

## Attachment 7

## **THE ROLE OF AIRPORT REGULATION AND ITS PRACTICAL IMPLICATIONS**

### **The UK System of Airport Regulation - Introduction/General**

1. The UK was the first country to privatise its major airports and it established a new form of economic regulation under the Airports Act 1986. There are two main elements relevant to Auckland Airport:
  - Price capping and quinquennial reviews of charges and conduct at airports designated by the Secretary of State. These are the three BAA London airports (Heathrow, Gatwick and Stansted) and Manchester. The designated airports are also subject to general conduct provisions; and
  - Conduct regulation of all significant commercial airports (presently defined as those whose operating company has an annual turnover of over £1 million).
2. The regulator is the Civil Aviation Authority (CAA (UK)) which was created in 1971 to operate the air traffic control system, to regulate aviation safety and to be the economic regulator of airlines and air travel organisers. The Airports Act therefore grafted the new role of airport regulation on to an existing body.
3. Airports were privatised as part of a wider policy of privatisation of public utilities, including telecommunications, gas, electricity, water, airlines and railways. There are several common features.
4. Although general competition and fair trading regulators already existed in the form of the Office of Fair Trading (OFT) and the Monopolies and Mergers Commission (now the Competition Commission), the government decided to create specialist regulators for each sector with their own duties and powers.
5. The regulators were appointed by, but acted independently of, the government.
6. The industries have the right to appeal against the regulator's decisions to the Competition Commission. (Airports are a partial and unique exception to this: see description of price capping below).
7. All the regulators use RPI-X price caps for the monopoly activities of the regulated industries. The original approach was developed for telecommunications. The decision not to follow US-style rate of return regulation was deliberate since ROR was perceived to encourage over-investment and to lack incentive properties.
8. The original telecommunications model has been adapted for each industry but in every case it is set for a period of three to five years with a strong presumption against mid-term reviews.
9. In 1998 the government enacted a new Competition Act modelled on the competition articles of the Treaty of Rome: these outlaw defined forms of restrictive and anti-competitive behaviour and also prohibit anti-competitive commercial agreements unless user benefits can be demonstrated.
10. In the following year it gave the sector regulators (with the notable exception of the CAA (UK)) powers to apply this legislation concurrently with the general regulator, the OFT. This was a continuation of a previous anomaly under which the CAA (UK), as a pre-existing regulator, had been treated somewhat differently. The government proposes to amend this anomaly at a suitable opportunity and the CAA (UK) will have concurrent powers for the regulation of the National Air Traffic System (NATS).
11. Regulators generally are taking some products and services out of price caps once they are satisfied their markets are competitive. Examples include telecommunications and, more recently, domestic gas supply.

### **Statutory Objectives**

12. The CAA (UK) has the following statutory objectives in airport regulation. They are closely modelled on those which applied to its pre-existing duties:
  - To further the reasonable interests of airport users
  - To promote efficient, economic and profitable operation
  - To encourage investment in new facilities in time to satisfy anticipated user demand

- To impose the minimum necessary restrictions
  - To take into account the UK's international obligations.
13. The government has proposed to make the duty towards users primary: this would be in line with the recent changes in respect of the other sector regulators.

### **Designation of Airports for Price Cap Regulation**

14. The government designated the three BAA London airports for detailed price and conduct regulation because Heathrow and Gatwick were in a clearly dominant position, particularly under common ownership. Stansted appears to have been included because:
- A major reason for privatising the three airports as a group was to pursue the then government policy of actively encouraging BAA to develop Stansted as London's third London airport. In practice this implied an initial cross subsidy to Stansted, which would be difficult to deliver if the three airports were not treated as a group and regulated by an overall price cap.
  - Other airports, particularly Manchester and Luton, were concerned that BAA ownership of Heathrow and Gatwick would enable it to set charges unreasonably low at Stansted to build it up at the expense of other airports. (Remedies are available under the complaints procedure which applies to all significant airports (see below), but rival airports thought that designation would give them a stronger platform). There was no suggestion that Stansted should be designated on the grounds that its charges were, or were likely to become, too high.
15. When the decision to designate was taken in 1986, Heathrow had 31.3 million terminal passengers, Gatwick 16.3 million and Manchester 7.5 million. (Stansted had just over 500,000). The next largest airports at that time were Glasgow (3.1m), Birmingham (2.1m), Luton (2.0m), Belfast International (1.9m), Edinburgh (1.7m) and Aberdeen (1.5m).
16. In 1999 Heathrow, Gatwick, Manchester and Stansted had risen to 62.0m, 30.4m, 17.4m and 9.4 m respectively. The four next largest were Birmingham (6.9m), Glasgow (6.8m), Luton (5.3m) and Edinburgh (5.1m)
17. The question of whether other airports should be designated has arisen with respect to the BAA Scottish airports and, more recently, to Luton.
18. BAA owns Glasgow, Edinburgh and Aberdeen airports. Despite their collective dominance of the Scottish market (at the time of privatisation BAA owned Prestwick, near Glasgow, as well), the government decided against designation. However Scottish members of Parliament observed that Glasgow and Edinburgh were returning healthy profits and enjoying high growth and asked the government to designate them. This was at a time when the devolution debate was active and then, as now, Scottish members were a powerful influence.
19. The government took advice from the CAA (UK) and decided not to designate the Scottish airports. However it accepted from BAA an undertaking to keep the charges within RPI-3 and this process has been rolled forward year by year.
20. In 1995 the government reviewed the framework for the economic regulation of airports and it published four criteria:
- The market position, including the extent of competition from other airports and other modes
  - Prima facie evidence of excessive profitability or abuse of a market position
  - The scale and timing of investment, and their implications for profitability
  - Efficiency and quality of service.

21. Earlier this year easyJet, a relatively new and fast-growing low fare airline asked the government to designate Luton airport. The essence of its case was that, in raising its charges from a very low introductory base to levels similar to those paid by other airlines, Luton was exploiting a dominant position. The government took advice from the CAA (UK) which considered the criteria for designation in detail. In recommending against designation, the CAA (UK) found, inter alia, that:
- The government's published criteria were not the only ones which should be followed.
  - Designation implies detailed regulatory oversight of an airport which is likely to entail significant costs and may create distortions of its own. As such it is not to be undertaken lightly."
  - Thus the test should be stronger than simply finding that the airport has market power.
  - Designation would be inappropriate in this case even if easyJet were shown to be a "captive customer" because the specific concerns could be dealt with under the complaints procedure.
22. The government accepted the CAA (UK)'s advice. In any event, and against a background of not wishing to appear over-interventionist, the government was under wider political pressure to avoid designation if at all possible.

