BAA would like to see this point acknowledged in policy.

Q6.3 Do you agree that it is appropriate for the economic regulator of airports to have regard to environmental limits? Does the proposed duty provide sufficient clarity over the respective roles of the Government and the CAA? Does the proposed duty risk compromising the clarity of the regulator's primary duty?

A6.3.1 BAA supports the proposal to establish an environmental duty for the CAA with respect to the impacts that airports have on the environment and local communities. However the wording of the proposed duty would extend the scope of the CAA's role beyond that of an economic regulator. BAA proposes alternative wording for this duty to reflect its specific purpose; the need to ensure that economic regulation of airports operates within the existing framework of environmental regulations. The reasoning for this is set out in full in Section 1.8.

A6.3.2 The Departments proposed wording for the environmental duty would risk compromising the clarity of the CAA's primary duty. This risk would be addressed by using BAA's proposed alternative wording which ensures the CAA's duty focuses explicitly on supporting airports in seeking to meet established environmental targets and obligations.

Q6.4 Given the proposed primary duty to promote the interests of consumers, is it necessary to have a further duty to ensure that all reasonable demands are met efficiently?

A6.4.1 BAA considers that any interpretation and application of the concept of reasonable demand needs careful consideration to be workable in the context of airports. However, BAA believes that it could be beneficial in terms of delivering new capacity for the CAA to have a duty to secure that demand for airport services is met. This would provide a useful strengthening of the CAA's existing duty to "*encourage investment in new facilities in time to meet anticipated demands.*" BAA accepts that the CAA should be under a duty to ensure that new facilities and infrastructure are delivered efficiently. This is inherent in its primary duty and does not require additional clarification through specification in a further duty. Issues associated with this proposed duty are discussed in Section 1.7.

Q6.5 Given the proposed primary duty to promote the interests of consumers, is a further financing duty required?

A6.5.1 BAA believes it is appropriate for the CAA to have a further duty to ensure licence holders are able to finance their activities. BAA considers that this duty is consistent with the primary duty, but having an explicit further duty would reassure investors that efficient investment provides a reasonable return on capital. BAA recommends some alternative wording to that proposed by the Department in Section 1.4 which should ensure that airports are able to finance their functions and in particular by securing reasonable returns on their capital.

Q6.6 What is the appropriate interpretation of a financing duty in the airports sector?

A6.6.1 The appropriate interpretation of a financing duty in the airports sector is discussed in Section 1.4. The interpretation of a financing duty will be more challenging than in other regulated sectors and it is important to reflect the economic characteristics of airports. It is also important for this duty to be accompanied by a “substantial effect” clause to enable the airport operators to apply to the CAA for a regulatory settlement to be reviewed when material factors outside their control occur.

Q6.7 Does the proposed duty provide the right balance between the roles of the Government and the CAA? Does the proposed duty risk compromising the clarity of the regulator’s primary duty?

A6.7.1 BAA supports a further duty on the regulator to assist in the delivery of Government policy. This will improve the level of coherence between the Government’s air transport policy and the delivery of the policy through the regulatory framework. BAA considers that this duty would be consistent with the regulator’s primary duty and it would provide useful direction to the CAA that its consideration of new capacity should take place within the policy framework proposed by Government policy. BAA envisages the CAA being highly active in assisting the delivery of Government policy. BAA’s views are set out in Section 1.7.

A6.7.2 There are a number of issues that need further development including; the specific drafting of the duty, the nature of the guidance and what would constitute a compelling reason for the regulator not to assist in the delivery of Government policy.

Q6.8 We would welcome comments on the appropriateness of the proposed duties and in particular, whether they will allow for an effective and efficient regulatory regime that meets the Secretary of State’s objectives for the Review. In considering the proposed duties stakeholders may wish to respond particularly on:

- **Whether the proposed duties provide a sufficiently clear framework for the CAA to operate within?**

A6.8.1. BAA supports the proposed primary duty and believes this provides a significant step forward from the current framework by helping provide additional regulatory clarity. Section 1.2 discusses BAA’s views on the primary duty further. Further work is required regarding the appropriate drafting, interpretation and interaction between all of the proposed duties.

