Evidence Base (for summary sheets)

Issue

1. Where there is effective competition, airports will be incentivised to provide airport services demanded by air passengers[1] both directly, and indirectly through airlines, at least cost[2]. In most sectors of the economy the threat of competition law is considered sufficient to address the risk of significant consumer detriment arising from firms charging higher prices, undertaking insufficient investment or providing significantly lower levels of service quality or choice than would be expected in a competitive market. However, where an undertaking has substantial market power, the threat of competition law may not be sufficient to address this risk since the firm has price setting power and could abuse its dominant position by setting high prices and restricting output. In such cases, economic regulation (e.g. the regulation of prices, service quality) by an independent and expert regulator may be warranted.

2. To protect passengers from such behaviour (and the resulting consumer detriment), airports with substantial market power (and where regulatory intervention is justified) are currently subject to economic regulation by the airport regulator, the Civil Aviation Authority (CAA). Economic regulation involves the regulation of outcomes including prices, service quality levels and investment in regulated airport services. There are a number of regulated sectors in the UK including: airports; air traffic; rail; gas; electricity; water; post; and telecoms and there are a number of independent sector regulators including: CAA, Office of Rail Regulation (ORR), Ofgem, Ofwat, Postcomm and Ofcom.

Is regulation still necessary to address the risk that an airport abuses its substantial market power?

3. In April 2008 the then Secretary of State for Transport announced a review of the framework for the economic regulation of airports. The review considered the need for regulatory intervention in the airports sector from first principles and comprised of three separate evidence gathering exercises. These included a stakeholder consultation dated March 2009; extensive discussions with stakeholders and the work of an Expert Panel led by Professor Martin Cave of Warwick Business School.

4. After a careful analysis of the available evidence[3] the review concluded that there was likely, at least for the foreseeable future, to be an issue of substantial market power at Heathrow airport that necessitate regulatory intervention. Going forward, the position at Gatwick and Stansted airports is less clear and will depend on a range of factors that will affect the degree of competitive pressure airports face. For most regional airports it appears likely that for the foreseeable future competition should be sufficient to protect passengers' interests. This finding is consistent with the Competition Commission's (CC's) assessment on the need for future regulation, as part of its BAA airports market investigation and it is also consistent with the fact that the Competition Commission reached adverse public interest findings with regard to Heathrow, Gatwick and Stansted airports at the most recent price control reviews[4]. Furthermore, this is consistent with the views of industry[5] submitted as part of the three separate evidence gathering exercises. In particular, the CC's report stated that even with separate ownership of the BAA airports "*the view of almost all the airlines at the BAA London [which at the time included Gatwick] from which we heard was that regulation would still be necessary to prevent pricing above the competitive level, given their view that competition would not be fully effective under separate ownership."* The CC in the same report agree stating "*because of Heathrow's market power, as the UK's only hub airport, and because it will take time for competition to develop, a need for the economic regulation of some or all of these airports [Heathrow, Gatwick and Stansted] will persist even under separate ownership*". Consequently, we conclude that

[1] Throughout the Impact Assessment for simplicity we refer to "passengers". The reforms set out here will provide benefits to all end users of air transport services, which include both passengers and owners of cargo. Hence, when "passengers" are referred to this also includes owners of cargo unless explicitly stated otherwise.

[2] Where there are constraints in the availability of supply, the airline may be able to take an additional rent due to the supply constraint.

[3] See chapter 4 of the consultation document " Reforming the framework for the economic regulation of UK airports" - http://www.dft.gov.uk/consultations/archive/2009/ukairports/

[4] Under the Airports Act 1986 the CAA is obliged to impose conditions upon a designated airport where the Competition Commission in its five-yearly review finds that the airport has pursued a course of conduct which has operated or which might be expected to operate against the public interest.

[5] Again see chapter 4 of the consultation document " Reforming the framework for the economic regulation of UK airports" - http://www.dft.gov.uk/consultations/archive/2009/ukairports/

economic regulation is still necessary to address the risk that an airport abuses its substantial market power.

Is the current regulatory framework for airport economic regulation fit for purpose?

5. The review of the framework for the economic regulation of airports also comprised an extensive assessment of the current legislative framework. The current regulatory regime for airports was established twenty-five years ago by the Airports Act 1986. Since then, the aviation sector has changed dramatically with large increases in passenger volumes, the expansion of regional airports and entry by low-cost airlines. The period has also seen major developments in utility regulation, including changes to the statutory framework for all the other major regulated sectors in the UK. Increasingly, a range of stakeholders have called for reform to the regulatory regime for the economic regulation of airports, including industry (both airports and airlines), the CAA, the CC and the Office of Fair Trading (OFT).

6. From a theoretical perspective, the current regime is likely to create consumer detriment in two ways:
   1) The 'one size fits all' approach to regulation under the current regime means that CAA is not able to address the consumer detriment arising from market power as effectively as it could with more flexible regulatory tools and where its decisions are more accountable.
   2) Various elements of the current approach (e.g. automatic referral of price controls to the Competition Commission) create inefficiencies and increase the costs of regulatory process. Removing these inefficiencies should reduce the distortionary effects associated with the regulatory process.

7. In practice, the main concerns with the current regulatory regime identified by a broad range of stakeholders are:
   - The current regime lacks flexibility, is disproportionate, and is overly bureaucratic. Under the current regime it is the Secretary of State and not the independent industry regulator who decides which airports should be subject to economic regulation. Once an airport is regulated, it is subject to a mandatory 5 year price cap and the CAA has limited ability to address passenger issues that arise during the 5 year price control period. The current legislation does not enable more targeted, deregulatory options (e.g. price surveillance supplemented by regulation of some aspects of an airport's service quality) or the removal of regulation where this is no longer warranted, which could lead to outcomes that better reflect those one would expect in a competitive market and reduce the distortionary effects of regulation.
   - The statutory duties of the regulator lack transparency. The duties refer to 'users of airports' with stakeholders unclear both about how the regulator balances the various interests (e.g. those of passengers and airlines) and how it weighs up its four co-equal duties.
   - It is felt that the regulator is not sufficiently accountable for its decisions. At present the CC is automatically bound into the price control process in an advisory role to the CAA. However, the final decision on the price control is for the CAA and there is currently no mechanism for stakeholders to challenge this decision on its merits. The process for involving the Competition Commission is also overly bureaucratic compared to other regimes and therefore imposes unnecessary costs on industry.

8. In 2007, the OFT referred the supply of airport services by BAA in the UK to the CC for further investigation. In its reference, the OFT noted three interlinked features of the market that it suspected was preventing, restricting or distorting competition: i) the joint ownership of Heathrow, Gatwick and Stansted by BAA; ii) the existence of development restrictions and capacity constraints; and iii) the regulatory regime that applied to BAA's airports.

9. In its subsequent market investigation into BAA's airports[6], the CC concluded that the current legislative framework for airport economic regulation is a feature which distorts competition between airlines by adversely affecting the level, specification and timing of investment and the appropriate level and quality of service to passengers and airlines. The CC noted in particular, the absence of licence provisions on airport operators; the limited scope for the regulator to act between

[6] BAA airports market investigation: A report into the supply of airport services by BAA in the UK". Available at http://www.competition-commission.org.uk/rep_pub/reports/2009/fulltext/545.pdf

quinquennial reviews; and the narrow focus of the CAA's statutory duties on economic regulation, and the way in which the CAA has given effect to its statutory objectives in fulfilling those duties[7]

10. As a result, it has been concluded that the current framework for airport economic regulation is not fit for purpose and that Part IV of the Airports Act 1986 should be replaced by a legislative framework which reflects developments in best practice in utility regulation and which can adapt to the changing needs of the airports sector. The new framework will also be consistent with the Government's Principles for Economic Regulation (see annex 4 and 5 for details).

Policy objectives

11. The ultimate aim of economic regulation more generally is to replicate the outcomes (in terms of price, service quality, reliability, investment and choice) one would expect in a competitive market. Given that regulatory intervention is required in the airports sector, the overall policy aim is therefore to replace the current legislative framework with one that better facilitates and incentivises the delivery of outcomes which more closely approximate to those one would expect in a competitive airports market. We also want to remove political involvement and unnecessary bureaucracy inherent in the current regime in order to reduce the distortionary effects (and therefore costs) associated with the regulatory process. The intended effect of the policy is ultimately to reduce the level of consumer detriment experienced as a result of certain airports not being subject to effective competition.

12. Furthermore, economic regulation has made significant advancements in the 25 years since the existing framework was introduced. The existing regime is widely considered by stakeholders not to be fit for purpose and consequently the new framework will be updated to introduce many of the best practices that have been developed in other sectors.

13. To avoid over-complicating the impact assessment, we refer throughout to the Airports Act 1986 which governs economic regulation in Great Britain. Northern Ireland has its own legislation which closely mirrors the Airports Act 1986. It is our aim, if feasible, that there should be one regime across the UK.

Summary of Options

Option 0: Do Nothing

14. The baseline for comparison involves retaining the current regulatory framework as set out in the relevant sections of Part IV of the Airports Act 1986. A description of the current regulatory situation is provided, for each main policy area, in the relevant sections below.

Option 1a: Airport economic regulation reforms (including rights to challenge airport licence modifications for airport operators only).

