

**Gatwick ACC response to the CAA's consultation: Proposed licence conditions in respect to price Commitments**

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## Summary

This response outlines the ACC's feedback on the revised commitment terms issued by GAL and the proposed licence conditions set out by the CAA.

While the majority of the modifications that the CAA has made to the licence are welcome, the airlines are in agreement that the modifications GAL has made to the terms of the proposed Commitments do not go far enough to remedy the risk of the airport exercising its significant market power. Moreover, they are also a long way off the terms airlines would expect in a normal commercial relationship, which we have not been asked to comment on in this response.

We, therefore, currently do not view the creation of such commitments (as currently proposed by GAL) as an effective remedy for the substantial market power that Gatwick continues to hold and it is difficult to see what benefits they offer passengers over RAB regulation.

We remain open to working with the CAA to further develop this proposal however, given the relatively limited timescale until the start of Q6, and the significant issues that need to be overcome, the ACC believes that unless GAL makes significant changes soon to its proposed commitments RAB regulation will be more appropriate. If the CAA is going to further explore the potential for price commitments it will need to be clear and precise about the requirements and benefits of any commitment regime.

In addition, it is vital that airlines are fully involved in any further work on commitments. GAL has not had meaningful engagement with airlines on the development of commitments and it is very unlikely that we will be able to support commitments if we are not fully involved in their development.

## Introduction

The ACC welcomes the opportunity to respond to the CAA's consultation letter of 8 July 2013 on price commitments. The ACC continues to believe that GAL holds significant market power. Despite this, we have been open to considering the concepts being explored around alternative forms of regulation and in particular contracts and commitments at the airport. However, as they were initially proposed by GAL we did not see these as a remedy to GAL's substantial market power.

As such, the ACC provided detailed responses to the initial commitments proposal put forward by GAL. We welcomed the extent to which some of these comments had been addressed by the CAA in its initial proposals. Since the publication of the CAA's initial proposals, GAL has published an updated version of its commitments and the CAA has provided more detail of how GAL's proposed commitments would operate within a regulatory licence. It is worth noting that this regulatory licence is not part of GAL's proposal.

We note the CAA has asked for feedback on two main questions:

- a) The CAA's proposed licence for a commitments model;
- b) Whether GAL's revised commitments proposal addresses concerns that terms in the commitments would not be in the interest of end users.

This response addresses these two questions in turn. Whilst this response focuses on the licence proposals put forward by the CAA, the market power assessment published by the CAA is important context. The ACC and individual airlines have responded separately to this consultation.

Before addressing the licence and commitment terms, it is worth noting, we are currently unpersuaded that the benefits of GAL's most recent proposal on commitments are greater than a traditional RAB-based licence. In particular, we think some of the benefits GAL see from commitments could be achieved through RAB regulation:

- Flexibility could equally be built in to a RAB based approach, for example by allowing for certain uncontroversial changes to be made by agreement – this is specifically permitted under the new Civil Aviation Act;
- We do not see any evidence that competitive contracts are more likely to emerge under a commitments approach and note that contracts would also be possible under a RAB based price cap without commitments;

- commitments are untried and untested and it is not clear that costs would be lower than under a RAB based approach which is fairly clear and uses relatively standard approaches to modification and enforcement.

## Background

The CAA's initial proposals expressed a preference for a 'commitments' based regulatory model for GAL in Q6, with some suggested modifications from the proposal put forward by GAL in its business plan in February. If these modifications cannot be agreed the back stop regulation will be a traditional RAB based mechanism.

The ACC welcomed the assessment from the CAA that there were a number of issues with GAL's proposal. In particular the CAA highlighted that the enforceability and the terms of the commitments are such that they do not offer sufficient protection to be in the passenger interest.

The ACC agreed that the commitments proposal previously put forward was not workable and provided evidence on this in a submission which centred around 6 main issues:

- The legal status of the commitments was inadequate – exposing airlines and passengers to significant risk;
- The proposed price in the commitments was too high and did not represent value for money for passengers;
- There was too much uncertainty around future charges; for example, from potential runway 2 costs and service bonuses;
- The commitments did not encompass all the charges paid at the airport – exposing passengers to significant risk from residual charges;
- The service proposals did not address the concerns set out by the ACC with GAL's original proposals; and,
- For these reasons the proposed commitments did not remedy Gatwick's significant market power

The CAA suggested a number of changes, in its initial proposals, that would need to be made to the commitments proposals to make them a workable solution to protecting passengers from GAL's market power in Q6. The first set of changes were new licence conditions that would need to be introduced to ensure the regulatory back-stop would provide enough protection. The CAA's initial views were that a licence should include:

- A condition enabling the CAA to enforce the commitments. This would provide a direct response to concerns about enforceability and would allow enforcement in the interests of end users, rather than simply airlines.