### Price Cap Regulation of Designated Airports

23. The Act requires the CAA (UK) to refer the designated airports to the Competition Commission every five years. It seeks the Commission's advice on the price cap for the next five years and then reaches a final decision after further consultation. The Commission is involved at this early stage since it was thought that non-aviation revenues, in which CAA (UK) would not be expert, would loom large in the final decision under the single till arrangement.
24. This to and fro process is long and expensive. The CAA (UK) typically consults the industry and users on the issues to be referred to the CC and prepares detailed evidence to back up the reference. The CC takes six months to investigate, taking written and oral evidence from the parties, including the CAA (UK). The CAA (UK) publishes proposals, holds further consultations and reaches a final decision about four months later. The whole process therefore takes about 15 months and the airport then has to turn the overall price cap into detailed charging proposals and consult the airlines on these. The CAA (UK) decision is issued around October to form the base of a new tariff in the following April.
25. The forthcoming review is taking still longer. Because of continuing uncertainty over Heathrow Terminal 5, the next price cap for London will take effect in April 2003 rather than 2002 and the Manchester review will be simultaneous with it. The CAA (UK) has decided to consider the methodology from first principles and has already put out a consultation paper which will lead to the Competition Commission reference in December 2001. The CAA (UK) is seeking, among other things, to put more emphasis on economic issues such as economic efficiency and the allocation of scarce resources.
26. The government is considering shortening this process by leaving the whole review to the CAA (UK) and making the CC the appellate body as in the other regulated industries. However the degree of detail and the extensive consultations would still leave a long and expensive timetable.
27. The timescales are partly determined by the sheer breadth and volume of the evidence required. In some other countries a stripped down form of RPI-X is used, under which precise calculation is avoided: a low value is set in the expectation that airports can make gradual efficiency improvements and airlines will be grateful for the fact that charges will fall in real terms. However developing a quantified formula requires first accounting for the regulated airport separately from the operating company's other activities and then making the following forecasts:
- Traffic, revenues and yields
  - Net commercial income, including rents, concessions, etc.
  - Staff numbers, wage rates, costs of goods and services

- Productivity
  - Financial costs and ratios
  - Value of assets
  - Cost of capital
  - Capital investment programme.
28. Since the airport supplies the information and has an interest in overstating the costs and understating the revenues, the regulator has to be able to question the airports assumptions and test its own. For example, capital investment programmes are never carried out precisely as forecast and in real life they must adapt to unforecastable changes. Thus the regulator has to take a view on the overall credibility of the airport's plans. For this it has to have:
- staff with the necessary skills and experience to partly overcome this asymmetry of information.
  - access to an agreed model of the airport's financial drivers and their effects.
29. The regulator also needs to establish whether the projections in the model reflect the facilities and standards which airport users want. Both under and over provision would be inefficient. This means that the process must be open, with full consultation with airport users and the users must have sufficient information to make informed judgements.
30. The CAA (UK) is required simply to set a maximum charge. It does not have to use any particular type of formula, or indeed RPI-X. However the first formula was set by the government (at the time of privatising BAA) at RPI-1 and the CAA (UK) has followed this model - albeit with generally higher values of X ever since. The history of the London and Manchester formulae is reviewed briefly in Appendix 5.1. Key features of the formula are as follows:
- It covers airport charges, ie aircraft landing and parking fees and per passenger terminal charges. This is a standard definition used in most countries.
  - Alternatives to RPI-X have not been seriously considered. There is a strong presumption that rate of return regulation would give perverse incentives.
  - The formula is expressed as revenue yield per passenger. A tariff basket is used in some other regulated industries and has been considered for airports but the CAA (UK) continues to marginally prefer revenue yield.
  - The cap is on all revenue from airport charges: there are no sub-formulae for individual charges. It is doubted whether the CAA (UK) could legally impose them unless the MMC found a public interest reason to do so or the CAA (UK) decided that they were an appropriate remedy in response to a formal complaint.
  - The formula can differ for individual years within a quinquennium. For example the annual X factors in the first London formula were 8,8,4,1 and 1, respectively. The idea was to squeeze out the excessively profitable base left by the government's initial RPI-1 and get down to a low and sustainable X which would approximately track likely future improvements in productivity.
  - Correction factors are applied two years after each year to claw back any over-recovery and to allow the airport to claim back any under-recovery. Over-recovery is discouraged by a penalty interest rate.
  - An added "S" term allows for the recovery of 95% of the cost of any additional costs of implementing new government security directives imposed during the quinquennium. Unlike some other regulated industries no other pass-throughs are allowed.
  - The opening revenue yield for the formula is important. The CAA (UK) has generally taken the forecast yield for the last year of the previous quinquennium period. Where this is below the allowable yield, the airport may press for a higher figure. The CAA (UK) has not accepted this, but the issue is not clear-cut and airports may therefore have an incentive to raise charges by more than necessary in the last year of a formula to secure a higher base for the next period.

- The CAA (UK) has considered or adopted adjustments to the formula to take account of unpredictable events or to give extra incentives for desirable actions. Specific examples are:
    - In the 1991 London review, the MMC suggested that the formulae for London should be loosened if BAA commenced work on Heathrow Terminal 5 or a similar development in 1995/96. The CAA (UK) did not adopt this.
    - In the 1992 Manchester review, the CAA (UK) allowed an X of 0 rather than 3 for the last two years provided that at least three baggage handlers were contracted in Terminal 1 by April 1996.
    - In the 1996 London review, the CAA (UK) obtained an undertaking that BAA would seek a review of the formula if Heathrow Terminal 5 did not go ahead or were substantially scaled down.
    - At the same time it provided for charges increases contingent on the loss of net revenue from the withdrawal of intra-Europe duty-free.
    - In the 1997 Manchester review, the CAA (UK) allowed for the loss of net revenue from the planned withdrawal of intra-EU duty free but obtained an undertaking from the airport that it would seek a review of the formula if this withdrawal did not occur.
    - The review of the next London price cap has been postponed for a year specifically because of uncertainty over Heathrow Terminal 5.
  - The single till is not mandatory but has been retained, partly because of perceived international constraints. However the CAA (UK) has raised the future of the single till as an issue for the next review.
  - Once set the formula stays in place for the whole period. There is an escape clause, which the CAA (UK) has said it would be highly unlikely to act on, whereby airports can apply for a review in an emergency. Airlines have no corresponding rights to trigger such a mid-term review.
  - Similarly there is no claw back of any super-profits. In practice, rather than provoke indignation, airports have not always charged to the limit of the formula where windfall profits have been earned. Less sensitive behaviour by some other regulated utilities led the new government to impose a windfall tax shortly after its election. The CAA (UK) believes that the disincentive effects of clawback might harm the long-term interests of users.
  - Nevertheless the CAA (UK) could claw back any excess attributable to its being deliberately misled at the time of a review.
31. The application of RPI-X to airports and to other industries has been generally regarded as successful. But difficulties have arisen: perverse effects have been identified; and regulators are more and more aware that, the more price setting can be settled by negotiation, the greater likelihood of a good quality result.
32. In the following paragraphs, we consider some of the issues which affect the dynamics of regulation. Most of them have been raised by the CAA (UK) in its current consultation papers.