15. This option involves repealing Part IV of the 1986 Airports Act and replacing this with legislation which will introduce:
    - a clear primary **duty** to further passengers' interests, wherever appropriate by promoting competition, supplemented by a set of subordinate duties (including a better regulation and a financing duty – see paragraph 79 for details). This should introduce a greater focus on passengers in regulatory decision making and encourage investment in the right sorts of facilities;
    - a more flexible and targeted **licensing** regime which better enables CAA to tailor regulation to the specific market circumstances facing an individual airport. Where it would benefit passengers, the licensing regime would enable the CAA to reduce the degree and scope of economic regulation on individual airports and it would give CAA much greater scope to address passenger issues (e.g. disruption caused by severe weather) in a more timely fashion. The regime will also enable introduction of licence conditions aimed at improving an airport's financial resilience and which facilitate continued airport operation in the event of the airport operator experiencing financial distress. The Secretary of State will no longer decide which airports should

[7] BAA appealed the CC's findings to the Competition Appeal Tribunal who partially upheld the appeal on grounds of apparent bias in December 2009. The CC subsequently appealed the CAT's findings to the Court of Appeal who said that the CAT was wrong to find "apparent bias" and restored the Commission's decision.

be subject to economic regulation; instead this will be a decision for CAA based on clear criteria set out in the legislation. Individual airports will only be subject to an economic licence if the CAA can demonstrate that the benefits of regulating the airport outweigh the costs;

- an **enforcement** regime focused on civil sanctions and including financial penalties. A more proportionate, responsive and therefore dissuasive regime should better incentivise airports to deliver outcomes that benefit passengers.
- a new system of merits based **appeals** which should make CAA decisions more accountable to passengers. The new system will replace the automatic reference of all price controls to the CC (thus saving industry time and money) and will include:
  - rights for parties with a sufficient interest in the CAA's decisions on which airports should be subject to economic regulation to challenge the merits of these decisions to the Competition Appeal Tribunal; and
  - System of challenges to licence modifications (including price controls) to the CC. The CC would then conduct either an investigation or an appeal depending on who has rights to challenge (see sub-options below). (Licence modifications include the imposition, amendment and removal of licence conditions).
  - rights for the licence operator and third parties to appeal enforcement sanctions to the Competition Appeals Tribunal.
- **concurrent competition powers** for the CAA to investigate and remedy anti-competitive behaviour in the provision of airport services at airports. These powers are concurrent to the OFT's powers that already exist for this sector (as well as the rest of the UK economy). Such powers should incentivise the regulator to seriously consider the enforcement of competition law as an alternative to sector regulation.

16. The question of who should have rights to challenge airport licence modifications is the one policy area where previous consultations have not provided sufficient evidence to clearly indicate what the preferred policy option should be. In addition, the parties who have a right to challenge determines the most appropriate form of challenge; either an investigation or an appeal[8]. As a result the five options presented in this impact assessment differ with respect to the parties with a right to challenge and the form of challenge only. All other policy areas are identical in terms of policy on: duties; licensing; enforcement; concurrent competition powers; and appealing CAA decisions on which airports should be subject to economic regulation. The key distinct features with option 1a are as follows:
    - Rights to challenge licence modification to the CC only for the airport operator. No other party would have rights to merits based challenges but these parties would be able to judicially review the CAA's licence modifications decisions.
    - Once a challenge is launched, the CC would conduct an investigation and reach its own decision on the relevant licence modification, applying the same duties as the CAA. Note, options 1b and 1c apply the same form of challenge for airport licence modifications.

Option 1b: Airport economic regulation reforms (including rights to challenge licence modifications for the Secretary of State and airport operator).

Same as option 1a except:

- Rights to challenge licence modification to the CC for the Secretary of State and the airport operator. No other party would have rights to merits based challenges but these parties would be able to judicially review the CAA's licence modifications decisions.

Option 1c: Airport economic regulation reforms (including rights to challenge licence modifications for a consumer body and airport operator).

Same as option 1a except:

- Rights to challenge licence modification to the CC for a suitable consumer body and the airport operator. No other party would have rights to merits based challenges but these parties would be able to judicially review the CAA's licence modifications decisions.

Option 1d: Airport economic regulation reforms (including rights to challenge licence modifications for airlines and airport operator).

Same as option 1a except:

[8] See paragraphs 155 to 159 for details of the two types of challenge and the reasons for why each option uses one of the two challenges.

- Rights to challenge licence modification to the CC for airlines and the airport operator. No other party would have rights to merits based challenges but these parties would be able to judicially review the CAA's licence modifications decisions.
- Instead of carrying out its own investigation and reaching its own decision on what the relevant licence modification should be, under this option the CC would only be able to disturb the CAA's decision if it first found in favour of the appellant that CAA had made a (possibly material) error. Further information on the differences between an investigation and an appeal is included in the section on challenge licence modifications (see paragraphs 155-158).

Option 1e: Airport economic regulation reforms (including rights to challenge licence modifications for airlines, a consumer body and airport operator).
Same as option 1a except:

- Rights to challenge licence modification to the CC for airlines, a consumer body and the airport operator. No other party would have rights to merits based challenges but these parties would be able to judicially review the CAA's licence modifications decisions.
- Instead of carrying out its own investigation and reaching its own decision on what the relevant licence modification should be, under this option the CC would only be able to disturb the CAA's decision if it first found in favour of the appellant that CAA had made a (possibly material) error. Further information on the differences between an investigation and an appeal is included in the section on challenge licence modifications (see paragraphs 155-158).

Discounted options

17. Several options have been considered as part of previous impact assessments and consultations (see references above). These alternative options (e.g. in relation to the regulator's duties, the licensing regime and a Special Administration regime) have not been pursued for the reasons set out in those impact assessments. For more information on the alternative options and the reasons why they were not pursued see the consultation stage impact assessment (March 2009)[9] and subsequent impact assessment (December 2009)[10]. The question of who should have rights to challenge airport licence modifications is the one policy area where previous consultations have not provided sufficient evidence to clearly indicate what the preferred policy option should be and hence more analysis and consultation has been undertaken.

One-in, One-out

18. The Government is committed to cutting regulatory red-tape with the One-in, One-out (OIOO) approach to regulation, whereby new regulation cannot be introduced without a greater cut in regulation elsewhere. **The recasting of this policy through repealing Part IV of the Airports Act 1986 and replacing it with a less burdensome regime is an OUT.** The reforms will make a positive contribution to this policy, since the reforms will generate a positive net benefit to business from replacing the existing regulatory framework. Further evidence and analysis is required to validate the value of this OUT and consequently, at this stage the OUT has not yet been quantified. The DfT with the assistance of the CAA have identified an approach to quantify this OUT but this quantification will not be possible until the CAA have completed further work on the next price review during the next two years. However, this will be ready to be included in the Statement of New Regulation for when the policy is implemented in April 2014. Further details of the OIOO contribution of this policy are presented in Annex 6.

Micro-Businesses

19. The Government aims to ensure that, as far as possible, micro-businesses[11] and new start-ups should be subject to no new regulation during a growth period which runs from 1st April 2011 to the 1st April 2014. The next set of price controls for the regulated airports (Stansted, Gatwick and Heathrow) will commence in April 2014 and hence there will be no impact from the price controls during the growth period. We do not expect any of the reforms to ever impact micro-businesses.

[9] http://www.dft.gov.uk/consultations/archive/2009/ukairports/
[10] http://www.dft.gov.uk/pgr/aviation/airports/reviewregulatioukairports/decisiondocument/
[11] A micro-business is any *business* or *civil society organisation* with fewer than 10 *employees* (or their *full time equivalents*).

Options appraisal

20. This section of the impact assessment is structured as follows:

    - The first part summarises the costs and benefits for the four options relative to option 0 (retaining the current regime);
    - The second part then explains the methodology for estimating the overarching benefits, which cannot be attributed to individual policy areas;
    - The third part explains the methodology for assessing the costs and benefits that can be attributed to the following individual policy areas:
        - Duties;
        - Licensing regime;
        - Enforcement regime;
        - Concurrent competition powers;
        - Appeals of the regulator's decisions about which airports should be subject to economic regulation; and
        - Challenging airport licence modification decisions.

21. The question of who should have rights to challenge airport licence modifications is the one policy area where previous consultations have not provided sufficient evidence to clearly indicate what the preferred policy option should be. As a result this impact assessment considers five options in relation to who should have rights to challenge airport licence modifications. These options are identical in terms of all other policy areas on: duties; licensing; enforcement; concurrent competition powers; and appealing CAA decisions on which airports should be subject to economic regulation – the only difference between them is who has rights to challenge licence modifications. The final section of the third part examines the differences between the options in this regard and explains why option 1d is the preferred option.

22. An assessment of the options against the Government's principles for economic regulation is included in Annex 4.

Summary of costs and benefits

Benefits

23. All five options are expected to facilitate the delivery of outcomes that better reflect the outcomes one would expect in a competitive airports market. Such outcomes should deliver better value for money to passengers characterised by some combination of the following five elements: a) lower prices; b) better service quality; c) better reliability of services; d) an increased range of services and/or e) investment in airport services that is better targeted to passengers' needs. The combination of these elements which best reflects the outcome one would see in a competitive market will depend on the preferences of passengers at a particular airport.

24. For example, the reforms could further reduce levels of consumer detriment resulting from certain airports not being subject to effective competition in the following ways:
    a. The combination of a greater focus on passengers, more flexible regulatory powers and increased accountability of CAA's decisions should lead to licence conditions (which directly or indirectly) incentivise more efficient delivery of operating expenditure (opex) at regulated airports;
    b. The same combination of policies should also result in licence conditions incentivising capital expenditure (capex) that better reflects passengers' needs and which better avoids gold plating[12]; and
    c. As a regulated airport has confirmed, greater regulatory certainty from providing the airport operator with rights to challenge regulatory decisions and removing the automatic reference of all price controls to the CC should reduce levels of regulatory risk, which could lead to a reduction in regulated airports' costs of capital.

[12] Gold plating can occur in Regulated Asset Based (RAB) based regulation, where there is an incentive for the regulated company to over invest to increase the RAB and hence the return to investors (which is determined as a percentage of the RAB).

25. In addition, the removal of unnecessary political interference (the Secretary of State deciding which airports should be subject to regulation) and bureaucracy (all price controls being automatically referred to the Competition Commission) as well as making the CAA more accountable for its regulatory decisions should all help to reduce the inefficiencies (and therefore costs) associated with the current regulatory process. Finally, all five options are expected to support investment while facilitating continued airport operation in the event of the airport operator experiencing financial distress.

26. Regardless of which outcomes materialise, we would expect the benefits (as well as the costs) to be passed on to passengers. Better service quality, reliability and investment that better reflect passengers' needs will directly benefit passengers and any cost efficiencies realised by the airport or reductions in regulatory costs will be passed on to passengers through two channels[13]:
    1) A direct efficiency gain (for example in terms of lower operating costs, capital costs and a lower cost of capital) would feed through to a lower price control. Given the airline sector is generally competitive, this would be then passed on to the passenger.[14]
    2) Lower administrative costs on the CAA will be passed on to passengers as the CAA is funded by industry and hence due to a competitive airlines sector is passed on to the passenger.

27. The majority of the monetised benefits (89.6%) estimated in this impact assessment comprise benefits associated with improved efficiency in the delivery of opex and capex and reductions in the airport's cost of capital. As it is the combination of a number of reforms, which should deliver these benefits (as described in paragraph 46 below), it is not possible to assign them to individual policy areas. This is consistent with the views of the regulator. We therefore describe these benefits as 'overarching benefits'. The remainder of benefits (e.g. those associated with the avoidance of automatic CC references) can be assigned to individual policy areas, but these benefits do not differ between the options considered for licence modification appeals.