- A condition preventing GAL from altering the commitments without good reason and from withdrawing the commitments. This would address the concerns that the conditions of use could allow the airport to unilaterally vary or withdraw the commitments.
- A condition allowing the CAA to direct changes to the commitments in response to a dispute where the commitments are operating against the user interest. This power would operate within quite narrowly defined circumstances.
- A condition allowing the CAA to introduce a freeze on charges if it is undertaking an investigation. This would prevent detriment during the time it takes to remedy the failure of the regime, for example while new licence conditions are introduced, or the MPT is being reassessed.

The ACC agreed with the CAA's assessment that any commitments framework should be backed up by a regulatory licence. However, if the commitments were just backed up by a licence some airlines identified significant problems and considered that the whole approach of having the Commitments simply backed by a licence would be questionable as a matter of law.

Other than the regulatory licence, the CAA's initial proposals also raised a number of other issues with GAL's proposals. These were around:

- **Price:** The CAA would want the commitments to offer a price that is fair.
- **Efficiency:** The amendment of the full pass through of the costs of changes to security requirements, to something similar to the Q5 arrangements, the removal of the pass through of taxation changes, and the removal of the pass through of development costs of a second runway.
- **Service quality:** The level of rebates and bonuses in the service quality scheme should prevent service quality from being reduced and provide bonuses only where there is significant outperformance of existing levels of service quality. The commitments should also include protection against repeated failures to meet service quality targets. Airline service quality targets should also not distort competition between airlines.
- **Capex:** A commitment to deliver any outputs resulting from the capex plan that are over and above the outputs that would be reflected in the service quality regime.
- **Consultation:** The commitments should include consultation requirements beyond those required by the ACD and address the significant information asymmetry between GAL and the airlines;

- **Transparency:** The commitments should provide sufficient information to airlines to allow them to understand whether charges are reasonable.
- **Operational resilience:** The commitments should provide clarity on what GAL will do and how it will interact with other operators at Gatwick to ensure the availability and continuity of airport operation services to further the interests of passengers, particularly during disruption.
- **Financial resilience:** The commitments should provide clarity on what GAL will do to ensure the financial resilience and continuity of service.

The ACC, therefore sought to engage with GAL during the CAA's consultation period to understand its reaction to the CAA's initial proposals and whether it would be providing an updated proposal on commitments.

GAL shared an updated version of its Commitments on the 7<sup>th</sup> June. As this came relatively late in the consultation period, and did not include a revised price, the ACC simply provided some initial points about the updated proposal from GAL in its response to the CAA's initial proposals:

- GAL maintained that a regulatory, licence back-stop was not needed and as such was not included in the updated commitments. The ACC continued to believe that a licence is desirable to provide sufficient protection for passengers (note that some airlines are looking at this again with GAL);
- GAL had not included an updated price in its proposals – this made it impossible to assess the commercial viability or value to passengers of any proposal;
- There remained significant uncertainty around future charges; for example, from potential runway 2 costs and service bonuses; and,
- There remained a proposal to include service standards on airlines which the ACC does not believe are appropriate, given the current SQR regime.

We, therefore, currently do not view the creation of such commitments (as proposed by GAL) as an effective remedy for the substantial market power that Gatwick continues to hold.

Since this feedback was provided, GAL has released an updated price on its commitments and the CAA has revised its licence proposal. This response focuses on these elements.

It is worth noting that GAL maintained its view in the updated proposals that commitments could be implemented without a licence and at least one airline is considering with GAL whether this proposal is viable.



## **The CAA's proposed licence for a commitments model**

The ACC appreciates the efforts made by the CAA to address concerns raised by airlines with the licence framework for the proposed commitments approach.

However, we do have a number of remaining concerns on the detail of the proposed licence framework and on the terms and conditions of the proposed commitments. These concerns are set out in detail below.

The ACC comments are set out on the basis that commitments are delivered through a licence.

### **Comments on the licence framework**

#### **Enforcement of the commitments**

The ACC support Condition 3.1 as a necessary and effective licence term, incorporating the commitments into the licence. A breach of a commitment would therefore represent a breach of a licence condition and all the enforcement powers under the Civil Aviation Act 2012 (the "Act") would be available to deal with it.