### Profit Sharing

33. If there are economies of traffic density and traffic is increasing, the X factor may still lead to high returns. This was the case at Manchester in 1988-93 where, under a regime of RPI-1, the airport did not fully recover the level of charges to which it was entitled but still enjoyed a stronger financial performance than had been expected when the formula was set. The same happened in 1993-98 under RPI-3. The current formula, also RPI-3, allows for a one-off reduction in net revenue for the loss of intra-EU duty free: nevertheless Manchester has still not taken the full allowable increase.
34. A regular theme in a fast growing industry is who should bear the risk and reap the consequent windfall profit or loss if traffic turns out to be much higher or lower than forecast. Airlines have tended to argue that they should share windfall gains but have not accepted that they should share unanticipated losses.

35. The CAA (UK) has been reluctant to transfer all or part of the traffic risk from the airports because of the consequent weakening of the incentive to provide for and to encourage additional demand. However risk-sharing mechanisms are simple to devise: Vienna airport, for example, has a sliding scale formula by which charges are adjusted if traffic falls outside a predetermined band. It would also be possible to introduce a traffic volume term into the RPI-X formula to share the traffic risk.

### Rate of Return

36. Rate of return is in practice one of the main criteria on which charges are set and some therefore argue that RPI-X ultimately degenerates into rate of return regulation. In previous reviews, BAA has argued that in a competitive industry the most successful companies earn higher returns and that the opportunity to do so is an essential incentive to good performance. Other regulators in the UK are seeking to relate their formulae to good performance benchmarks, but this is easier in industries where there are sufficient similar companies for yardstick comparisons to be made.
37. Nevertheless, even if some kind of risk-adjusted “normal” rate of return is used, the worst effects of rate of return regulation are avoided by RPI-X because it is set ex ante on the basis of an indicative set of forecast revenue yields rather than ex post to precisely match a target rate of return. What matters is that an airport is able to profit by better than expected performance during the formula, even if this improvement is consolidated into the cost base for the next formula.

### Glidepath Regulation

38. A related problem is that efficiency improvements towards the end of a formula period have a correspondingly short payback. It is therefore in the interests of the airport to hold back such improvements until the next period: (BAA is known to have done this in the past.
39. A solution, which is now being canvassed in other sectors and which will probably arise in the next airport reviews, is to separate out such unforecast gains and allow them to be retained for a full period irrespective of the date of the review.

### Single Till

40. Single till is established practice in the UK, but dual till is increasingly used in other systems and the CAA (UK) has already raised the possibility of moving to dual till in the next review.
41. Single till requires the regulator to take a view on non-aviation revenues. This may be difficult for a specialist aviation regulator.
42. The CAA (UK) recognises that dual till involves the difficult issue of the allocation of common costs: however it believes it to be more economically efficient for congested airports.
43. One problem was that BAA was earning a minority - and a shrinking minority - of its income from airport charges at Heathrow and Gatwick, while returning strong results for these airports as a whole. However, the situation is changing to the extent that the loss of intra-EU duty free has reversed this process.
44. There is increasing focus on the apparent absurdity of low charges at an airport where demand vastly exceeds supply.
45. Airport charges are not normally sufficient to cover their associated costs.
46. Pure dual till would face strong opposition from airlines, and possibly also foreign governments mindful of ICAO guidelines and airport charges articles in bilateral agreements.
47. In practice any move towards dual till in the UK is expected to be less than pure.

### Performance Standards

48. The current regulatory debate in the UK is focussing increasingly on the setting and measuring of performance standards and of rewarding good performance. If the privatisation of NATS goes ahead, the government is expected to give the CAA (UK), as economic regulator, a role in this area.
49. The CAA (UK) has been encouraging airports and airlines to develop service level agreements with appropriate rewards and penalties. It has also canvassed the idea of different charges for different service levels.
50. In an industry which lacks clear benchmark comparators, this focus will place increased emphasis on shaping standards by discussion between the airports and the airlines - i.e. moves towards a more contractual form of regulation with the regulator as facilitator and final arbiter.

### Benchmark Costs

51. In its recent consultation papers, the CAA (UK) has raised the possibility of regulating charges on the basis of benchmark comparisons rather than on the airport's accounting costs. This approach is being partially introduced in some of the other regulated utilities.

### Capital Investment

52. Airlines have pressed for direct links between the price formula and the delivery of an agreed capital investment programme. The CAA (UK) has resisted this on the grounds that it would risk setting investment decisions in stone when they need to be sufficiently flexible to meet changing circumstances and traffic patterns.
53. However the CAA (UK) has said that it wants closer involvement of airlines in capital projects and has taken steps to require greater cooperation and disclosure. But this may also lead to greater CAA (UK) involvement (British Airways has suggested, in its response to the first CAA (UK) consultation papers, that the CAA (UK) should be in a position to form its own judgements on the capital programme, using consultants if necessary).
54. The CAA (UK) now publishes annual assessments of regulated airports' performance in these and other matters. As with service standards, this is a deliberate move towards a more contractual state of regulation; but, paradoxically, this is likely to lead to greater regulatory involvement, at least in the short term.
55. Australia and South Africa have mechanisms to treat agreed major capital projects outside the price cap. This could be a logical step in the UK.

### Default Price Cap

56. In its consultation paper, the CAA (UK) used the term "default price cap". This suggests that the ideal is for some (and perhaps eventually all) charges to be set by negotiation and the price cap to exist as a residual backstop to encourage airports to negotiate in good faith.
57. The next logical step would be for the price cap to wither away, as was the intention right from the beginning for the regulated airports in Australia.

### Consultation and Transparency

58. The CAA (UK)'s policy has been to make the maximum amount of information - including financial and forward planning information - available to users. It has encouraged genuine consultation between airports and airlines on charges and capital expenditure and now publishes regular reports on the progress of BAA and Manchester in these and other areas.
59. It has been reinforced in this by formal findings and exhortations by the MMC against the quality of consultation at Manchester and - to a lesser extent - at London.
60. Disputes about the quality of consultation at Manchester have strained relations with its customers despite their overall satisfaction with the quality of service.