28. The level of overarching benefit associated with each of the five options is likely to differ. Firstly there may be varying degrees of regulatory risk associated with the different options. Additional regulatory risk from an investor's perspective could theoretically result in a higher cost of capital, which would reduce the level of the overarching benefits estimated. Although the airports believe that options 1b, 1d and 1e[15] could create additional regulatory risk, they have not been able to provide any quantitative estimates that would enable us to quantify the difference in overarching benefits between the options. Secondly, there are likely to be varying degrees of increased accountability (relative to option 0 - the current regime) associated with the different options. Accountability is measured in terms of the quality of scrutiny that will be applied to CAA's decision making. More effective scrutiny should lead to licence conditions which better minimise levels of consumer detriment. The quality of scrutiny will depend on:

    - how well appellants understand passengers' interests;
    - alignment of appellants' interests with passengers;
    - appellants' ability to engage with complex regulatory decisions; and
    - ultimately how credible an appellant's threat to appeal is.

29. The quality of scrutiny is not necessarily proportionate to the number of appeals. This is because the credible threat of an appeal can be sufficient to discipline regulatory decision making. This could also be the case if there was a risk of unmeritorious appeals (which would not contribute to better decision making). Greater accountability of CAA's decisions will lead to better decision making by the CAA and should ensure that passengers get better value for money[16] (i.e. the level of consumer detriment is reduced). Greater accountability is likely to increase the level of overarching benefits. This is because it is likely to be an important driver of efficiencies in the delivery of opex and capex

[13] A small proportion of the total costs (6.1% - for the preferred option1 d) and the benefits (0.4% - for all options) estimated in this impact assessment are expected to be passed on to the public sector.
[14] In economic theory, there is 100% cost pass through when a market is perfectly competitive. In particular, this requires a large number of firms and no barriers to enter the market. A report produced by Vivid Economics on behalf of Defra and DfT (see http://www.vivideconomics.com/docs/Vivid%20Econ%20Aviation%20Tickets.pdf) provides evidence to support that this is the case for the airline industry. In particular, the report states "*When modelled, the theoretical range of cost pass-through is found to be 80–150%, with few exceptions*". Although in some cases where there are constraints on the supply of airlines services, these may not be fully passed on.
[15] Note the informal consultation did not consider 1e as a stand alone option but given the airports believed that option 1d would create additional regulatory risk because the airlines are granted a right of appeal, we assume the same views applies for option 1e.
[16] In terms of lower prices, better service quality, greater reliability and/or investment in airport services that is better targeted towards passengers' needs.

through greater and more effective scrutiny of opex and capex from appellants. It may also improve the likelihood of any improvements to an airport's cost of capital being passed onto passengers through the price control (for example in its most recent regulatory reference the CC concluded that Bristol Water's cost of capital should be 0.5% lower than Ofwat's allowance of 5.5%) through greater and more effective scrutiny of the cost of capital.

30. For some of the options it is not clear whether the positive impacts of increased accountability outweigh the negative impacts of increased regulatory risk and stakeholders' views on this are mixed. As it is not possible to rank the five options in terms of their net effect on the monetised overarching benefits, we have not monetised the differences in overarching benefits between the options. Instead we consider regulatory risk and increased accountability as qualitative impacts.

Costs

31. All five options are also expected to incur some costs arising from the resources required to implement and manage the new regime. For example, the CAA is expected to require some resources to set up new processes (e.g. the development and publication of an enforcement policy) and for the ongoing modification and enforcement of licence conditions. The Competition Appeals Tribunal and the CC will also require resources to hear appeals and conduct investigations. Finally, airports and the other appellants (which vary depending on the option) will also incur costs from launching appeals. These costs can be assigned to individual policy areas. The number of appeals and therefore the costs are likely to vary between the four options. It is possible to estimate how the costs differ between options if we make assumptions about the possible number of appeals that would result. Annex 7 provides further details on the methodological assumptions that underpin the estimates.

32. Considering first the monetised costs and benefits (see tables 1-4 below), option 1a (where rights to object to proposed licence modifications are limited to the licensee) has the highest monetised net present value of £163.7m. This compares to £154.1m for option 1b (licensee and Secretary of State rights to object); £152.0m for option 1c (licensee and passenger representative body have rights to object); £160.0m for option 1d (licensee and airlines have rights to object) and £157.0m for option 1e (licensee, airlines and a consumer body have rights to object). Note, as explained in paragraphs 27-30 the monetised benefits in the tables below do not vary across the options only the costs differ. Furthermore, as explained in more detail in paragraph 45, the large range for the overarching efficiency benefits is due to the small efficiency savings (less than 1%) being applied to very large cost bases (approximately £16bn in total). The CAA has agreed these assumptions are sensible for the purpose of this impact assessment.

Table 1: Summary of costs and benefits (Option 1a)

Policy area	**Total costs**	**Total benefit**	**Net benefit (range)**	**Net benefit (best estimate)**
Overarching efficiency	-	£0m to £896.1m	£0m to £896.1m	£174.6m
Duties	£0m to £0m	£0m to £2.3m	£0m to £2.3m	£1.1m
Licensing	£4.2m to £12.8m	£0.2m to £2.1m	£-12.6m to £-2.2m	£-7.9m
Enforcement	£1.3m to £11.6m	£0m to £0.5m	£-11.6m to £-0.8m	£-3.7m
Appeals (Licence Decision)	£0m to £11.4m	£0m to £0m	£-11.4m to £0m	£-5.7m
Challenges (Modifications)	£0m to £31.2m	£5.5m to £32.8m	£-25.7m to £32.8m	£7.8m
Concurrency	£1.9m to £7m	£0m to £1.1m	£-7m to £-0.7m	£-2.6m
TOTAL	**£7.5m to £74.1m**	**£5.8m to £934.9m**	**£-68.3m to £927.5m**	**£163.7m**

33. Options 1a to 1e only differ with relation to one policy area; challenging licence modification decisions with two elements differing across the options within this policy area: the parties with a right to challenge and depending on which parties have a right to challenge, the form of the challenge (either an appeal or an investigation). Therefore, the costs and benefits of the other policy areas remain unchanged across the four options. Tables 2 to 5 below set out the cost and benefits for the licence modification challenge policy area for options 1b to 1e and show the resulting impact on the total costs and benefits for these options:

Table 2: Summary of costs and benefits (Option 1b)

Policy area	Total costs	Total benefit	Net benefit (range)	Net benefit (best estimate)
Challenges (Modifications)	£2.5m to £55.6m	£5.5m to £32.8m	£-50.1m to £30.3m	£-1.7m
TOTAL	**£9.9m to £98.5m**	**£5.8m to £934.9m**	**£-92.7m to £925m**	**£154.1m**

Table 3: Summary of costs and benefits (Option 1c)

Policy area	Total costs	Total benefit	Net benefit (range)	Net benefit (best estimate)
Challenges (Modifications)	£3m to £61.8m	£5.5m to £32.8m	£-56.3m to £29.8m	£-3.8m
TOTAL	**£10.4m to £104.7m**	**£5.8m to £934.9m**	**£-98.9m to £924.5m**	**£152.0m**

Table 4: Summary of costs and benefits (Option 1d)

Policy area	Total costs	Total benefit	Net benefit (range)	Net benefit (best estimate)
Challenges (Modifications)	£0m to £38.4m	£5.5m to £32.8m	£-32.8m to £32.8m	£4.1m
TOTAL	**£7.5m to £81.2m**	**£5.8m to £934.9m**	**£-75.5m to £927.5m**	**£160.0m**

Table 5: Summary of costs and benefits (Option 1e)

Policy area	Total costs	Total benefit	Net benefit (range)	Net benefit (best estimate)
Challenges (Modifications)	£3m to £41.3m	£5.5m to £32.8m	£-35.8m to £29.8m	£1.2m
TOTAL	**£10.4m to £84.2m**	**£5.8m to £934.9m**	**£-78.4m to £924.5m**	**£157.0m**

34. As explained above, there are differences between the options which are not reflected in the monetised impacts and which will affect the levels of benefits achievable under the new regime. In particular there are two specific qualitative impacts that are considered to impact on the overarching benefits: regulatory risk and the degree of accountability. An increase in regulatory risk will lead to a higher cost of capital, as investors will demand a greater return from their investment to reflect the greater risk. The degree of accountability over CAA decision making will depend on the level of scrutiny that parties with rights to challenge provide. Greater accountability will lead to greater scrutiny of CAA decision-making, which should deliver greater efficiencies in opex, capex and the cost of capital. These non-monetised impacts associated with the different options are summarised below:
    i. Under option 1a the level of regulatory risk is likely to be lower than for the other options but the degree of accountability is also lowest. In addition some stakeholders believe there is a risk that option 1a could lead to unbalanced negotiations and increase the risk of regulatory capture. Although, the evidence from other sectors is inconclusive (see paragraphs 70-80), if this risk materialises, this could have significant implications for the delivery of efficiencies in capex and opex; it could also reduce the likelihood of benefits being passed on to passengers through the price control.
    ii. Stakeholders generally do not believe that option 1b would make CAA decisions on licence modifications more accountable to passengers than option 1a. Some stakeholders believe the prospect of politically motivated appeals could create regulatory risk; although stakeholders generally believe this risk is greater than the risk under option 1a, their views on how this risk differs between options 1b, 1c and 1d are mixed.
    iii. Stakeholders generally agree that option 1c would provide some additional accountability over option 1a; although they differ markedly in their views about how much. In the absence of an independent air passenger representative body and given uncertainty about Consumer Focus' future, it is not clear which consumer body (if any) would be well placed to take on this role. Stakeholders also differ in their views about the level of regulatory risk and how this compares to the risk under options 1b and 1d.
    iv. Stakeholders agree that option 1d provides more accountability than options 1a, 1b and 1c. However, they disagree in their views on the level of regulatory risk created under this option and how this compares to the risks under options 1b and 1c. Many stakeholders believe the level of regulatory risk created under this option will depend on how the regime is designed and whether it can deter unmeritorious appeals.
    v. It is unclear the level of additional accountability option 1e could provide over options 1c or 1d but because there are more parties with rights to appeal there is likely to be greater regulatory risk.