Condition 3.2, requiring compliance in a manner designed to further the interests of users of air transport services in specified particulars, is also a positive move that should have the effect of filling unintended gaps in the commitments and minimising the risk of unfavourable interpretations of them by GAL. As a drafting point, we consider that Condition 3.2 needs to be modified to say, "*In complying with the commitments and this Condition 3...*" as we are not convinced that the existing drafting is sufficient to have the intended effect. Condition 3.1 turns the commitments into licence conditions but it is not obvious that it makes them part of "*this Condition 3*".

Conditions 3.1 and 3.2 successfully address our objection that it could be considered unlawful to impose obligations in a form that were not capable of being enforced under the Act.

#### **Modification of the commitments**

The CAA's draft licence conditions make good progress in addressing many of our previous concerns about modification of the commitments.

In particular, the CAA's revised proposal addresses the concern that GAL could alter or withdraw from the conditions of use, by making the commitments conditions of the licence. As such, none of the commitments can be varied unless the subject of a specific exception

(set out in the commitments and, hence, in the licence) allowing variation in particular circumstances. We consider that this is an effective mechanism.

We previously expressed concern that the CAA appeared to envisage GAL having the ability to unilaterally vary at least some of the commitments where it had an undefined "good reason" for doing so. Whilst we still do not have the drafting for the relevant provisions of the commitments, it now appears that the only power to vary will be as specified in the commitments and thus, for example, where there is approval by x% of airlines paying fees calculated under the commitments. We consider that this could address our concern (subject to comments below about the particular percentage).

We previously expressed concern that the proposal would remove the statutory processes surrounding the modification of regulatory obligations, including rights of appeal. The CAA has correctly pointed out that section 21(3) of the Act envisages circumstances in which conditions can include powers of modification other than under the provisions of the Act (and, thus, without a right of appeal under the Act). Changes are possible only:

*"if it specifies or describes—*

*(a) the circumstances in which it may be modified,*

*(b) the types of modification that may be made, and*

*(c) the period or periods in which it may be modified."*

We cannot say if these requirements are satisfied until we see the drafting for the variation provisions in the commitments, but we can see that the conditions could be satisfied. The drafting implies that the power to modify in this way should be limited to a narrow range of situations.

Subject to the drafting of the relevant provisions of the commitments, the approach suggested by the CAA could be sufficient to overcome our objections based on modification powers to the legality of licence-based commitments.

We do still, though, have an issue of principle with the modification proposals. We accept that there are circumstances where modifications will be uncontroversial and where there is a good case for some sort of "fast track" procedure. It may be that if there are very high levels of support by airlines and by GAL for a modification then it is enough that the CAA has a power to intervene of its own motion relying on Condition 3.2 if it considers that the amendment nevertheless is not in the interests of air transport users. Where, however, there is significant airline opposition (which could be the case with objections from airlines accounting for significantly less than 49% of fees paid under the commitments), we do not agree that the rights available under section 22 should be denied, namely:

- a formal explanation of the reasons for making the modification;
- a period for making formal representations;
- a reasoned response to representations; and
- a right of appeal rather than just judicial review.

In the circumstances, we would suggest that the ability to use the section 21(3) route rather than the section 22 route should be restricted to those circumstances where there is unanimity over the proposed modification or, perhaps, a very high percentage of airlines in support. Of course, the extent of airline support could be something taken into account by the CAA under section 22.

The other issues with any proposed approach to modification depending on endorsement by a given percentage of airlines paying fees under the commitments are that:

- There may be issues about how to calculate the relevant percentage, e.g where an airline pays some fees under the commitments and some under bilateral agreements or where percentages vary over time. This is only compounded by the fact that support required varies depending on the type of modification; and
- there may be circumstances where it would be legitimate for an airline to object to a modification even if it does not pay fees under the commitments or otherwise qualify to be counted in the relevant percentage, yet the section 21(3) approach would not necessarily give any prior notice to that airline or any opportunity to make an informed objection.

We therefore propose that the modification process in the commitments requires the support of airlines representing a higher percentage passengers, excluding any airlines unaffected by the change. This would at least minimise the risks in this respect since it would effectively limit use of the mechanism to uncontroversial proposals.

### **CAA resolution of disputes**

We remain unsure what the CAA has in mind in respect of dispute resolution. Paragraphs 22 and 23 of the letter create some confusion.

It appears that the CAA has in mind acting as an avenue of appeal from arbitral decisions under the commitments in relation to proposed modifications. This appears to be based on a misunderstanding of what GAL is proposing. GAL does not appear to suggest that there should be any role for an arbitrator or independent adjudicator in modification of the commitments. Modification depends simply on numbers of airlines in support - 51% of the relevant airlines. The independent adjudicator role described in the heads of terms for the commitments appears to be limited to disputes over compliance with the commitments, not

over modification to them. Moreover, the decision of the independent adjudicator is only temporarily binding pending a reference to the courts or mutual agreement, so there is no need for an appeal to the CAA.