## Conduct Regulation

61. All airports whose operator has an annual turnover of over £1 million must apply to the CAA (UK) for Permission to Levy Airport Charges. This is granted automatically: safety is licensed by a different mechanism. The sole function of this Permission is to allow the CAA (UK) to apply conditions to the levying of airport charges.
62. Section 41 of the Act provides for such conditions to be attached to deal with courses of conduct which are set out in Appendix 5.2 but which may be summarised as follows: (note that this applies only to “relevant activities” as defined in the Act: non-aviation activities are the responsibility of the OFT under general competition legislation):
  - Trade practices or pricing policies which unreasonably discriminate against any user of the airport or class of user, or which unfairly exploit the airport’s bargaining position relative to users generally
  - Any practice in granting rights to trade on the airport which unreasonably discriminates against or between grantees, or which unfairly exploits the airport’s bargaining position
  - Unreasonable limitation of such rights
  - Fixing charges below cost or, in the opinion of the CAA (UK), artificially low and which materially harm, or are intended to harm, other UK airports.
63. The CAA (UK) acts on complaint. If it finds a prima facie case, it publishes it and invites comment. It then investigates it, usually through an adversarial hearing; and, if it decides a remedy is necessary, it can seek an appropriate undertaking from the airport or impose conditions on it. The airport can appeal to the Competition Commission.
64. The following points are interesting in the context of charges regulation:
  - The procedure can be applied to deal with excessive charges. Indeed the CAA (UK) has recently advised that easyJet’s complaint against Luton (see section on designation above) could best be handled in this way
  - In practice all but two of the cases heard have been on doing-business issues rather than on charges, and every case has been against designated airports
  - One of the charges cases was Luton’s claim that Stansted’s charges were too low. The only one on over-charging was a complaint by airlines operating domestic services at Heathrow that BAA’s restructuring of charges within the overall price cap had hit them disproportionately hard. The CAA (UK) required BAA to moderate the rate of increase to these airlines relative to increases generally over the remainder of the formula period
  - However several potential complaints have been resolved through the threat of the procedure, including some at non-designated airports and some of alleged over-charging
  - One basic weakness of the complaints procedure is that it can deal only with actual rather than prospective behaviour. Thus action can happen only after excessive - or unreasonably low - charges have been introduced. This could be reviewed if and when the Airports Act is reviewed as expected, although it may be overtaken by more fundamental changes as described below
  - In the new Competition Act the government has aligned competition legislation with the competition articles of the Treaty of Rome and, by giving concurrent powers to the other sector regulators to apply the Act, has brought the regulation of utilities into line with general rather than sector-specific legislation
  - The government has also canvassed giving the CAA (UK) concurrent powers for airport regulation. If it were to do this the part of the Airports Act which defines anti-competitive behaviour for the purposes of the complaints procedure would most likely be repealed
  - In a recent consultation paper on airport regulation the government said “we consider that airport’s conduct should be subject to the general competition law applying to other sectors of the UK economy, and not to separate regulation where this is unnecessary”

- The relevant sections of the Competition Act are set out at Appendix 5.3. They closely mirror the competition provisions - Articles 81 and 82 of the Treaty of Rome. In summary they prohibit:
- Agreements between undertakings, decisions by associations of undertakings, and concerted practices which prevent, restrict or distort competition or are intended to do so
- Abuse by one or more undertakings in a market which may affect trade within the UK.

### Overall Conclusions from the UK Experience

65. After ten years experience, supplemented by analysis from the MMC (now Competition Commission), the CAA (UK) has initiated a fundamental review of the current system and methodology. It has raised basic questions to which unambiguous answers are unlikely to be found. It therefore follows that, despite the complexity and depth of the analysis, there will be no "right" value of X.
66. The present system involving the CAA (UK) and the CC has already been found to be too expensive and too cumbersome (and would almost certainly have been simplified already but for the need for primary legislation).
67. In the case of Manchester, the airport has always charged under the allowable yield from the formula, raising the question of whether the expense and uncertainty of a complex system are justified, even for an airport of its size. It is possible that in the absence of RPI-X Manchester would not have been able to justify even the levels that it did charge.
68. The CAA (UK) is putting increasing emphasis on the desirability of negotiated charges arising from consultation, transparency and service level agreements. Current law requires the CAA (UK) to set a price cap for the designated airports, but the CAA (UK) has made it clear that its ideal is for this to be a "default" cap - a residual backstop for charges which are not successfully negotiated.
69. The government has decided not to apply price cap regulation to the Scottish airports despite their common ownership, relative size and clear market power and strong pressure from influential Scottish MPs. It has also refused an airline's request to designate Luton airport for price regulation.
70. Although it is best known for the heavy-handed regulation of the four designated airports, the UK also uses a very light form of regulation for the other airports. The Scottish airports have a voluntary cap and all other airports are free to set their own charges subject only to the possibility of complaint that they are exploitative, discriminatory or predatory.
71. This light system has worked well. . There have been no formal complaints or serious concerns that the charges at these other airports are unreasonably high, despite the fact that they are generally higher than at the larger regulated airports.

### RPI - X Regulation in Other Countries

72. We now consider RPI-X regulation of airports in other countries under three separate headings. Some countries have "developed systems" by which they calculate formulae designed to achieve forecast results. Others use "simple systems" whereby they take a low value of X, which is not precisely evaluated but is intended to strike a pragmatic balance between airports and customers while maintaining efficiency incentives. Finally Australia and Berlin have "temporary RPI-X", which is to be withdrawn on a specified timetable.

### Developed Systems

73. The UK system was the first and is the most elaborate. It was used as a model for Australia, South Africa and Vienna and Argentina. However there are, as explained below, important differences.

### Australia (Concession Airports)

74. Detailed price control is applied to the Concession Airports. It will also be applied to the Sydney airports after they are leased. Key features of the system, which is intended to be temporary, are as follows:

- It is administered by the Australian Commerce and Competition Commission (ACCC) rather than by a sector regulator.
- The Airports Act 1996 sets clear objectives for the regime including promotion of efficient and economic development and operation of airports, and having due regard to users.
- Facilitating the comparison of airport performance is an objective in its own right.
- Single till is not required.
- The cap varies between airports: for example X is 4 at Melbourne, 4.5 at Brisbane and 5.5 at Perth.
- The X value is specifically intended to reflect expected general productivity increases at the airports.
- The cap is based on tariff basket rather than revenue yield.
- There is 100% pass through of government-imposed security costs.
- Domestic Terminal Infrastructure (DTI) charges are outside the cap but are monitored.
- The ACCC can consider increases outside the cap for necessary new investment. It has guidelines for assessing such proposals and is also required to provide a statement of reasons if it refuses them.
- The ACCC monitors service standards.
- The ACCC also has surveillance over other aeronautical charges at airports with market power. Airports are required to apply for increases and the ACCC may refuse them.
- The ACCC is reviewing charges regulation for the phase one airports with the objective of replacing the price caps with some other form of surveillance. The former Department of Transport and Regional Development set guidelines for the review in November 1996, the first of which is that "the CPI price cap applied to aeronautical charges during the first five year period will no longer operate." Although this could be read as allowing for a new cap with different numbers, a more natural meaning of the words is that the present form of cap will not apply. The full review guidelines are attached at Appendix 5.4.

### South Africa

75. The South African system is closely modelled on the UK and is applied to the Airports Company South Africa (ACSA) airports:

- The formula is set by a Regulating Committee.
- The regulator's objectives are similar to those of the UK CAA (UK), but one important difference is that shareholders' interests are balanced against the public interest.
- The present formula allowed CPI-0 for the first three years and CPI-2 for the last two. It expires in March 2003.
- The formula was originally based on a single till approach, but the Airports Company Act was amended in 1998 to change to dual till - a move described by ACSA as "progressive and far-sighted".
- ACSA applied for the next permission in September 2000 and work has begun on the new formula.
- At the same time airports with a turnover of less than 10 million rand per year were taken out of price regulation.
- Lumpy investments can be taken out of the cap through a "K" factor.
- The regulator sets quality standards.