35. Our best estimate of the monetised net benefit for option 1b is £154.1m. Given that stakeholders believe this option would not provide additional accountability but could create regulatory risk and the NPV is lower than for options 1a and 1d, we believe this option should not be pursued.

36. Our best estimate of the monetised net benefit for option 1c is £152.0m and for option 1e is £157.0m. Government policy on consumer representation is currently being considered in light of the recent consultation on consumer empowerment and therefore is outside the remit of this IA; however given the Government's announcement in 2010 not to give Passenger Focus a new remit to represent air transport passengers we assume for the purpose of this IA there will continue to be no independent body representing air transport passengers in the foreseeable future. This means giving a consumer body rights to appeal airport licence modifications (options 1c and 1e) would involve extending an existing consumer bodies remit to air transport (although it would not extend to general passenger advocacy or complaints handling). Moreover the additional costs associated with the extension of an existing consumer bodies remit would, according to Treasury consolidated budgeting guidance, need to be met by an equivalent reduction in the Department's budget. Stakeholder views on the level of accountability that would be provided by a consumer body are mixed: airports believe this option would make decisions more accountable to passengers but airlines disagree due to the expertise required to engage meaningfully in regulatory decisions. In addition a consumer body is unlikely to provide any additional accountability to the forthcoming regulatory settlements, which are due to be introduced by April 2014. Furthermore, in terms of the monetised impacts, options 1a and 1d are expected to deliver a larger NPV of £163.7m and £160.0m respectively than these two options. Given that the cost benefit analysis does not provide a convincing, clear cut case for providing a consumer body with a right to appeal (i.e. pursuing either option 1c or 1e) – which would need to be the case to divert Departmental spend away from other Government priorities – options 1c and 1e have been discounted.

37. This leaves options 1a and 1d. Option 1a has a higher monetised net benefit than option 1d but this disregards the impacts and risks that have not been monetised. These include:
    i. Risk of unbalanced negotiations and regulatory capture, which go unchallenged under option 1a;
    ii. Increased accountability under option 1d; and
    iii. Greater prospect of regulatory risk under option 1d.

38. The difference between the (monetised) net benefits of options 1a and 1d is £3.7m over the 20 year period. Although option 1d could result in greater regulatory risk than option 1a, this needs to be offset against the fact that option 1d will provide the greatest accountability to passengers and guard against any increased risk of unbalanced negotiations and regulatory capture. As set out in the section on challenging licence modifications below, we believe the design of an appeals regime (e.g. the inclusion of costs awards to the loser of an appeal and possibly limits on the appeal body's ability to intervene unless it concludes that the regulator has made a - possibly material - error) should help to deter unmeritorious appeals and this should help to minimise any additional regulatory risk associated with option 1d. On the other hand, improved accountability is likely to be an important driver of efficiencies in the delivery of opex and capex; it should also improve the likelihood that any reductions in an airport's cost of capital are passed onto passengers.

39. There is general agreement between stakeholders that airport licence modification decisions should be accountable to one or more parties who are incentivised to challenge such decisions where they do not fully reflect passengers' interests. We conclude it is more likely than not that the unmonetised benefits associated with improved accountability under option 1d are likely to exceed the sum of i) any additional regulatory risk; and ii) the shortfall of £3.7m in monetised net benefits of option 1a. This is consistent with the results of Ofgem's analysis in the energy sector as part of its RPI-X@20 review[17] and the CC's recommendation in its investigation into BAA airports. It is also consistent with the Government's recent decision to provide affected parties with rights to appeal price control decisions in the postal services sector [18].

40. **Therefore our preferred option is option 1d**. However we emphasise that this assessment is based on the assumption that the design of the appeals regime will include a number of safeguards

[17] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=6&refer=NETWORKS/RPIX20/CONSULTREPORTS
[18] http://www.publications.parliament.uk/pa/bills/lbill/2010-2011/0066/lbill_2010-20110066_en_1.htm

aimed at deterring unmeritorious appeals – if this were not the case then the above assessment would not necessarily hold.

Overarching benefits (which cannot be disaggregated to individual policy areas)

41. The new regulatory framework will provide CAA with clearer objectives, a more flexible set of regulatory tools and make its decisions more accountable. However, it will be for CAA to use its expert knowledge of the sector and its understanding of the circumstances facing an individual airport at a particular point in time to determine the exact form of licence conditions to set. Therefore it is very difficult to accurately predict future regulatory outcomes and estimate the benefits – in the form of reduced consumer detriment – that would result.

42. That said it is possible, if we make some assumptions, to estimate the sorts of benefits that could be delivered under the new regime using a 'top down' approach. For example, a sharper focus on passengers, more flexible regulatory powers and greater accountability could result in:
    - licence conditions that better incentivise the removal of 'slack' or inefficiencies in current operations and therefore efficiencies in the delivery of an airport's operating expenditure (opex): and;
    - capital expenditure (capex) that better reflects passengers needs and which is delivered more efficiently (for example removing 'gold plating'[19]).

    By applying very modest improvements to the CAA's existing targets for opex and capex efficiency gains, we are able to illustrate the scale of potential benefits to passengers (or put differently the potential reduction in consumer detriment) that could be delivered by the new regime.

43. Another way in which the new regime could lead to improved regulatory outcomes and reduced consumer detriment is by reducing the cost of capital. The cost of capital allowance that is factored into the price cap reflects the return that investors demand to compensate them for the risks of investing in airports. Reductions in risk will reduce this cost, as investors will accept a lower return for a less risky investment. Removing the automatic referral of every price control decision to the CC, introducing rights for airport operators to challenge regulatory decisions on their merits and introducing a financing duty for the regulator should deliver improved certainty (and therefore reduced risk) for investors, and it is therefore possible that the reforms could lead to a reduction in the cost of capital. By applying very modest reductions to the current cost of capital, we are able to illustrate the scale of potential benefits to passengers (or put differently the potential reduction in consumer detriment) that could be delivered by the new regime. Airport operators have indicated that they believe many elements of reform will reduce the level of regulatory risk, which could have a positive impact on the cost of capital.

44. The methodology and assumptions used to estimate the overarching benefits in this section has been developed jointly by DfT, Cambridge Economic Policy Associates and in consultation with the CAA. The CAA has agreed that the assumptions set out below are sensible working assumptions. This approach is a top-down approach estimating potential efficiency gains that could be made from improving the regulatory regime. These efficiency gains will be passed through to the passenger through either lower prices, improved services, improved reliability or a combination of the three. An alternative approach would be a 'bottom-up' approach that predicted future regulatory outcomes and examined the resulting reduction in costs incurred by the passenger from each stage of their experience at each stage of the airport. Unfortunately, because the required granularity of data to model these costs is not available, this approach is not feasible.

45. Neither DfT, CAA nor the expert economic consultants employed by DfT (Cambridge Economic Policy Associates) could identify any relevant direct empirical evidence available on the benefits from moving from the type of regime operated for airports currently to the proposed licensing regime. In order to reflect future uncertainty we have presented these benefits (as with the other benefits and costs – see annex 7 for details) as a range. This range is large, not because the assumptions vary significantly, but because the assumed efficiency improvements are applied to very large cost bases[20]. CAA agrees these assumptions are sensible for the purpose of this impact

[19] Gold plating can occur in Regulated Asset Based (RAB) based regulation, where there is an incentive for the regulated company to over invest to increase the RAB and hence the return to investors (which is determined as a percentage of the RAB).
[20] Opex, capex or for the cost of capital the Regulated Asset Base (RAB). The combined value of the Regulated Asset Base across the three airports is almost £14bn; for opex it is £1.1bn per annum and for capex it is £1.5bn per annum.

assessment. We have conservatively chosen as best estimates efficiency savings towards the lower end of the range. We intend, as part of the Post Implementation Review (PIR), to evaluate the extent to which these benefits are realised (see annex 1).

46. CAA and other stakeholders agree it is not possible to assign the overarching benefits to specific policy areas, since the package as a whole delivers the benefits and each policy element contributes to the delivery of the overarching benefits. Therefore, in each of the seven policy areas that follow, we describe the benefits in a qualitative way and explain, theoretically, how the specific policy area should contribute to the delivery of benefits.

47. There are further benefits in addition to the overarching benefits (which are not described in this section but in each of the seven policy areas below) that are directly attributable to a specific policy area. These benefits are all resource savings to various public bodies and industry generated by the specific reforms of each policy area.

48. We separate our approach to estimating overall benefits into three broad areas:
    - Operational expenditure (opex);
    - Capital expenditure (capex); and
    - Cost of capital.

49. Furthermore, from a theoretical perspective, market power has two effects: it creates inefficiency (or in economics terms a 'dead weight loss') and it also transfers surplus from consumers to producers. Although there are many features of the airports market which could undermine the achievement of fully optimum outcomes (e.g. restrictions on capacity), at a basic level enabling CAA to more effectively address the impact of market power should therefore remove inefficiencies and transfer surplus from airports to passengers. The benefits estimated in this IA focus solely on the former of these two effects. Even though IAs focus on full economic costs and benefits (including to consumers and producers), one could also argue that the transfer of surplus from airports to passengers would be welfare enhancing if it was appropriate to attach greater weight to benefits derived by consumers than those derived by producers. Attaching greater weights to passenger benefits would be consistent with the overall policy aim to put passengers at the heart of how airports are regulated. That said it is not clear what weights should be used and therefore the monetised estimates included in this impact assessment focus on the removal of inefficiencies only. However, we note that the benefits could be significantly greater than those estimated if society also benefitted from the transfer of surplus from airports to passengers.

50. Finally, this section also discusses the benefits associated with a combination of measures that are expected to reduce the risk of the airport becoming unable to finance its functions and minimise the risk of disruption to passengers in the event of insolvency where the airport might cease to be able to carry out its functions. Expert financial advice implies that although service disruption caused by operator financial distress could have very significant impacts, the probability of this happening is low. Given that we cannot accurately quantify the change in probability associated with the proposed reforms we have not included these benefits in the overarching (monetised) benefit estimates.

Opex

51. Efficiency improvements to an airport's opex result in either reduced costs at a given level of service; improved service quality at a given level of cost or some combination of the two. The combination of: a greater focus on passengers (resulting from the new primary duty); more targeted and responsive powers (resulting from the new licensing and enforcement regime); and greater accountability (resulting from the new system of appeals) could facilitate greater efficiencies in the delivery of an airport's opex. For example, giving one or more parties rights to challenge licence modifications decisions where they are not fully aligned with CAA's primary duty to promote passengers' interests should put further pressure on both airport operators and the CAA to ensure licence conditions require opex to be delivered as efficiently as possible. The ability to impose more qualitative, outcome focussed service quality conditions (examples of which are provided in the section on licensing below) should also help ensure that required levels of service quality are maintained. This should further incentivise efficiencies in opex as airport operators cannot simply reduce levels of service quality to meet required reductions in costs.