In the circumstances, we consider that draft Conditions 3.4 to 3.6 should be deleted and Condition 3.7 modified to delete reference to Condition 3.5.

### **CAA power to freeze charges**

The CAA has provided a little more information on how the proposed power to freeze charges would work and why it is limited to charges. This extra information is sensible. We still believe, though, that the power should go further and allow the CAA to reduce charges. At a minimum, we believe that it should allow the CAA to reverse any recent increase in charges not explicitly approved by the CAA as our concern is that the commitments, being novel, may leave scope to GAL to increase prices without prior notice to or approval by the CAA in some circumstances but in a way that is nonetheless seriously detrimental. The CAA needs to have powers to enforce quickly and effectively and it may not always be in a position where it can act before an increase is imposed. Merely freezing prices is not enough, especially as it is not clear whether this would be a nominal or real terms freeze.

## **The ACC's view on GAL's revised commitments proposal**

### **Summary**

The CAA has asked for a view on whether GAL's latest proposal on commitments addresses the concerns raised previously. The ACC's view is that the latest version of GAL's proposals are not in the interest of passengers and contain a number of issues and risks.

Moreover, the ACC notes that the revised terms are also a long way off the type of commercial agreements we would normally expect. With GAL appearing to 'cherry-pick' elements of a contract it finds attractive whilst offering little or no safeguards to its customers or the passengers they carry.

In particular:

- The proposed price remains too high. There are also considerable risks to the out turn price to be paid by airlines caused by the CRD, any second runway proposal, generous bonus payments [we do not have a common view on these two];
- The pricing principles that will be used by GAL do not form part of the commitments and are subject to change;
- The ACC considers that GAL's ability to change the terms of the commitments needs to be more tightly constrained;
- The ACC believes there are significant weaknesses with the service quality regime proposed and if commitments are to be workable, a more commercial, focussed and output based regime needs to be enforced. In particular, with neither commitments to deliver particular capital projects, nor a strong service quality regime, there is a significant risk that GAL would delay necessary investment or refuse to make investments unless airlines agreed to further price increases.
- It is not clear that airlines would be provided with sufficient information to be able to ensure that GAL's charges were consistent with the price commitments. Even so, monitoring compliance with the commitments would be much more complex than monitoring a RAB based price control and there would be significantly less certainty about the price path of airport charges over the period.

There also remains considerable uncertainty over the process after 7 years both from the CAA and GAL as to how market power and the appropriate ongoing form of regulation and price will be judged.

The ACC does therefore not believe that GAL's revised commitment proposals are in the interest of end users.

## **ACC evaluation of GAL's commitments**

The ACC has a number of further detailed points on the revised terms. These are explained below and ACC airlines will individually provide further comment.

### **Pricing**

- The commitments proposal of RPI +2.5% is above the CAA regulated price proposal of RPI+0% for a 7 year period, which itself was above the ACC's view on an efficient price settlement;
- GAL seeks to advise of a blended yield of RPI +1.5%, which would reflect the average price paid by airlines, it is therefore difficult to assess the price path for individual airlines so we have to assume the price of RPI +2.5%. It could also be difficult to monitor compliance with the RPI+1.5% blended yield cap as other airlines will not be able to see the contracts or the resulting revenues and the CAA would not provide independent assurance as they do currently.
- There are considerable risks to the out turn price to be paid by airlines caused by the CRD, any second runway proposal, generous bonus payments;
- The pricing principles that will be used by GAL do not form part of the commitments and are subject to change.

### **Second runway**

- The ACC believes it is inappropriate for passengers to pay an open ended sum in advance for the development of a second runway. These charges should only be passed on once any second runway is operational.

### **S Factor**

- The ACC believes the inclusion of an s-factor within price commitments is inappropriate. We would expect changes, either tightening or loosening of security policy, to be included within an overall price. If a major change occurred then there are processes to re-open the commitments which would be more appropriate.

### **Airline Service Quality**

- Whilst individual airlines have different views on whether airline service standards could be included in a bilateral contract, the ACC continues to have a number of concerns with the airline service standards included by GAL in its draft commitment terms:
  - a) It is not for GAL to set airline service standards. The passenger purchases a ticket with an airline based on the experience the airline has sold to the passenger and that

the passenger expects to receive from such airline. The contract is between the airline and passenger only.