A6.8.2. Only when further detail is known will it be possible to give a fully comprehensive evaluation of the duties against the Department’s objectives. At the current stage it is reasonable to expect that the proposed reforms to the CAA’s statutory remit will have a positive impact on passenger experience, the delivery of the new capacity and addressing

environmental impacts. It is important that further work is carried out to ensure that the CAA works in a sufficiently clear framework.

A6.8.3. To ensure the objectives of the review are achieved, the Department will need to maintain leadership of the review through the various stages of the process, right through to the implementation of the new framework. The Department will also need to ensure that the CAA is demonstrably ready and capable of discharging its new powers including having the necessary resources and skills to operate the new framework, before it is implemented.

- **Whether the proposed hierarchy and number of duties for the CAA are appropriate?**

A6.8.4. BAA supports the distinction between the primary and further duties in statute. BAA recommends further clarification regarding the appropriate interaction between the duties as set out in Section 1.1. BAA considers that the content of the proposed duties covers the areas needed in the economic regulation of airports. On this basis, the number of duties for the CAA seems appropriate.

- **Whether there are other factors or issues that should be included in additional specific duties?**

A6.8.5. BAA does not consider that other duties are necessary in the reform of the regulatory framework.

7 Designing a flexible, fair and effective enforcement regime

Q7.1 Do stakeholders agree with the proposed approach to developing a new licensing regime for airports?

A7.1.1. BAA supports the principle of moving to a licensing regime for airports. However, the licensing regime for airports should be considered *ab initio* to ensure that it reflects the specific economic characteristics of airports which are quite different from other sectors with licensing regimes.

A7.1.2. BAA's broad support for the key elements of the Department's proposed reforms is, therefore based on the assumption that the anticipated benefits of the proposals will be shown to be proportionate to their costs. Part 2 of BAA's response sets out its views on aspects associated with the licence-based regime.

A7.1.3. As a matter of principle, BAA should be permitted to recover all implementation costs associated with the licence-based regime.

A7.1.4. With regards to the detailed licence conditions, further thought and effort is required to design a broad range of standard and special conditions that accurately reflect the full range of airport operations and activities. Such an approach would allow the CAA the flexibility to tailor licences between airports by activating relevant conditions and deactivating other conditions as required.

- **Do you agree with the proposed tiers for the licenses, including the criteria and thresholds that will be used to determine which tier an airport will be in?**

A7.1.5. BAA broadly supports the tiered approach to regulation. This is discussed in full in Section 2.3. In summary, BAA supports the proposed tests for entry into Tier 1 and the threshold for entry into Tier 2, whilst it raises points for further development and clarification. With respect to Tier 3, BAA considers it important that the Department focuses on establishing whether there is a compelling rationale for its introduction.

- **Do you agree that the criteria for determining whether an airport has a Tier 1 licence should be enshrined in Primary Legislation?**

A7.1.6. BAA believes that setting out the criteria in Primary Legislation is unduly restrictive. Primary legislation should set out the need for appropriate criteria to be established. Secondary legislation can then be used to set out the criteria. This offers greater flexibility than the proposed approach.

A7.1.7. In considering this issue, the Department should have regard to the flexibility that was provided by the current regulatory framework in considering the designation status of Manchester and Stansted airports. The framework allowed the Department to review the criteria without having to amend primary legislation.

- **Do you agree that the regulator should retain the option of regulating small airports that have substantial market power with a Tier 1 licence, including a price control, subject to the satisfaction of the criteria set out above and the appeal process?**

A7.1.8. BAA believes that whilst it may be useful for the regulator to have the flexibility associated with regulating small airports with Tier 1 conditions, the assessment criteria associated with the costs and benefits of regulatory intervention will be of particular importance, and will likely lead to a conclusion that no such intervention would be justified. This is due, in part, to the likely higher burden that the costs of regulation will have on a smaller entity, making up a larger proportion of their cost base compared with larger airports. In all cases, it is critical that the solution of price regulation is proportionate to the market failures that are present at the airport concerned.

- **Do you agree that the regulator should be able to impose a Tier 3 licence on certain small airports that would allow market power at these airports to be addressed whilst stopping short of price control?**

A7.1.9. BAA considers it important that the Department focuses on establishing whether there is a compelling rationale for its introduction. BAA discusses this issue further in Section 2.3.