52. Two assumptions are required to determine the magnitude of the opex efficiency benefit derived from implementing the new regime: the size of the operating cost base over which gains can be realised and the size (as a percentage of this base) of the efficiency benefit. The CAA's existing judgements for the three regulated airports build in efficiency gains of 1.5% per year for the regulated airports. This provides a reference for our base case against which further efficiencies can be assumed. We conservatively assume that the proposals contained in this impact assessment could have the potential to contribute around 0.25% additional efficiency savings per year. Although this figure is not based on empirical evidence, this potential improvement is not inconsistent with evidence from other sources including the magnitude of efficiency savings estimates in price determinations made recently in other regulated sectors (such as ORR, Ofcom, Ofgem, Ofwat, Postcomm and the CAA for air traffic services). An overall improvement in opex costs of 1.75% (which included the 1.5% assumed by the CAA and the further 0.25% assumed for the best estimate) is towards the middle of the range of these efficiency improvements in other sectors. CAA believes this is a sensible working assumption for the purpose of illustrating the likely benefits achievable under the new regime.

53. It is possible that such efficiency gains would not be possible across airports' entire cost base, for example because some costs are dictated by safety requirements or the airport does not have control over some costs. To take this into account we exclude rent, rail and police costs from the calculation. This therefore amounts to an adjusted operating cost base of £1,132m across the three airports (with Heathrow's adjusted opex at £764m, Stansted's at £115m and Gatwick's at £254m as reported in each airport's 2010 regulatory accounts[21]). Applying the assumed efficiency benefit to this adjusted cost base suggests that benefits in the order of around £2.8m per year, or £40.2m in PV terms might be achievable. This illustrates that even marginal efficiency savings would deliver significant benefits to consumers. Should more radical innovative approaches to regulation be identified, efficiency savings on a larger scale might be obtainable. For example, with a more aggressive – but still plausible – estimate of a further 1% per year efficiency gains, the order of magnitude benefits could be as high as £160.9m (in present value terms over 20 years). This benefit relates to existing costs only (which for the purpose of the impact assessment we assume are constant over the period) and does not reflect the increasing cost base over time; given the difficulty in predicting the precise source of benefits, we consider this to be a prudent approach. The lower end of the range assumes no efficiency gain and hence has a PV benefit of £0m.

Capex

54. As for opex, the package of reforms has the potential to deliver efficiencies in capex in a variety of forms:
    - A given amount of capex could be delivered at lower cost;
    - The scope of planned capex could be closer to the optimum, economically efficient amount (note that this could reflect either an increase or a decrease); and
    - The timing of planned capex could be better synchronised with passengers' needs, minimising the costs of holding an asset that is delivered earlier than necessary.

55. For example, the ability for one or more parties to challenge licence modifications where they do not fully reflect passengers interests should put further pressure on both airport operators and CAA to ensure that capex fully reflects passengers' needs and is delivered efficiently (i.e. not gold plated). In contrast to the current regime, where price caps must last for 5 years, under the new regime there will be no restrictions on the time period for individual licence conditions. It is possible that longer regulatory timescales could incentivise longer term thinking, give investors more certainty and airports more confidence to undertake longer term investment. It is also possible that such investment projects could be more efficient than a number of consecutive shorter term projects.

56. Furthermore, under the new regulatory regime the CAA would have more flexibility to explore alternative regulatory approaches to specifying and financing capex, building on concerns expressed by the CAA and stakeholders (e.g. easyJet, in its 2008 submission to the CAA) that the existing 'building block' approach can result in misaligned incentives in relation to capex. For example, it is generally accepted that in some cases the current regulatory regime may incentivise

[21] See http://www.gatwickairport.com/Global/GAL%20Regulatory%20Accounts%2031%20March%202010.pdf; http://www.baa.com/assets/Internet/BAA%20Airports/Downloads/Static%20files/2010_HAL_Reg_Accts.pdf; http://www.baa.com/assets/Internet/BAA%20Airports/Downloads/Static%20files/2010_STAL_Reg_Accts.pdf

airport operators to over-specify investment or prioritise investment that does not reflect the user's needs. The new regime will allow for the regulator to consider different and innovative regulatory approaches that might be able to correct for such inefficiencies.

57. Two assumptions are required to determine the magnitude of the capex efficiency benefit derived from implementing the new regime: the size of the capital base over which gains can be realised and the size (as a percentage of the capital base) of the efficiency benefit. As with opex, there is a question over the proportion of the overall capex base over which such gains can be realised. We take a relatively conservative approach by assuming that some capex is 'locked-in' and difficult to adjust, while (stand-alone) major projects have more potential to be delivered with greater efficiency. We use an indicative annual capex base, based on CAA's[22] and CC's[23] forecasts of average annual costs (for the current quinquennial price control period – 'Q5') relating to: major investment projects at Heathrow (Eastern Campus, Terminals 3, 4 and 5, and Connections & Baggage) with a value of £659m; service quality and capacity growth capex at Gatwick with a value of £133m; and SG2 capex at Stansted with a value of £236m. The total capex across the three airports is £1,027m). We note that outturn capex at each individual airport over the forecast period could differ from these amounts (particularly with respect to SG2 costs), but consider the total to be a reasonable indication of the typical annual cost across all three airports.

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58. The size of the efficiency base for capex is harder to estimate in advance than for opex since the efficiency gains in capex will depend on the characteristics of the capital projects, which can vary significantly over time. On the other hand, components of opex are generally constant over time and the CAA consistently undertakes analysis of opex efficiency gains for the regulated airports. The CAA analysis provides a benchmark in which to assume additional efficiency gains directly attributable to the new regime. For capex, because of the nature of these costs there are no benchmarks. However, because no available evidence exists to suggest that the efficiency gains from the new regime will materially differ for opex and capex and because it is likely that the same level of scrutiny is provided to capex as opex, we assume for simplicity that the same efficiency gains will be achieved for both sets of costs. Therefore, we assume for our base case a low marginal level of efficiency gains of 0.25% per year. As stated previously, there is no empirical evidence to support this assumption in terms of its magnitude when moving from a rigid regulatory regime to a more flexible regime (as proposed here); therefore we have made what we believe are conservative assumptions. Once again CAA agrees this is a sensible working assumption for the purpose of illustrating the likely benefits achievable under the new regime.

59. Putting our two assumptions together, we estimate that capex efficiencies could be delivered in the order of magnitude of around £2.6m per year, or £36.5m in PV terms over 20 years. As for opex, we consider this a relatively conservative estimate; efficiency gains as high as 1% could be plausible, which would entail a PV benefit of £146.0m over 20 years. As for opex, as the efficiency improvements are applied to very significant amounts of capex, it illustrates that even modest marginal efficiency improvements would result in significant benefits to passengers. This benefit relates to existing costs only (which for the purpose of the impact assessment we assume are constant over the period) and does not reflect the increasing cost base over time; given the difficulty in predicting the precise source of benefits, we consider this to be a prudent approach. The lower end of the range assumes no efficiency gain and hence has a PV benefit of £0m.

Cost of capital

60. Another way in which the proposed reforms could, theoretically, lead to improved regulatory outcomes is by reducing the cost of capital. The cost of capital allowance that is factored into the price cap reflects the return that investors demand to compensate them for the risks of investing in airports. Reductions in risk can reduce this cost, as investors will accept a lower return for a less risky investment. The proposals should deliver improved certainty (and therefore reduced risk) for investors in several ways, and it is therefore possible that the proposals might lead to a reduction in the cost of capital. This would be a benefit that would result in lower borrowing costs to airport operators, and therefore lower prices for airport users. Airport operators have indicated that they believe that many of the elements of the reforms will reduce levels of regulatory risk, which could

[22] For Heathrow and Gatwick – see http://www.caa.co.uk/docs/5/ergdocs/heathrowgatwickdecision_mar08.pdf.
[23] For Stansted – see http://www.competition-commission.org.uk/rep_pub/reports/2008/fulltext/539.pdf.

have a positive impact on the cost of capital. Although, they suggested it would be very difficult to quantify this impact.

61. The financing duty clarifies that an efficient operator should be able to finance its activities; this should reduce the risk that airport operators face a situation in which they cannot deliver a financial return, which in turn should reduce the perceived level of risk faced by investors.[24] Removing the automatic reference of all price control proposals to the CC and replacing this with rights for airport operators to challenge regulatory decisions on their merits, and giving CAA responsibility for deciding which airports should be subject to economic regulation against clearly specified criteria in the legislation should also decrease perceived regulatory risk. As noted above, reductions in regulatory risk are factors that can contribute to a reduced cost of capital. Some stakeholders are concerned that airlines having rights could create regulatory risk if it led to numerous unmeritorious appeals. As such, the degree to which this will be an issue for options 1d and 1e should depend on the extent to which unmeritorious appeals can be deterred.

62. The precise impact on the cost of capital that could be achieved by the reforms is extremely difficult to accurately predict in advance, particularly since much depends on the reaction of investors and there is no past empirical evidence from other regulatory regimes or internationally which disaggregates the impact of similar regulatory reform. However, the proposed measures are widely perceived by stakeholders to clarify the approach of the regulatory regime, and a moderate net reduction in perceived risk is therefore entirely possible. We reflect this by assuming an average reduction of 0.05% in the cost of capital across the three regulated airports, a very small reduction in relation to the allowed cost of capital for the current price control period (6.2% for Heathrow, 6.5% for Gatwick, and 7.1% for Stansted). Once again CAA agrees this is a sensible working assumption for the purpose of illustrating the likely benefits achievable under the new regime.

63. We apply this saving to the total forecast closing Regulatory Asset Base (RAB) in 2010 across the three airports (a total of £13,766m for the three airports with Heathrow at £10,729m, Gatwick at £1,745m and Stansted at £1,293m based on the 2010 regulatory accounts (see footnote 19)). In practice, the RAB is expected to grow over the forecast period, but to remain conservative we assume a RAB that remains fixed at its current level. Our best estimate assumption is therefore that a reduced cost of capital could deliver additional benefits in the order of magnitude of around £97.8m of PV benefits over 20 years. With a more substantial reduction of 0.25% in the cost of capital, and assuming a representative value of the RAB over the forecast period is the CAA's projected Q5 closing RAB estimate for each airport, the benefits to consumers could be very large, of the order of around £589.2m in PV terms. The lower end of the range assumes no efficiency gain and hence has a PV benefit of £0m.