- b) The airlines are responsible to passengers only for airline service quality. Therefore it is not acceptable for GAL to be able to forego rebates to airlines based on the airlines performance to a passenger.
- c) In addition, GAL is maintaining a right to unilaterally adjust the standards which is not acceptable.
- d) Moreover, if these terms are to be included within a regulatory licence it is not appropriate for the CAA to impose economic regulation on airlines who operate in a competitive market.

### **Core Service Standards**

- GAL sets out the ability to adjust core service standards if agreed by airlines that account for 51% of passengers utilising the airport and 51% of airlines responding in writing. This is not workable as Gatwick has a diverse airline base (low cost, charter, leisure, business) and could be discriminatory on certain airline groups.
- A proposal for how to amend this is covered in the licence section of this response.

### **Service Quality Regime and CAPEX**

- The ACC believes there are significant weaknesses with the service quality regime proposed and if commitments are to be workable, a more commercial, focussed and output based regime needs to be enforced. In particular, with neither commitments to deliver particular capital projects, nor a strong service quality regime, there is a significant risk that GAL would delay necessary investment or refuse to make investments unless airlines agreed to further price increases. We do not consider that the SQR regime, especially the one proposed by GAL, is strong enough to incentivise GAL to make some necessary investments because:
  - a) the rebate payments could be small in relation to the cost of the remedy (it would then pay to fail);
  - b) the SQR scheme does not provide cover for all facilities that are necessary, especially on the airfield. For example, if a taxiway was congested or needed resurfacing, the airport would be unlikely to pay rebates;
  - c) under GAL's proposals, rebate payments would be around half the existing level and could be offset by generous bonus payments, significantly reducing GAL's exposure to financial risk under the scheme;

d) this would also be further compounded by the incentive to spend capital by virtue of future profits being linked to the RAB being gone.

- GAL has said that it is incentivised to deliver capital investment but this has to be backed up with a more robust contractual commitment to deliver outcomes needed for passengers.
- It is not clear how GAL will consult with airlines (who are best placed to represent passengers) on future infrastructure requirements. Combined with a very weak service quality commitment the ACC has significant concerns that this could lead to a degradation of service to passengers.

### **Contractual Obligations/ General**

- The airlines still remain in the commitments proposal “the insurer of last resort”. In a standard commercial relationship, the supplier would have a contractual liability for direct costs incurred by the customer through supplier under performance or negligent actions. For example, if GAL closed a runway due to a lack of action within its control, which resulted in the airline having to hotel, feed, refresh or compensate passengers, GAL is not liable for these direct costs. This is unacceptable in a commercial relationship. For the avoidance of doubt a rebate SLA relating to runway availability is not the measure to compensate for direct costs incurred due to GAL’s in action, this rebate is to compensate the customer (airline) for not receiving a service it has paid for. In any case, we understand that GAL does not currently support a runway availability measure.

### **Financial performance and resilience**

- The publication of the airport asset base does not accord with the formula for rolling forward the RAB. A shadow RAB should be reported, using the same calculations. Given the airport’s market power and the significant concerns expressed by airlines and the CAA about GAL’s proposed commitments, we request that if the CAA does adopt this approach for Q6, it ensures that a return to a RAB based approach.

### **Operational resilience**

- Whilst we welcome and support GAL’s proposed commitment to coordinate and cooperate with all relevant parties, using best endeavours to coordinate communication during periods of disruption, we do not support GAL’s statement that:

*“The Conditions of Use shall require all providers of air transport services and ground handlers to comply with rules of conduct relating to minimum service provision and in particular to actions to be taken during periods of disruption.”*

- Airlines already have strong incentives to meet passenger needs where they operate in a competitive market. They are also liable for large compensation payments under EU



rules. It would be wrong for Gatwick, which has no such financial obligations, to unduly constrain airlines where they know their businesses best needing an unfettered flexibility in how they manage disruption.

- While there may be a case for imposing some operational restrictions on airlines and ground handlers (but only on a strict consensual case-by-case basis such as fair sharing of reduced facilities or temporary changes to processes if key infrastructure is not available), GAL's powers should not be so wide as to risk GAL undertaking action in their own interests or imposing additional costs, burdens or constraints on airlines. Therefore if this part of the Commitment is to be included, it must be subject to a clear qualification that removes any the risk of abuse. For example, the following text could be added:

*"...providing that any such rules are agreed ex-ante and are necessary, not discriminatory, proportionate, in the passenger interest and only applicable for as long as the disruption continues."*

- This would provide some safeguards to airlines in any consultation process always requiring GAL to properly justify any such rules.