Q7.2 Do you agree with the principle of using the proposed licence regime for the economic regulation of airports to implement certain aspects of the Airport Charges Directive?

A7.2.1. BAA supports the principle of using the proposed licence regime to implement certain aspects of the ACD. The conditions for Tier 2 airports should reflect the spirit of the Directive, and should not be applied arbitrarily without regard to the specific circumstances of the airports concerned. This is discussed further in Section 2.4. BAA will respond separately in detail to the consultation on ACD.

Q7.3 We would welcome comments on these initial thoughts about the conditions that should be included in the license for each tier.

A7.3.1. BAA's views on these issues are set out in Section 2.4. BAA agrees that airports in Tier 1 that can be demonstrated as possessing some degree of market power may require some form of proportionate and transparent regulation, whilst airports in Tier 2 should encompass obligations which relate to the requirements of the ACD.

Q7.4 We view the introduction of the proposed licensing regime as being beneficial to consumers although we understand that there will be associated implementation costs. What do you think the likely scale and value of these costs will be?

A7.4.1. Whilst BAA supports the principle of moving to a licence-based regime, the introduction of licences needs to be based on the costs of moving towards such a regime bearing a reasonable and proportionate relationship to expected benefits. Annex A responds to the Department's initial Impact Assessment (IA) regarding costs and benefits of the proposals.

A7.4.2. Depending on the final terms of the licensing regime there may be aspects for which BAA will require consent from its creditors, including provisions relating to termination of the licence and sanctions (see sections 1.5-1.6 and Annex A). Gaining consent may prove costly although, it is difficult to assess the likely costs and likelihood of requiring consent until the proposals are specified in more detail. At this point the Department should engage in further consultation with stakeholders on its IA prior to making policy decisions.

Q7.5 We would welcome comments on the proposed process for changes to licence conditions. We would particularly welcome comments on the proposed process for collective licence modifications.

Do you agree that in a reformed regulatory regime the Secretary of State should retain the right to refer changes to licence conditions, even where agreed by the licensee, to the Competition Commission? Is this an appropriate scope for an intervention power for the Secretary of State?

A7.5.1. BAA considers that it would not be appropriate for the Secretary of State to retain the right to refer changes to licence conditions to the Competition Commission. BAA does not see any justification for intervention by the Secretary of State where a licence condition (or modification thereof) has received the agreement of the licensee.

Do you agree that where a proposed change of licence condition would apply identically to a group of airports that this change would come into effect if it was accepted by 80% of these airports representing 80% of total passenger numbers across the group?

A7.5.2. It is unclear which conditions would be standard given the rarity of Tier 1 licences. BAA considers that there should be an appropriately high hurdle in order to ensure there is not an unnecessarily high level of challenges to collective modification decisions. BAA has not yet considered the merits of the specific threshold proposed by the Department. The proposed 80% rule may be appropriate but consideration could be given to other measures. BAA welcomes a further opportunity to respond to the Department on this matter.

Q7.6 Do you agree with the proposals to put in place similar provisions for sanctions and enforcement by the CAA for the airports sector that apply in the other main regulated sectors in the UK? Are there any particular features of the airports sector that would justify or require a different approach to licence revocation?

A7.6.1. BAA supports the principles identified by the Department that are intended to shape the sanctions regime. It is important that sanctions apply to the parties directly responsible for the behaviour that gives rise to the sanction.

A7.6.2. With respect to Revocation, it is critical that this only applies to a very limited set of circumstances. There are airport specific factors which must be taken into account in the design of the new framework in this area. For example, failure to start supply or the cessation of supply would be problematic in the context of an airport given that supply is sometimes subject to disruption due to external factors.

A7.6.3. BAA's views on such conditions are discussed in full in Section 2.2 and the considerations mentioned in A7.4.2 would also apply.

Q7.7 Do you agree that the CAA should have concurrent competition law powers for airport services in the UK?

A7.6.4. BAA agrees that the CAA should have concurrent competition law powers for airport services.