64. This benefit pertains to a relatively modest reduction in the cost of capital, one which remains in line with the cost of capital for other regulated industries. Despite the small reduction, the benefit is substantial in PV terms.

Continued operation in the event of financial distress

65. The reforms aim to support investment and reduce the likelihood of the airport operator experiencing financial distress whilst facilitating continued airport operation in the event that financial distress does occur. CAA will have a supplementary financing duty and consistent with other licensing regimes we expect there to be a number of related licence conditions – for example those which make up the financial ring-fence. The proposed suite of provisions that make up the financial ring-fence will include derogations for provisions for which the cost of introduction exceeds the benefits. Previous impact assessments have demonstrated that without such derogations there is a risk of triggering significant costs as a result of a requirement to amend financing agreements, where introducing ring-fencing would require the consent of the lenders. This consent may not be given, in which case a full refinancing would be necessary. The disruption to planned investment and pressure for higher prices to which this would contribute would not be in the interests of passengers. Derogations will be allocated where the costs of the ring-fence provision in question outweigh the benefits.

[24] Note that this does not necessarily imply that the present price control does not supply a financial return. The cost of capital reflects the risk that *future* returns may be insufficient.

66. One of the aims of the financial ring-fence is to prevent the airport disposing of property in ways that could ultimately undermine the provision of services to passengers. However, the licence conditions making up the ring-fence will only apply to the airport operator(s) (who will be the licensee(s)); and possibly related third parties. It will not apply to any third parties who own or have an interest in airport property if they are not also the airport operator(s). It is therefore possible that third parties could dispose of airport property in such a way that could undermine the provision of services to passengers. To address this potential loophole we are considering seeking industry's views on the introduction of a power in primary legislation that would enable the Secretary of State to introduce secondary legislation specifying that certain airport property cannot be disposed of without the prior consent of CAA. This would be considered in a different impact assessment if the Secretary of State enables the secondary legislation. A similar power exists in the water sector. We do not expect any material costs or benefits to result from the mere presence of such a power; however it is likely that additional impacts would arise if the power was utilised. The utilisation of the power would require a separate impact assessment which would consider the additional impacts that are expected to arise.

67. In order to increase certainty for operators and investors, the legislation would include special licence modification procedure determining how CAA might remove derogations. The legislation would require that CAA must determine that two tests have been met before derogations can be removed:
    - a material change of circumstances since the derogation was made; and
    - a requirement to publish its cost benefit analysis for its decision.

68. The special modification procedure would apply to the initial derogations granted in the first licence only. The appeal for the removal of derogations would be same in terms of process, appellant body and appeal rights as for standard licence modifications. This reflects the judgement that removing a derogation from a ring-fencing condition comprises a single decision with three distinct parts: the two tests that must be satisfied, and the subsequent licence modification itself.

69. We had previously considered the possibility of introducing a Special Administration regime. On the basis of evidence raised in consultations previous impact assessments demonstrated why a Special Administration regime would not represent a proportionate regulatory response to the low probability, high impact risk of airport closure due to insolvency. As a result we expect there to be a licence condition requiring airport operators who are subject to economic regulation to produce and maintain a Continuity of Service Plan (CSP). A CSP is intended to minimise disruption to the business from an insolvency process, thus increasing the likelihood of continuity of operations. The CSP would achieve this by providing information about the key processes and services required to keep an airport operating, and measures that could be taken to ensure continued operations through a transition of control to an insolvency practitioner. This information would offer some transparency to airports' operating and financing structures, which are often complex, and would assist a smooth transition.

70. The primary benefit of the measures designed to facilitate continued airport operation is that passengers will gain because their service is less likely to be affected by an operator's financial distress. The probability that airport service is interrupted due to financial distress is a function of two events: (a) an airport experiences financial distress, and (b) that financial distress causes service interruption. Arguably the combined probability of these two events is small, but the resulting impact on passengers could be very high.

71. The total benefit of continued operations conceivably has a broad range, since the cost arising from service interruption could be high. For example, the temporary disruption to service on the opening of Heathrow Terminal 5 in 2008 was reported to have imposed direct costs on British Airways (BA) of around £16m.[25] A second example is the prolonged closure of Bangkok's main airport, also in 2008, of which the overall cost was indicatively estimated to be as high as $8,000m, (£4,900m).[26] This scenario includes both costs to passengers and wider economic costs, for example due to reduced tourism. Bangkok is a reasonable comparator airport for London Heathrow for the purposes of this exercise. Both airports were among the top ten airports in the world ranked by international

[25] According to a BA statement to analysts. Deutsche Bank initially estimated the final cost could be as high as £150m, though this assumed that problems would persist.
[26] Bank of Thailand study.

passengers in 2007, with around 62m in Heathrow and 32m in Bangkok. Both are also among the world's busiest for total passenger numbers, although international passengers account for the majority of passengers. Additionally, both airports are important regional hubs. Thus, although London Heathrow is a significantly busier airport, the two do share important characteristics.

72. Although these examples are illustrative, we consider that the supplementary financing duty and the ring-fence would reduce the probability of financial distress emerging in the first place, and the CSP would seek to minimise the risk of disruption to the business from an insolvency process.

73. We note that the proposed measures may not have a large effect as the same outcome might well occur without the proposed measures. Airports are asset intensive, and so in the short term are cash generative. Additionally, many airport assets are highly specific and illiquid, and it is unlikely that a quick sale to a non-airport operator could be achieved. For these reasons, in the rare event of a major operator experiencing financial distress full airport closure may not be a likely preferred option for the administrators. As a result, we do not include the indicative estimates described in paragraph 71 in our monetised estimates of the overarching benefits that could be delivered by the reforms.

Summary

74. Overall, we expect the interplay of a clearer remit, more proportionate and responsive regulatory powers and a system of merit based challenges to ensure the regulator is kept to account could generate overall benefits in the order of around £174.6m in PV terms over 20 years. As we cannot predict the licence conditions that CAA will set in advance there is considerable uncertainty regarding the range of these benefits and hence we present a low case scenario that provides no overall benefits and a high scenario where benefits are £896.1m. We have consulted the CAA regarding the assumptions used and it has confirmed it believes these are sensible working assumptions for the purpose of illustrating the likely benefits achievable under the new regime. Table 6 below presents a summary table of the three sources of the overarching benefits in present value terms across the low, best and high scenarios:

Table 6: Summary of overarching benefits in PV terms (£m)

Benefit	**Low**	**Best**	**High**
Opex	0.0	40.2	160.9
Capex	0.0	36.5	146.0
Cost of Capital	0.0	97.8	589.2
Continued operations in the event of financial distress	Unquantified	Unquantified	Unquantified
Total	**0.0**	**174.6**	**896.1**

Costs and benefits for individual policy areas

Duties

75. The statutory remit of a regulator – i.e. its statutory duties - sets its aims and objectives. A clear remit will enable the regulator to readily understand its principal purpose and focus its activities accordingly. It will also help regulated companies, customers, investors and other stakeholders to better understand how and why the regulator makes its decisions. Finally, it will also reduce the risk of the regulator taking unnecessary actions in an attempt to satisfy or balance a range of potentially competing objectives.

76. In assessing the costs and benefits of this individual policy area, we consider two options: first, the no-change scenario of four co-equal duties; second, a single primary duty with a set of supplementary duties that sit below it.

Option 0: Do nothing

77. Under current arrangements, the CAA has a discrete set of duties for the purposes of economic regulation of airports, distinct from its wider duties and functions (e.g. those relating to safety). These duties state that the CAA must perform its functions in respect of economic regulation in a manner which it considers is best calculated:
    - to further the reasonable interests of users of airports within the UK;
    - to promote the efficient, economic and profitable operation of such airports;
    - to encourage investment in new facilities at airports in time to satisfy anticipated demands by users of such airports; and
    - to impose the minimum restrictions that are consistent with performance by the CAA of its functions.

78. As noted in the consultation document some stakeholders are not clear how the CAA balances its current duties and others were concerned it placed undue prominence on specific duties (for example the Competition Commission raised concerns that the CAA may place undue prominence on its duty to impose minimum restrictions). The CAA has at times had to use resources to consider and defend its approach to interpreting the four duties. This is the baseline against which option 1 will be compared.

Options 1[27]: Primary duty to promote the interests of passengers supported by four supplementary duties

79. This option would involve replacing the four duties of the CAA with a single primary duty to further passengers' interests, wherever appropriate, by promoting competition and a set of subordinate duties which will include: a financing duty; a better regulation duty; a duty to promote economy and efficiency; a duty to secure that all reasonable demands are met; and a duty to have regard to guidance. These subordinate duties cannot, individually or collectively, override the primary duty. Instead they will set out the factors that the CAA should consider in discharging its primary duty. The actual wording of the duties will be subject to input from Parliamentary Counsel and the Parliamentary process.

Benefits

80. The core benefit of the revised duties is improved clarity regarding the CAA's responsibility to promote passenger interests. This itself carries three distinct benefits:
    - a potential cost saving for the CAA (improved clarity of remit could enable the CAA to dedicate more resources to substantive issues rather than to issues of interpretation);
    - benefits to passengers from improved regulatory outcomes as a result of CAA's sharpened focus on passengers and, where appropriate, the promotion of competition; and
    - clarity for wider stakeholders about why the regulator's decisions have been made.

81. Any cost savings to the CAA and to industry as a result of dedicating fewer resources to issues of interpretation are likely to be modest. In the absence of better information, our best estimate assumes an efficiency gain equivalent to one full time equivalent (FTE) spread between CAA and industry, saving £0.08m per year (£1.1m in net present value (NPV) terms).