## Vienna

76. Austria was the second country in Europe to introduce CPI-X, which applies only to Vienna airport. Vienna is interesting because its charges are among the highest in Europe:
- The regulator is the Austrian CAA (UK), which is within central government.
  - This means, inter alia, that the process is less transparent than in the UK and Australia, particularly since airlines are not consulted and no report is published.
  - The formula was set in 1994 for three years. It has been rolled forward since then, and is currently due to be reviewed.
  - It is basically CPI-0 but there is a sliding scale for increases or reductions if annual traffic growth is less than 7% or more than 11%.
  - The formula was calculated on the basis of single till.
  - It uses tariff basket rather than revenue yield.
  - There are no conditions in the formula governing service standards, investment etc.
77. There is no information on whether detailed analysis was carried out when the formula was rolled forward. However, it is likely that the system was envisaged as being close to Simple RPI-X (see below) even when it was first devised and has now evolved into it in practice.

## Mexico

78. Mexico is leasing its 35 profitable airports to the private sector; the remainder will remain with the government. The current form of regulation is not described in detail but it is referred to because it appears to be a good example of complex RPI-based regulation and because it has important differences from the other complex systems:
- Regulation aims to prevent monopoly abuse, promote efficiency, allow (but not guarantee) fair rates of return, provide certainty, promote competition for complementary/commercial services and eliminate cross subsidy between airports.
  - There will be an independent regulator but initially the regulator will be the Ministry of Transport (SCT) who will:
    - Set the initial tariffs and structure
    - Determine 15 year projections for traffic, operating margins and investments
    - Determine a target rate of return
    - Determine the regulatory asset base, using a NPV approach
    - Set binding efficiency factors for each airport for the first five years and indicative factors for the following five.
  - The price cap is on aeronautical charges only - ie it is not single till
  - It is multiplicative: the limit is on charges times an X factor
  - It is based on tariff basket, not revenue yield
  - There will be five yearly reviews but the first will be triggered only if capex or passenger numbers deviate by a defined percentage from the original projections
  - The regulator will set service standards
  - Airports are required to consult users

- They must submit annual reports on master plans and investments
- The regulator can adjust tariffs to avoid fluctuations
- Airports have the right to seek interim reviews.

### Argentina

79. Argentinian airports were originally regulated by the Air Force. The 30 main ones are now under a 30-year concession contract with a possible 10-year extension. A specialist regulator has been appointed with a five-person board, responsible for:

- Supervision of the contractor
- Access to airports and non-discrimination
- Adequate airport capacity
- Supervision of airport investments
- Air traffic development
- Environmental compliance.

80. There is also a price formula which includes the following:

- CPI - X
- Revenue yield rather than tariff basket
- Charges may be set for a minimum of 3 and a maximum of 5 years
- Single till
- Formula allows for necessary investment and an adequate rate of return
- Regulator will require the concessionaire to maintain the agreed investment programme but this may be renegotiated if in any year the traffic falls more than 10% below the tender forecasts
- Regulator will specify service standards and commission annual surveys: it can modify the formula or impose fines if the standards are not met
- Regulator will seek cost reductions.

### Conclusions on Developed Systems

81. The five systems described above are very different.
82. As in the UK, the South African, Argentinian and Mexican systems both attempt to set the formula on the basis of a range of cost and revenue drivers and therefore involve much financial modelling, detailed work and assessment of the airports' assumptions. There are consequently large margins for error.
83. The Mexican system is particularly complex in theory, to the point at which it is highly questionable whether it can be applied as designed in practice. The Argentinean approach is also highly complex and interventionist.
84. The Vienna system appears to have lapsed into RPI-0 without detailed analysis or underpinning from cost and revenue forecasts. However it is being reviewed.
85. The South African system is closely modelled on the UK. It has recently been amended to remove the single till requirement.
86. The Australian system is driven by the actual starting yield and X is simply a target productivity assumption. It is therefore not based on so much detailed modelling and calculation and in any event the ACCC looks unlikely to renew it after the current review.

87. South Africa and Australia take major agreed investments outside the formula. This recognises, as has the UK CAA (UK) (which has made specific adjustments for capital expenditure), that lumpy investments are difficult to accommodate under RPI-X. However, as an ACCC Position Paper on New Investment Costs Pass - through showed in April 2000, there are some difficulties in defining new as opposed to replacement or maintenance expenditure and also a risk of biasing airports towards new investment rather than renewal.

### Simple Systems (PRI-X Regulation)

88. Some countries use a very simple version of CPI-X which is designed to capture some of the incentive properties of more complex systems but which do not, or at least do not appear to, involve significant resources.

### Ireland

89. In Ireland, the Government's policy is to encourage and facilitate the development of cost- competitive air services for the benefit of Irish tourism, trade and industry. Their current strategy with respect to airports is stated to be as follows.
90. To ensure that Irish airports are cost competitive and have appropriate infrastructure to meet the current and prospective needs of the international airline industry.
91. To provide the necessary infrastructure and services at Dublin, Shannon and Cork airports, at the lowest possible cost, consistent with safety and commercial operations.
92. To provide a financial return to the shareholder consistent with the foregoing requirement.
93. To promote the development of traffic at Dublin, Shannon and Cork airports.
94. To exploit new business opportunities, provided they are organically linked to the company's core business and do not detract from core responsibilities.
95. To propose a more clearly defined Airports Regulatory Framework in response to the future privatisation of Aer Rianta coupled with emerging European regulatory legislation on airport ground handling services and airport charges.
96. At present, the prices set by Aer Rianta for its aeronautical services require the approval of the Minister for Public Enterprises. Historically, Aer Rianta has adopted a single-till approach in setting the prices paid by airline users, subsidising its aeronautical charges with duty-free revenues. As a result, aeronautical revenues in 1998 were only 16% of Aer Rianta's total revenues.
97. The proposed legislation is encapsulated in the Irish Aviation Regulation Bill 2000. This Bill has already been passed by the Upper House and is currently making its way through the Lower House. The Bill will establish a one to three-member Commission for Aviation Regulation as the regulator of airport charges and aviation terminal services charges. The Commission will exercise its future functions independently but must comply with recommendations made by the Minister for Public Enterprises. The Commission will likely act as an arbitrator (or engage one to act on its behalf) should any price disputes arise. In the interim, an American anti-trust lawyer has been appointed as the sole member of the Commission.
98. If the Commission accepts the recommendations in a recent consultant's report, a single-till price cap will be applied to Dublin Airport, and the airports at Shannon and Cork will not be regulated, (mainly because Shannon and Cork airports are believed to be exposed to market forces and will therefore have to set their own prices in response to demand and supply).
99. The price cap formula for Dublin will limit aeronautical fees to a fixed amount per enplaned passenger. In establishing the initial level of aeronautical fees per passenger, the Commission will likely use a rate of return on net operating assets method of calculation based on an appropriate weighted average cost of capital). Aer Rianta will then subsequently be allowed to make annual adjustments in line with inflation (RPI, the retail price index) less a productivity factor, X. The productivity factor will be revised once every five years.

100. With respect to the single versus multiple till issue, the Government's consultants recommended some modifications to the single-till approach currently being used at Dublin (to achieve greater fairness and to encourage further development of the non-aeronautical areas). The proposed amendments were to include in the regulatory till only revenues from those core activities that are not open to competition.
101. With respect to airport commercial revenues, it is proposed to introduce an incentive for Aer Rianta to continue to develop the commercial side of Dublin airport. Although the details have yet to be worked out, it is likely that commercial revenues in excess of a baseline projected level will be shared between Aer Rianta and its airline users - with the greater share probably going to Aer Rianta.