8 Enhancing Accountability

Q8.1 We would welcome views on the proposed approach to allowing appeals regarding CAA decisions about whether an airport should have a Tier 1 licence and regarding licence modifications. We would particularly welcome comments on which parties should have the right to appeal and on which decisions particular parties should have the right to appeal. We would also welcome views on the most appropriate approach to ensure that appeals are neither frivolous nor vexatious.

A8.1.1. BAA believes there is merit in giving a single body, the Competition Commission, responsibility for handling all appeals of the CAA's decisions. BAA's views on Appeals are set out in Section 2.5. All parties with a "material interest" should have the ability to appeal CAA decisions regarding whether an airport should have a Tier 1 licence. With regard to licence modifications, the right to appeal the CAA's decisions should be limited to the relevant airport licensee.

Q8.2 Do you agree with the proposal that the CAA would be required to consider the regulatory status of a Tier 1 airport at the end of each price control period (the sunset clause)?

A8.2.1. BAA supports the Department's proposal to require the CAA to review the regulatory status of Tier 1 airports at the end of each regulatory period. BAA expects that this requirement will result in the CAA undertaking ongoing monitoring of airports' market power.

- **Do you agree with the proposal that CAA decisions about whether an airport should have a Tier 1 licence should be subject to a merits based appeal to the CAT?**

A8.2.2. In line with its view to give a single body responsibility for decisions on appeals, BAA considers that the CAA's decisions regarding a Tier 1 licence should be subject to a merits based appeal to the Competition Commission, not the CAT.

- **Do you agree that access to merits based appeal on the CAA's decision about whether an airport should have a Tier 1 licence should be granted to all parties with a material interest, including the licensee, airlines, specified consumer groups and other airport operators?**

A8.2.3. BAA agrees all parties with a “material interest” should be granted rights to a merits based appeal.

- **How should provision be made in the new regime to deter frivolous or vexatious appeals?**

A8.2.4. BAA considers this can be best achieved through setting a threshold for parties constituting a “material interest.” An appeal on Tier 1 status should only be brought by a particular airline (or a group of airlines which jointly agree to bring the appeal) representing at least 50% of either passenger volume, aircraft movements or cargo tonnage at the particular airport.

Q8.3 **As set out at the beginning of this section, we would welcome stakeholders’ comments on how the right of appeal on licence condition changes should be framed. The three options we would like specific feedback upon are:**

- **Option 1 – Rights to a merits-based appeal on all licence modifications granted to all parties with a material interest, including the licensee, airlines, specified consumer groups and other airport operators;**
- **Option 2 – Rights to a merits-based appeal on all licence modifications granted to the licensee. A right of appeal for other parties with a material interest (including airlines, specified consumer groups and other airport operators) on a limited range of issues, including – but not limited to – the CAA’s decision on whether an airport should be subject to a Tier 1 licence. Within this option there are sub options relating to how appeal rights could be extended beyond the licensee upon which we would welcome stakeholders’ views. Two sub options, that are not necessarily exclusive are:**
 - **A right of appeal on the CAA’s decision to endorse an airport operator’s statement of charging principles setting out how a price control once set will be translated into the detail of airport charges.¹¹⁷; and**
 - **A right of appeal on a statement of principles by the CAA setting out the fundamental basis on which price control decisions are made (asset out at paragraph 8.7).**
- **Option 3 – Rights to a merits-based appeal on all licence condition changes granted to the licensee. Other parties with a material interest (including airlines, specified consumer groups and other airport operators) granted access to a merit based appeal on the decision whether an airport should have a Tier 1 licence but not to licence modification decisions.**

A8.3.1. BAA supports Option 3 where only the licensee would have rights to a merits-based appeal on all licence modifications. In BAA’s view, the licence modification process needs to establish a balance between the regulator and licensee, whereby the process encourages both parties to accept compromises to avoid unnecessary appeals being taken to the Competition Commission. This has been a key feature of utility regulation in

the UK over the last decade or so and has achieved a reasonable balance of tough outcomes but relatively efficient processes. BAA considers that such a balance would be disturbed by giving appeal rights to third parties. Section 2.5 discusses this rationale further.

Q8.4 Does a procedure which involves either the agreement of the licensee only or a determination of the public interest by the Competition Commission properly take account of airline and other third party views?