82. The more significant benefit of regulatory outcomes which better reflect those we would expect to see in a competitive airports market, as a result of the CAA's sharpened focus on passengers, is difficult to estimate in isolation. The role of the regulator is to address a lack of competitive pressure arising from an airport operator having substantial market power (and where regulatory intervention is justified). By focusing on passengers (and explicitly recognising the role of competitive pressure where possible) the CAA will follow the most direct route towards addressing issues of substantial market power. Every action the CAA takes will need to be consistent with the promotion of passenger interests. The primary duty therefore sets the context for a clear and coherent set of policies that together should deliver significant benefits for passengers. For example, a sharper focus on passengers, coupled with greater accountability should put further pressure on airport operators and CAA to ensure that opex and capex is delivered as efficiently as possible and that service quality fully reflects passengers' needs. We consider that the evidence from other regulated

[27] As explained in paragraph 16, the five options (options 1a to 1e) are identical for this policy area. Therefore, for simplicity we refer to the five options as option 1.

sectors with such a clear primary duty to focus on passengers' interests supports the view that significant benefits will arise. For example, (although it is not directly comparable to the airports sector) in the energy sector, Ofgem's 2008–9 Annual Report (available at www.ofgem.gov.uk) emphasises how its focus on consumers' interests has been at the heart of reforms to make it easier for consumers to shop around by reducing the cost of switching suppliers, which has led to financial benefits for consumers.

83. The financing duty clarifies that an efficient operator should be able to finance its activities; this should reduce the risk that airport operators face a situation in which they cannot deliver a financial return, which in turn should reduce the perceived level of risk faced by investors.[28] This could lead to a reduction in the airport's cost of capital, which could be passed on to passengers in the form of lower prices, higher services quality for the same price (or some combination of the two).

84. For the reasons given above we expect the duties to contribute to the overarching benefits estimated above. In addition, some stakeholders have reported being unclear how the CAA balances its current duties, and a single primary duty to passengers will be easier for all stakeholders to interpret. We acknowledge that this may result in tangible savings (similar to that which may be realised by the CAA through reduced burdens of trying to understand how to interpret its four duties), but these will be diffuse and difficult to anticipate and so for the purposes of this IA we do not include any monetised benefit.

Costs

85. Given that the primary duty is, at the very least, as easy to interpret as the present set of four co-equal duties it is realistic to assume that no additional resources will be required. Hence we believe the additional costs associated with the primary duty should be negligible, if there are any at all.

86. Our assumption for the supplementary duties, as for the primary duty above, is that there will be no additional costs. Again, since the intention of the duties is to clarify the CAA's role and the factors it will consider in making its decisions, it is reasonable to assume there is no incremental burden associated with these duties.

87. The subordinate duty to have regard to guidance issued to it is likely to amount to a clarification of what the CAA would do anyway, and as a result we do not believe this aspect of the duty should impose any additional costs over and above the status quo. Similarly, the "reasonable demands" duty should serve to focus the regulator on the matters to be taken into account in reaching its decision. Finally, the 'better regulation' duty helps to support appropriate decision-making, in particular by emphasising the importance of consultation with stakeholders. We believe that in order to adhere to its primary duty the CAA is likely to follow the principles of better regulation (under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed) and have regard to guidance anyway. Therefore this supplementary duty should not impose any additional costs.

88. We believe that the most realistic best estimate assumption is that option 1a, 1b, 1c, 1d and 1e imposes negligible additional costs and may lead to some resource cost savings for the CAA and other stakeholders, in addition to which there are benefits to passengers as well as wider stakeholders associated with a clear primary duty focussed on passengers. **Therefore option 1 is our preferred option for this policy area.**

Licensing

89. We propose that the existing rules-based system for airports subject to economic regulation - where the Secretary of State decides which airports should be regulated and where regulated airports are subject to mandatory 5 year price caps - is replaced by a licensing regime where the industry regulator decides which airports should be regulated and how. A licensing regime should facilitate more flexible and targeted regulation of airports as the CAA would be able to tailor an airport's licence conditions to the market conditions facing the individual airport. It would also give the CAA

[28] Note that this does not necessarily imply that the present price control does not supply a financial return. The cost of capital reflects the risk that *future* returns may be insufficient.

flexibility to amend licence conditions as the conditions at an airport change and adapt over time (in contrast to the current regime where CAA has limited powers to intervene during regulatory periods).

90. The options outlined below are different from those set out in the December 2009 impact assessment, which included two further options:
    - A three-tier licensing regime; and
    - A two-tier licensing regime (the previously preferred option).

91. The first option above was discounted (in the December 2009 impact assessment) on the grounds that it would have additional resource costs on the CAA; contribute to uncertainty about future regulation and could dilute some of the clarity that results from the policy reforms as a whole. Furthermore, the consultation carried out in March 2009 revealed it was not a popular option with industry.

92. In light of this Government's public announcement in July 2010 that it is not going to make Passenger Focus the independent air transport passenger representative body, a two-tier licensing regime (the second option above) is no longer considered preferable. The tier 2 licence was primarily a vehicle for funding Passenger Focus and implementing the EC Airport Charges Directive (ACD) and since there is now no requirement to fund Passenger Focus, we believe it would be preferable to implement the ACD through a Statutory Instrument and not use tier 2 licences. It is possible that a tier 2 licence could risk creating regulatory uncertainty if licensees perceive that CAA could introduce further regulation on them via the modification and/or introduction of licence conditions. The removal of the tier 2 licence would remove this risk for six airports (Manchester. Luton, Birmingham, Edinburgh, Glasgow and Bristol) based on 2009 passenger numbers.[29]

93. Having discounted the options considered above we consider two further options: first, the do nothing option in which the existing rules-based system is retained; and second, a licence-based regime where licences are issued only to those airports that are subject to economic regulation (currently Heathrow, Gatwick and Stansted).

Option 0: Do nothing

94. The existing rules-based system where the Secretary of State decides which airports should be subject to economic regulation is widely considered inflexible and bureaucratic. For example, under the current legislation, all airports subject to economic regulation must be subject to five yearly price caps – the CAA is not empowered to use less burdensome forms of regulation (for example the combination of price monitoring and service quality standards) even if it was confident that such deregulatory action would benefit passengers. Under the current regime, service quality standards must be quantitative and some have argued that this can lead to a 'tick box' approach to regulation. CAA is not enabled to set more qualitative, outcome based, service quality standards on airport operators nor is it able to impose conditions that aim to improve an airports financial resilience. CAA also has limited powers to intervene during regulatory periods. The current legislation does not specify the criteria used by the Secretary of State in deciding which airports should and should not be subject to economic regulation. In 2007 the DfT published policy criteria that would be used; however one could argue that putting the criteria in legislation would provide industry with greater legal certainty.

95. One of industry's main concerns about the current, rules-based, regime is the lack of flexibility that it entails. Stakeholders also believe it is not appropriate for the Secretary of State to decide which airports should be subject to regulation; instead this should be a decision for the independent regulator taken against clearly specified criteria that are set out in the legislation. Hence it is not considered desirable to retain the present system.

[29] ACD is to be implemented at airports with annual passenger numbers that exceed 5 million.

Option 1[30]: Licence-based regime

96. Under option 1, the CAA would have responsibility for deciding which airports should be subject to economic regulation. The criteria to be used would be set out in the legislation. A licensing regime would be introduced which would split UK airports into two categories:
    - Licensed airports – Airports with substantial market power and for which the benefits of regulatory intervention outweigh the costs would be subject to an economic licence. Heathrow, Gatwick and Stansted airports have previously been assessed to fall into this category.
    - Other airports – All other airports would not need an economic licence to operate.

Benefits

97. A licence-based system is crucial to facilitating more flexible and proportionate regulation of airports. More targeted regulation should minimise the distortions associated with regulatory intervention – this should benefit passengers by facilitating the delivery of outcomes (e.g. price, service quality) that better reflect those that would prevail in a competitive, well-functioning market as well as potentially reducing costs associated with the regulatory process.

98. The licence-based regime will give the CAA flexibility to determine the appropriate length of regulatory settlements (as opposed to restricting the length to 5 years as under the current regime). This would allow the CAA to move away from mandatory five year price caps towards alternative approaches that may better incentivise investment in facilities that reflect users' needs. For example, Ofgem has announced that it will move towards 8 year regulatory periods in order to better incentivise longer term thinking about investment. It is possible that longer regulatory timescales could also give investors more certainty and airports more confidence to undertake longer term investment – this could deliver efficiencies if such investment projects were more efficient than consecutive, shorter term, projects.

99. By allowing more proportionate regulation, the new regime will also enable CAA to take steps to reduce the degree and/or scope of economic regulation imposed on individual airports if it believed this would benefit passengers. (For example it could move away from setting price controls and decide to monitor prices while regulating certain aspects of service quality instead). Such action could reduce the number of resources airport operators need to dedicate to economic regulation. However, since it is not yet clear whether the CAA would, at some point in the future, conclude that such action would benefit passengers, for the purpose of this impact assessment we have not quantified any savings to industry associated with this. It is also worth noting that regulation can 'crowd out' commercial incentives so action to remove any unnecessary regulation on airports could incentivise commercial action (for example airlines negotiating long term contracts with airport operators) that could benefit passengers, for example by resulting in a more tailored range of services, and also deliver efficiencies in the delivery of opex and capex.

100. The current regime requires that all airports which meet the turnover threshold (£1million per 'financial year' in at least two of the last three 'financial years') in the Airports Act 1986 must have obtained permission from CAA to levy charges. Any such airport faces the prospect of being required to provide specific accounting information to the CAA. The new licensing regime would remove this requirement and therefore the prospect of such accounting conditions for airports not subject to economic regulation. This could reduce administrative burdens on the affected airports, although this is likely to be marginal, since this requirement is imposed discretionarily by the CAA on airports with a turnover above £1m. Consequently, our best estimate assumption is that there is no quantifiable benefit. However, the CAA agree that the cost saving could be as high as £1.1m in present value terms, equivalent to a single FTE spread over the affected non-designated airports depending on the number of airports subject to this requirement[31]. Consequently, this forms our high scenario assumption for this benefit.

101. Under the new regime, the Government will no longer decide which airports should be subject to economic regulation and as a result there will be cost savings resulting from less duplication of work. For our best estimate, we assume that there are 3 such decisions over the 20 year period. We

[30] As explained in paragraph 16, the five options (options 1a to 1e) are identical for this policy area. Therefore, for simplicity we refer to the five options as option 1.

[31] Potentially this could be up to 48 airports but currently the CAA only impose this condition on a few airports.

assume, based on historical resource costs from Manchester and Stansted designation decisions, that the DfT requires internal staff resources equivalent to 0.8 FTE, and external support of £0.1m, per decision. This has a NPV of £0.7m.