### Other Countries

102. The Danish government considered imposing CPI-2 on Copenhagen but decided against a formal arrangement. Instead the airport accepted "voluntary" restraint up to 1998. There was a 15% increase in January 1999, which was the first since January 1992. This increase was associated with the abolition of intra-European duty-free in June 1999 and, whether by coincidence or otherwise, matched the two increases of 7.5% allowed by the UK CAA (UK) for the BAA London airports to offset the corresponding loss of revenue. The regulator is the Minister of Transport but he does not appear to take an active role. There is an understanding that underlying cost increases can be recovered and the airport may also take into account prices at competing airports when setting its own.
103. Belgium has an even simpler system. Charges are increased each year in line with the CPI.

### Temporary RPI-X Systems

#### Australia

104. One variant, of which Australia is the classic example, is to use price cap regulation in the early stages (following the corporatisation or privatisation of airports) and to withdraw it once users and airports have become accustomed to setting charges by negotiation. In its airport Pricing Policy Paper in 1996, the Australian Department of Transport and Regional Development said:

It is the Government's intention to step back from setting prices at individual, privately leased airports; and to provide a framework in which - over time - airport operators and their customers are encouraged to negotiate directly and resolve prices rather than involve the Government of the day.

105. The ACCC has recently started its review of price regulation, and has reaffirmed the presumption that the price cap will not continue in its present form. However it will apply price surveillance to "those airports where airport operators have most potential to abuse market power."
106. The form of such surveillance is for discussion. The ACCC already applies pricing oversight to some aeronautical charges which are not price-capped, under which permission is required for increases and there are provisions for objection and investigation. But the ACCC has pointed out that there are other options.

#### Berlin

107. Berlin is interesting because a temporary RPI-X formula has been set to 2002. Arrangements thereafter are much more liberal and designed to secure investment in the new Berlin Brandenburg Airport (BBI):
  - Charges will be capped to CPI-1 to 2002.
  - Additional increases of 5% were allowed in 1999 and 2000 to offset the loss of intra-Europe duty-free sales.
  - Future charges will be set by contract between the shareholders and the contractor for BBI.
  - The shareholders have said that they will allow any increases in charges which are necessary for the capital investment programme.
  - There may be a specific development fee on top of the BBI airport charges.

### Conclusions on Simple RPI-X

108. Simple RPI-X systems have a number of obvious advantages:
- They are easy and cheap to manage
  - They preserve the incentive to reduce costs and maximise traffic
  - They give airlines both certainty and the reassurance that charges will gradually fall in real terms in normal times
  - They avoid the pseudo-precision which inevitably arises in complex systems.
109. However:
- They may be an excuse for soft targets for airports which should be expected to perform better.
  - They may allow excessive returns or inefficiencies to be maintained or even increased.

### Conclusions on RPI-X Generally

110. RPI-X is probably the least bad form of regulation if market conditions are such that direct price control cannot be avoided. This is because it preserves the profit and efficiency incentive, especially if it is fixed for some years ahead. However it has its own drawbacks.
111. Unless the starting point is right the X factor may simply institutionalise excessive returns to an airport. This was the problem at the end of the first five-year formula for BAA, when much larger values of X had to be set to get the cap down to a level which avoided an unreasonably high rate of return.
112. Depending on the detailed formulation, RPI-X may encourage airports to delay efficiency improvements or the introduction of new sources of revenue until the first year of a new regulatory period.
113. If there are economies of traffic density and traffic is increasing faster than expected, the X factor may still lead to high returns. An airport will then be able to levy higher charges than would have been acceptable in the absence of the price cap.
114. If an airport needs a large capital investment programme, even a low X may be insufficient to generate an adequate return: from time to time X may need to be nil or negative. One solution to this is to treat agreed major projects outside the formula, as in Australia and South Africa. Another is a development charge as in Berlin.
115. Under a single till system, if the ratio of the regulated airport charges income to total income is low, quite large differences in X will be needed to have a significant impact on the overall result.
116. The logic of single till is debatable, especially if the capacity of existing runways or terminals is under pressure. One of the countries which originally adopted it (South Africa) has dropped it and the UK is consulting the industry and users with a view to doing the same. Mexico uses a dual till approach in its new system.
117. The attraction of a temporary RPI-X system is clear if there is a need for a generally acceptable control pending a more market-orientated and liberal approach. In the two cases where it has been used the regulator has made it clear that temporary does mean temporary. Unless this is fully accepted, there is a risk that temporary RPI-X will slip into permanent control.

### Profit Control Systems of Regulations

118. Profit control, or rate of return regulation, is the traditional form of price regulation for privatised utilities and it remains the norm in the United States. It is based on the idea that the main purpose of regulation is to prevent holders of private monopolies from earning excessive profits from essential goods and services.
119. The main features of rate of return regulation are:
- The regulatee earns no more and no less than his cost of capital.

- The return is on a capital expenditure programme approved by the regulator.
  - Overshoots or undershoots are corrected by the regulator.
120. In the sense that it is the most obvious way of dealing with excessive profits, profit control has strong presentational and popular appeal. However, with the advent of the wave of utility privatisations, beginning in the UK in the 1980s, there was more emphasis on efficiency and therefore on forms of regulation which encouraged efficiency.
121. More recently, concerns have arisen about over-generous RPI-X formulae for some industries which in turn has led to extensive debate, (particularly within the Labour Party in the UK), about the merits of profit sharing. However, the UK government, as part of its review of utility regulation generally, recommended the retention of RPI-X and dealt with the excess profit problem through a "one off" windfall tax.
122. The original seminal work in the UK was done by Beesley and Littlechild, and this set the pattern for the regulation of British Telecom. This argued strongly against profit control on grounds which are now familiar:
- Because the target return cannot be not reached or not exceeded the company has no incentive to maintain or improve efficiency.
  - The focus on actual rate of return gives the company an initiative to over-invest - known as the Averch-Johnson effect or "gold plating".
  - If the regulator sets too high a rate of return, the company will be over-rewarded anyway.
  - If the regulator sets the rate too low, the company may not be able to invest sufficiently.
123. To these may be added that rate of return is unattractive to investors and to managers because it creates a "dull utility" with limited opportunity for creativity and no benefit from better than expected performance. However this would be partly mitigated under dual-till approach where these incentives would apply for the non-regulated part of the business.
124. It is important to note that rate of return still plays a major part in CPI based systems since it is a major ingredient in determining the level of X. The important point is that a company can benefit from outperforming it during the period of the formula and will lose if it under- performs.
125. Nearly all the airport price control formulae around the world are based on RPI rather than rate of return. One of the main exceptions is the system of regulation for the new Athens Spata airport:
- At Spata the price regulation system is part of an Airport Development Agreement between the government and the airport company.
  - The focus of the control is a rate of return of 15% per annum on "air activities capital" - ie it is a dual till approach.
  - This 15% is over a period and intentionally allows for higher returns in the earlier years than in the later years of the project. However the cumulative return may not exceed 15% in three of any four consecutive periods.
  - There will also be a government departure tax to contribute to the construction of the new airport.
126. This form of control is designed essentially to recognise the life cycle costs of the airport project and to enable it to be delivered.
127. Spata may be a special case. It is unlikely that rate of regulation would be adopted de novo unless there were a similar investment imperative, and it is particularly unattractive for privately owned or operated airports.