A8.4.1. BAA considers that the procedure set out in Option 3, would adequately take account of airline and third party views. The standard process from other regulated sectors does indeed involve the agreement of the licensee but it also involves consultation with all stake-holders and the approval of the regulator. The CAA will also be subject to a potential Judicial Review by parties. The Competition Commission's remedies and other aspects of regulation will lead to significant dialogue between operators and users and the process followed by the Competition Commission is fully consultative.

Q8.5 Should airlines and other third parties have a specific right to be consulted on proposed licence modifications?

A8.5.1. BAA considers that airlines and other third parties should not have specific rights to be consulted on proposed licence modifications. This is because in discharging its duties the CAA will need undertake adequate consultation including with airlines and other third parties. For instance, in taking account of the principles of Better Regulation including the principle specific to transparency, BAA considers consultation as a key part of best practice in this respect.

Q8.6 Do you agree that Tier 1 and 2 airports should be required to submit an annual report to the CAA and other environmental regulators about their environmental performance? Are there any specific requirements that you consider should be in such a licence condition?

A8.6.1. In order to minimise duplication, as discussed in Section 1.8, BAA considers that it would be appropriate for there to be a review of the current public reporting by Tier 1 and Tier 2 airports to identify whether regulation in this area would promote additional disclosure that would be of value. BAA does not consider that it would be appropriate for airports to be under an obligation, by virtue of economic regulation, to submit reports to environmental regulators. If these bodies require information from BAA they would be expected to request it directly.

Q8.7 The Government is considering applying the Compliance Code to CAA's economic functions. Are you in favour of extending the coverage of the Code in this way? Please give reasons to support your views.

- A8.7.1. BAA notes that the Government introduced the Regulator's Compliance Code in 2008, based on the principles of effective inspection and enforcement first set out on the Hampton Report. The aim of the code, as paragraph 8.36 of the consultation document states, is to 'embed risk-based, proportionate and targeted approaches to regulatory enforcement'.
- A8.7.2. BAA fully supports the CAA being given some form of statutory duty to support and improve the quality of regulation of the airport sector. Given that some of its functions are already covered by the Compliance Code, it may be appropriate to extend the code to its function as an economic regulator.
- A8.7.3. BAA considers that due caution should be exercised before the code is extended to the economic functions of the CAA, given that thus far, Parliament has not required other economic regulators to become subject to the code.

9 Aligning airport services with passengers' needs

- Q9.1 What specific information gathering powers will the regulator need to facilitate an effective Constructive Engagement process? What information do airlines require to empower them to influence investment programmes in the interests of consumers?**
- A9.1.1. Constructive Engagement already provides a comprehensive platform for negotiations between airports and airlines and the information directives to which BAA is currently subject are exhaustive. This is discussed further in Part 3. The rigour of the Constructive Engagement process has also been enhanced through a succession of directives issued to BAA by regulatory bodies, establishing the level of information to be provided on issues relating to capital expenditure (Annex G – CAA Decision – Heathrow and Gatwick Airports, March 2008, Annex D – CAA Decision – Stansted Airport, March 2009, Annex F – Competition Commission Decision, March 2009).
- A9.1.2. On this basis, BAA considers that the level of information currently provided to airlines to empower them to influence investment programmes is appropriate. The CAA's ability to disallow capital expenditure from being included in the RAB, if consultation is not carried out properly, provides a powerful incentive on airports to engage effectively with airlines on investment programmes and capital projects.
- A9.1.3. Although it is appropriate for the CAA to oversee the Constructive Engagement process, a more extensive role for the CAA would disrupt the process and affect the dynamic of consultation. It would also add significant cost and complexity to consultation with airlines, with little apparent upside.

- A9.1.4. BAA considers an important objective for this review is to establish an effective role for consumers in the consultation process through enhanced passenger representation airport – airline negotiations. Further consideration needs to be given to the detail of how the framework should be reformed and BAA would welcome an opportunity to contribute its views on this issue.
- Q9.2 Is there a need for the CAA to consider extending SQRs beyond those activities under the direct control of the airport operator? What would be an appropriate mechanism for doing so?**
- A9.2.1. The Department's current proposals would not give the CAA powers to require performance improvements from all parties involved in the end-to-end experience. In Part 3, BAA discusses the ways in which this could be achieved.
- A9.2.2. BAA considers as part of this review, the passenger end-to-end experience can be improved significantly at some airports by creating additional transparency around the performance of all parties that have a role in providing services to passengers.
- A9.2.3. As part of improving the end-to-end experience, the Department may wish to consider extensions to the SQR regime. However, an important principle is that penalties should only be imposed on parties that are directly responsible for the service issues that give rise to the penalty.
- Q9.3 How could the SQR metrics be changed to provide a better fit to the outcomes that affect passengers' experience. Should someone other than BAA monitor the SQR metrics?**
- A9.3.1. BAA considers that the existing metrics adequately reflect those aspects of service most critical to passengers. However, these may be subject to change in subsequent regulatory reviews and should be considered on a case-by-case basis. They should also be flexible enough to be relevant to the specific issues faced by each airport.
- A9.3.2. BAA believes that the ongoing use of independent audits on its approach to monitoring service quality performance should provide sufficient assurance to negate the requirement to appoint an agency other than BAA to collect this data.
- Q9.4 How might incentives upon airport operators to deliver appropriate levels of service quality be improved in the new regime to produce better outcomes for consumers?**
- A9.4.1. BAA considers that in implementing the new framework, the CAA will need to set appropriate incentives to ensure airport operators deliver appropriate levels of service quality (and price) in consumers' interests where airports exhibit significant market power.

A9.4.2. The CAA should consider on a case-by-case basis the appropriate measures needed, hence the regime needs to be flexible enough to be relevant to the specific issues faced by each airport.

Q9.5 **We would welcome comments both on the merits of allowing terminal competition and the best way for the regulatory framework to permit such competition.**

A9.5.1. BAA does not support the introduction of terminal competition as it does not believe it to be in the best interests of consumers. The reasons for this are discussed in Section 2.2. The negative impacts would be greatest at Heathrow, where the provision of customer service relies heavily on the integrated nature of the operations and the efficient use of scarce capacity.

Q9.6 **The Department would welcome the feedback of stakeholders on the issues raised relating to airports' financial resilience, in particular:**

- **Should the Department introduce a Special Administration regime for the airports industry?**
- **Are airports sufficiently important assets for the Government to take steps to ensure their continued operation? If the Government were to introduce Special Administration for airports how should this be designed and implemented? Do you believe that a staged implementation of the Special Administration regime over a period of time would be helpful?**
- **Should the regulatory regime be reformed to allow the regulator to introduce licence conditions to ring-fence regulated assets?**
- **Should the regulatory regime be reformed to allow the regulator to introduce licence conditions obliging regulated businesses to maintain an investment-grade credit rating and if so in what form?**
- **How might such provisions be introduced to minimise disturbance to existing financing arrangements?**

A9.6.1. BAA's views on the proposals relating to airports' financial resilience are covered in Sections 1.4 and 1.5.

10 Enhancing consumer representation within the aviation sector

Q10.1 **Do you agree with the proposal to give Passenger Focus responsibility for consumer policy advocacy with regards to airlines and airports, funded through airport licence fees? In particular, we welcome views on the proposal for Passenger Focus to develop and support a network of consumer panels at leading airports.**

A10.1.1. BAA supports the proposal for Passenger Focus to act as policy advocates for passengers, as discussed in Part 3. BAA sees value in establishing a network of

passenger panels at some airports to complement its work at a national level. BAA welcomes further discussions with the Department and Passenger Focus regarding the most appropriate arrangements for establishing local passenger groups at its airports.

Q10.2 Do you agree with the proposal to give Passenger Focus responsibility for complaints handling on airline and airport issues alongside its policy advocacy function? How can we best ensure the expertise and sector knowledge in relation to EU air passenger rights built up over time by the AUC is retained?

A10.2.1. BAA supports the proposal for giving Passenger Focus responsibility for complaints handling alongside its policy advocacy function, as discussed in Part 3. Passenger Focus will need to develop appropriate expertise in airport and airline operations and an understanding of how this affects the passenger experience. BAA will provide Passenger Focus with the necessary assistance to develop this understanding of airport operations.

Annex C: An alternative to Special Administration

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