### Conclusions on Profit Control

128. The case against profit control is widely accepted and its disincentive properties alone should rule it out in most cases.
129. It may have a role where the real purpose of regulation is to enable an airport to raise charges high enough to recover the cost or minimise the loss on investment which the government has decided to be socially necessary.

### Price Surveillance Systems

130. Price surveillance is an example of an intermediate level of regulation between price caps and the more liberal systems of light-handed regulation described below. It means that prices are not capped but that increases must be referred to a regulator who can, either on its own initiative or on request, investigate the increases and has powers to prevent them.
131. This is the traditional system in much of the world, where airports are required to submit increases to the government for formal approval. Whether or not this is an active process depends on the nature of the relationship. It may be genuine control, government agreement to what are effectively its own requirements, or rubber-stamping of the airport's own proposals.
132. Australia has an active system under which the ACCC is specifically mandated to oversee charges which are levied by airports which are considered to be in a position to abuse market power. The charges include aircraft refuelling, maintenance sites and buildings, freight storage facilities, ground transport equipment sites, etc.
133. The airports are required to notify any proposed increases, which may be challenged and investigated and, if necessary, frozen.
134. However the Prices Surveillance Act is at present under review by the Australian Productivity Commission. The interim findings include the statements that:
- "Prices oversight should be used as a remedy of last resort because of its limitations and potential costs".
  - "The PS Act fails to meet best practice principles for legislation and prices oversight".
  - "The PS Act also has the potential to inhibit and retard the development of pro - competitive options, particularly in industries which historically have been considered to have market power".

### Conclusions on Price Surveillance

135. Australia does not cap some airport charges but requires increases to be filed and the regulator can freeze them.
136. The Australian government is reviewing the Price Surveillance Act and the interim report was very critical.
137. The effect of price surveillance will depend on the policy of the regulator.
138. If the regulator chooses, or is allowed, to be heavy handed, price surveillance could degenerate into a rigid system which would deny airport companies much of their commercial freedom and make them very unattractive to investors.
139. If it is clear that surveillance is regulation by exception and only clear cases of abuse are called in, it can be a liberal and relatively cost-free form of backstop regulation.

### **Light Handed Regulation**

140. By light handed regulation we mean in this context that, although government and/or regulators may influence charges by other means, there is no automatic review or approval process and no formal price cap is imposed. However there is always the threat of government intervention if it is perceived not to work. There are several variants of this.

### **Price Cap by Government Influence**

141. This is essentially what happens at the BAA Scottish airports where, under threat of designation, the government has persuaded BAA to introduce a voluntary RPI-3.

142. The informal arrangements for Copenhagen are close to a government cap.

143. Luftfartsverket (LFV) is the Swedish Civil Aviation Authority, a government-owned enterprise, which manages fourteen civil and five military airport facilities. LFV sets airline charges according to the single-till approach. However, proceeds from non-aeronautical activities are only 35-40% of total revenues. LFV is self-regulated and structures its airport charges so as to achieve long-term profitability at an after-tax rate of at least 8% on invested capital.

### **Specific Conduct Regulation**

144. The UK is also the obvious example here. A specialist regulator (under airport specific legislation) oversees airports' conduct. There are no pre-set price controls for the majority of airports but airlines can complain about exploitative or discriminatory behaviour.

### **General Conduct Regulation**

145. This means that airports are not subject to industry - specific legislation but are answerable to the relevant competition or commerce regulator if they infringe general competition rules. These rules generally proscribe abuse of a dominant position or collusion to set prices or to control markets.

146. This is already the position in several countries, including the USA (as well as New Zealand), and it may be adopted in future, at least for some airports, in Australia.

147. The Netherlands government has been evaluating means of regulating a privatised Schiphol airport. It considered RPI-X but has recently decided to rely on general competition law, administered by the Netherlands Competition Authority.

148. The European Commission is attempting to introduce an Airport Charges Directive which will require transparency, non-discrimination, cost-relatedness and consultation. However its regulatory influence in the aviation industry comes mainly through the general competition articles of the Treaty of Rome.

149. The UK government has stated its intention of repealing the conduct provisions of the Airports Act and instead using the Competition Act 1998. Although the CAA (UK) would continue to be the regulator, this change would mean that the non-designated airports would be subject only to general competition legislation.
150. An important variant of this form of regulation is that industries which have market power may be required to meet prescribed conditions for transparency and consultation (along the lines of the system that has already been introduced for airports in New Zealand). The UK is placing increasing reliance on them as part of its aim towards a more contractual form of regulation of the designated airports.
151. Nevertheless, the 'general conduct' form of regulation has not been trouble-free:
  - When BAA was first privatised, it tried to secure large increases in those of its charges which were not directly controlled. Charges to buses and coaches serving airports were referred to the Office of Fair Trading and BAA suffered strong public as well as industry reaction and had to rescind its proposed increases. After a short while BAA decided that its best interests lay in a more constructive relationship with its customers and the regulator.
  - In the United States, government concerns about airports' commercial behaviour have led to a joint task force of the FAA and the Office of the Secretary for Transportation to investigate airports' business practices.
  - In New Zealand, the government introduced the Information Disclosure Regulations 1999 (to require transparency and consultation) and the current Inquiry is considering the possibility of greater regulation of airport charges.

#### **Conclusions on Light Handed Regulation**

152. All regulation imposes costs and distorts incentives, so as a general principle there are benefits in having regulation that is as light as possible. This is widely accepted even in those countries which have more interventionist systems of regulation.
153. There can be initial problems following privatisation of utilities if highly motivated and commercially focussed managers are not aware of the consequences of abusing market power.
154. Airlines and other airport users will more easily accept light regulation of airports if consultations are real and all necessary information is provided for them to assess charges and influence capital expenditure programmes.
155. Defects in consultation arrangements and in the provision of information create mistrust and have a disproportionate effect in creating pressure for tighter regulation.

## APPENDIX 7.1

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### HISTORY OF RPI - X AT LONDON AND MANCHESTER

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#### London

##### First period 1987-92

The first formula was set by the government before privatisation and before the power to set charges passed to the CAA (UK).

It was RPI - 1 for each of the five years. It was applied to Heathrow and Gatwick and to the three airports as a whole: ie Stansted was capped indirectly through the all - London formula.

##### Second period 1992 - 97

This was the first cap set by the CAA (UK) following a CAA (UK)/MMC review.

It was RPI-8 for the first two years, RPI - 4 for the third year and RPI - 1 for the last two years. It applied to the individual airports in the same way as before.

The purpose was to reduce the excessive returns of the first period but to reduce to a low value of X by the end of the second period.

##### Third period 1997 - 2002

This is RPI - 3 in each year for Heathrow and Gatwick combined and RPI + 1 for Stansted. However there are some important variations.

- Within the overall Heathrow and Gatwick formula the differential between the two airports should increase by at least one percent in each year.
- There should be a mid-term review in the event that Heathrow Terminal 5 does not go ahead or, for reasons connected to planning permission, proceeds on a significantly different scale.
- Maximum charges at Heathrow and Gatwick combined and at Stansted could increase by 70 pence per passenger in the two years following the withdrawal of inter - EU duty free sales. (This was equivalent to an increase of about 15%).

The current formula has been carried forward for another year because of the continuing uncertainty over Terminal 5.

#### Manchester

##### First period 1988-93

The CAA (UK) set this after a CAA (UK)/MMC review. On the basis that it had insufficient evidence to support a fully developed formula the CAA (UK) mirrored London and set RPI - 1 for each of the five years.

##### Second period 1993 - 1998

The next cap was set after a full CAA (UK)/MMC review.

The cap was RPI - 3 for each year.

However as a result of MMC findings about the liberalisation of ramp handling Manchester was allowed RPI - 0 in 1996/97 and 1997/98 provided that by 1 April 1996 at least three separate baggage handling companies were operating in Terminal 1. Manchester achieved this deadline but did not take the increase.

### Third period 1998- -2003

The third cap is RPI - 3 throughout. However the following points should be noted:

- There is no separate adjustment for the loss of intra - EU duty free. Indeed Manchester was required to invoke a mid-term review if the abolition, by then firmly expected, did not go ahead.
- Because Manchester had charged below its allowable yield in the previous period it was allowed a starting base higher than the actual yield of the last year of the second cap.

## APPENDIX 7.2

### EXTRACTS FROM SECTION 41 OF THE UK AIRPORTS ACT 1986

#### Discretionary conditions

41. (1) The CAA (UK) may, if it thinks fit in the case of any airport which is not a designated airport, impose in relation to the airport such conditions as are mentioned in section 40(2), either at the time of granting a permission under this Part in respect of the airport or at any other time while it is in force.
- (2) Where, at the time of granting a permission under this Part in respect of an airport (whether a designated airport or not) or at any other time while such a permission is in force, it appears to the CAA (UK) that the airport operator is pursuing one of the courses of conduct specified in subsection (3), then (subject to subsection (6) and section 42) the CAA (UK) may, if it thinks fit, impose in relation to the airport such conditions as it considers appropriate for the purpose of remedying or preventing what it considers are the adverse effects of that course of conduct.
- (3) The courses of conduct referred to in subsection (2) are-
- (a) the adoption by the airport operator, in relation to any relevant activities carried on by him at the airport, of any trade practice, or any pricing policy, which unreasonably discriminates against any class of users of the airport or any particular user or which unfairly exploits his bargaining position relative to users of the airport generally;
- (b) the adoption by the airport operator, in relation to the granting of rights by virtue of which relevant activities may be carried on at the airport by any other person or persons, of any practice which-
- (i) unreasonably discriminates against persons granted any class of such rights, or any particular grantee of such a right, or unfairly exploits his bargaining position relative to the grantees of such rights generally, or
- (ii) unreasonably discriminates against any class of persons applying for such rights or any particular applicant, or unreasonably limits the number of such rights that are granted in the case of any particular services or facilities,
- or which has resulted in the adoption by any other person of a practice that does any of those things;

- (c) the fixing by the airport operator of any charges levied by him at the airport in relation to any relevant activities carried on by him there at levels which-
  - (i) are insufficient, even after taking into account such other revenues (if any) as are relevant to the fixing of such charges, to cover the costs of providing the services or facilities to which the charges relate or are, in the opinion of the CAA (UK), artificially low, and
  - (ii) materially harm (or are intended materially to harm) the business carried on by an airport operator at any other airport in the United Kingdom.

### **APPENDIX 7.3**

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#### **EXTRACTS FROM THE UK COMPETITION ACT 1998**

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The Chapter 2 prohibition of abuse of a dominant position in the UK is set out in Section 18 of the Act.

1. Subject to section 19, any conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom.
2. Conduct may, in particular, constitute such an abuse if it consists in -
  - (a) Directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
  - (b) Limiting production, markets or technical developments to the prejudice of consumers;
  - (c) Applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
  - (d) Making the conclusion of contracts subject to the acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of the contracts.

### **APPENDIX 7.4**

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#### **REVIEW GUIDELINES FOR THE ACCC REVIEW OF THE PHASE 1 AUSTRALIAN AIRPORTS**

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“The ACCC’s first review of prices oversight arrangements will be based on the following terms:

- (a) The CPI - X price cap applied to aeronautical charges during the first five year period will no longer operate;
- (b) Future prices surveillance will be applied to those aeronautical services and those airports where airport operators have most potential to abuse market power;
- (c) Airport operators may propose alternative approaches to prices oversight which would provide equal or better protection of users;
- (d) Prices oversight arrangements should minimise compliance costs on operators and the Government;
- (e) Prices oversight arrangements should promote efficient operation of airports; and
- (f) Prices oversight arrangements should promote benchmarking comparisons between airports and facilitate competition in the provision of services within airports, especially protecting against discrimination in relation to small users and new entrants.

If operators have consistently abused their market power, the ACCC may recommend to the Government stronger forms of prices oversight where this may be necessary.

Timings for the review process will be as follows:

- (a) At the end of year four after leasing an airport, the ACCC will begin its reviews, calling for submissions from interested parties;
- (b) The reviews will be completed and the report handed to the Government six months before the end of the five year period at that airport;
- (c) The government will make decisions on future prices oversight arrangements at each airport taking into account the ACCC's recommendations; and
- (d) New prices oversight arrangements will apply from the end of year five after leasing an airport."

## APPENDIX 7.5

### SUMMARY OF REGULATORY REGIMES

Price Regulation	Price Cap	Mechanism	Government / General / Sector Regulator	Regulatory Review	Mandatory Single Till	Cap-ex Pass Through	Volume Term	Quality Standards Fixed
Argentina	yes	cpi-x	Sector	3-5 years	yes		Link to capex	yes
Australia	Probably Temporary	cpi-x	General	5 yrs	no	yes	no	Monitored
Austria	yes	cpi-x	Govt	3 yrs	yes	no	yes	
Berlin	Temporary	cpi-x	Govt	Na		Possible		
Denmark	no	Restraint	Govt then Contract	1998				
Greece	yes	Profit	Govt	None	no	Development Fee		
Mexico	yes	cpi-x	Govt then Sector	5 yrs	no		Partial	yes
New Zealand	no	none	General	None	n/a	n/a	n/a	n/a
South Africa	yes	cpi-x	Sector	5 yrs	no	yes	no	
UK Designated Airports	yes	cpi-x	Sector	5 yrs	yes	no	no	Monitored
UK Other Airports	no	Restraint/ none	Sector	None	n/a	n/a	n/a	n/a