102. Furthermore, it is possible that removing Government from this role and setting out the criteria to be used by CAA in the legislation (in contrast to the current situation where they are only set out in policy guidance) will reduce levels of regulatory risk. Evidence from Moody's credit rating methodology shows that "unpredictability" and a "politically charged" regulatory framework can reduce the regulated industry's credit rating and hence increase the cost of capital. We do not attempt to quantify separately the benefits associated with this, but insofar as this aspect of the reform will lead to a reduction in the cost of capital, the benefits will affect the overall benefits estimated above.

103. Finally the new licensing regime will also enable the CAA to set more qualitative, outcome focused, service quality standards on airports. The use of more qualitative, outcome focused service quality requirements, in combination with a more proportionate and credible enforcement regime, might, for example, have better incentivised airports to reduce delays following the introduction of the liquids ban in 2006. At the time the quantitative standards for the queue length for passenger security screening were suspended until the airports had made the necessary arrangements to accommodate the new requirements in their routine operations. In the absence of a more outcome focused service quality requirement (e.g. to take all reasonable steps to minimise the impact of operational problems on passengers), airports not only had less incentives to minimise delays until a more normal service was resumed and the quantitative queuing time standards reinstated, but there were possibly even perverse incentives on airports to delay the return to a routine operation (as this would have allowed the reinstatement of the quantitative security standards).

104. Such qualitative conditions could also reduce the costs imposed on passengers from unexpected circumstances – such as heavy snow or volcanic ash. For example, in the event of extended delays caused by bad weather a licence condition requiring the airport operator to take all reasonable steps to minimise disruption to passengers could better incentivise the airport operator to work with the airlines and other service providers to ensure that adequate food and refreshment was available. If CAA felt that the airport was not taking all reasonable steps to minimise the impacts on passengers it could incentivise compliance by signalling its intent to impose a sanction. Similar conditions could also be introduced to incentivise better provision of information to consumers and coordination between different service providers at the airport.

Costs

105. Transition to a new regime will require airport operators with economic licences to familiarise themselves with the new licence-based regime. Given the regime is closely aligned with most other regulated sectors in the UK, the CAA should be able to minimise any transition costs by adopting best practice from other regulated industries. On the other hand, and as discussed above, the introduction of the licensing regime will provide the CAA with flexibility to use alternative forms of price regulation so regulation is no more burdensome than absolutely necessary - this could feasibly reduce the regulatory burden on airports that are subject to economic regulation relative to the status quo and therefore result in cost savings. As the net impact could plausibly be either positive or negative we have not quantified the impacts on industry resulting from the introduction of the new licensing regime for the purposes of this IA.

106. However, we expect the new licensing regime (including costs for setting up finance-related provisions such as the costs related to the supervision of the development of the CSPs) to result in one-off (assumed to be realised in the first year) resource costs to the CAA associated with the transition to the new system, as the CAA sets up relevant processes. Having consulted CAA, we believe the costs incurred on them could range from £0.1m to £1.0m (a one-off present value cost). For our best estimate we assume a one-off present value cost of around £0.5m.

107. The ongoing administration of the new regime would also involve a more active role for the CAA – including deciding which airports should be subject to economic regulation (currently decided by the Secretary of State), and ensuring that licence conditions are appropriately tailored to the conditions at an individual airport. Having consulted with the CAA our best estimate is that CAA would require an additional 0.4 FTE to take decisions about which airports should be subject to

economic regulation and 1 FTE for modifying licence conditions, a cost of £0.11m per year (and a total of £1.6m in present value terms). This assumes that major licence conditions are reviewed approximately every five years, each requiring one full time staff member for the full 6-9 month duration of the review, with a full time licence manager overseeing the application and modification of licence conditions. It also assumes that the CAA has the flexibility to apply a broad range of price regulation on licensed airports and utilise subsidiary documents.

108. The reforms will also remove the automatic referral of price control decisions to the Competition Commission. The avoided cost to the Competition Commission is discussed in more detail in the section on challenging licence modifications, but we note here that the removal of the Competition Commission from the process will mean the CAA has to dedicate additional resources to administering licence conditions. There will be economies of scale associated with having one regulator (i.e. the CAA) designing price controls so it is plausible to assume a significant proportion of the Competition Commission's costs are avoidable. For example, there will be no duplication of analysis. The CAA believes it can avoid around 50% of the CC's costs, which means there will be £0.3m of additional costs to the CAA per annum. This translates into a PV cost of £4.3m.

109. Our best estimate, based on advice from CAA, is that CAA would require 1.5 additional FTE on an ongoing basis for financial related provisions, primarily to carry out tests related to the switching on or switching off of ring-fencing provisions. We note that in some cases these tests would be relatively minor or routine, but where the test leads to a proposed licence modification the review would become much more resource intensive. The assumption reflects the expected average annual resource requirement. This amounts to an annual cost of £0.1m and £1.7m in present value terms.

110. The CAA would also require access to external advice and support for these provisions, which based on advice from CAA, we expect would amount to £0.04m per year on average (or £0.6m in PV terms). In total, our best estimate of CAA's resource costs are estimated to amount to £8.6m in PV terms. Should the requirement to carry out tests be more (less) intensive than assumed this cost could instead be £12.8m (£4.2m).

111. In theory there is a cost to airport operators of producing and maintaining a CSP. However, we note that the majority of the information should be easily accessible already, and therefore producing a CSP will primarily be a collation exercise. We therefore assume that this cost is negligible for the purposes of this IA.

112. Compared to option 0, the net monetisable impact specifically associated with transition to and administering a licence-based system would therefore be likely to be negative overall. However the licensing regime is expected to contribute to the delivery of overarching benefits estimated above. We also believe licence conditions aimed at improving an airports financial resilience represent a proportionate response to the low probability but high impact event of service disruption due to operator financial distress. Overall, we judge the total benefits (both monetised and unmonetised) of increased flexibility and proportionality – which should result in better outcomes for passengers that more closely mirror the outcomes one would expect in a competitive airports market and which should also ensure that any regulatory burdens on industry are minimised – to significantly outweigh the relatively modest monetised costs. As a result, **option 1 is our preferred option**.

Enforcement regime

113. We have assessed the do nothing option against a single option reflecting the overall intent of the policy, which is to bring the CAA into line with other economic regulators in the UK. In most other regulated sectors, the sanctions available to regulators broadly includes: the issue of an enforcement order; the imposition of a penalty; and/or revocation of the licence. The proposed policy would grant the CAA similar powers within a 'sliding scale' approach that would support proportionate and flexible regulation.

Option 0: Do nothing

114. The present enforcement regime under the Airports Act 1986 lacks the clarity and strength of other regulatory regimes. Under the Airports Act, the CAA only has powers to issue compliance

orders for airports breaching conditions imposed on them as part of the five-yearly price control settlements. In addition, the CAA can impose criminal sanctions on airports that are in breach with the accounts condition and on parties that do not comply with information requests issued by the CAA under s73 of the Airports Act (non-provision of information, and the deliberate provision of wrong or misleading information).

115. As a result, the CAA's ability to respond in a proportionate manner to potential non-compliance is limited and the do nothing option is not judged to be consistent with the overall policy aim of facilitating flexible and proportionate regulation, nor with the delivery of outcomes that better reflect passenger interests.

Option 1[32]: A sliding scale of sanctions

116. Under this option the enforcement regime would focus on civil sanctions and be comparable to civil enforcement regimes in other regulated sectors. The intention is to provide the CAA with maximum flexibility and discretion to secure compliance from the airport operator in a way that is proportionate, dissuasive and effective. As such the CAA will have access to a "sliding scale" of sanctions that includes the issuing of an initial notification indicating a suspected breach of licence condition, the issuing of enforcement orders in relation to failure to comply with such a condition, the ability to impose financial penalties and ultimately the sanction of licence revocation for the most serious offences. This range of civil sanctions will allow the CAA to impose a less serious sanction at the outset and move to a more serious sanction if non-compliance continues.

117. In relation to financial penalties for breach of licence condition, there will be a cap equal to 10% of qualifying turnover[33] under this option. This is in line with many other economic regulators in the water, gas, electricity, rail and telecommunication sectors where the maximum limit for a financial penalty is set in statute at 10% of turnover. The licence holder will be able to appeal the imposition or the amount of the penalty or the period allowed for payment to the Competition Appeals Tribunal (CAT). A regime focused on civil sanctions will help create a more effective and responsive enforcement regime which does not rely on inflexible and disproportionate criminal sanctions that characterise the provisions of part IV of the Airports Act 1986. Under this option, offences relating to economic regulation within the airports sector will be taken out of the criminal courts and dealt with by the CAA, as the sectoral regulator, and if needed, the Competition Appeals Tribunal (CAT).

Benefits

118. A more flexible and credible enforcement regime should better incentivise compliance with licence conditions and should therefore contribute to the delivery of overarching benefits described above. A more effective enforcement regime is also crucial to enabling CAA to set more qualitative, outcome focused, service quality standards on airports. As described above, such conditions could help to ensure that required levels of service are maintained and guard against the risk that airports simply reduce levels of service quality in order to meet efficiency targets.

119. Additionally, we recognise that the present enforcement regime – focused on criminal penalties and with limited flexibility – is unlikely to present a strong deterrent because the CAA has no credible penalty for breaches other than the most serious. With time, a flexible, proportionate, dissuasive and most importantly, credible sanctions regime would be expected to influence behaviour via the threat of action. Such a deterrent effect would lessen the overall burden on the CAA, and thus enable it to focus its attention on other areas (while retaining the capacity to impose sanctions where necessary). We assume for our best estimate that this could, after an initial period of five years, result in a resource saving equivalent of 0.5 FTE for the remaining fifteen years of the appraisal period. This has a present value of £0.4m[34]. The sanctions regime that is proposed is similar to that in most other regulated sectors in the UK, so stakeholders should more easily understand how it can broadly be expected to work in practice.

Costs

[32] As explained in paragraph 16, the five options (options 1a to 1e) are identical for this policy area. Therefore, for simplicity we refer to the five options as option 1.

[33] The exact definition of qualifying turnover is to be set out in the Bill.

[34] See annex 7 for details of FTE costs.

120. We expect the new enforcement regime to result in one-off (assumed to be realised in the first year) resource costs associated with the transition to the new system, as the CAA sets up relevant processes (for example, the development and publication of a sanctions and enforcement policy). Having consulted CAA our best estimate is that a single FTE will be required for one year, at a present value cost of £0.08m.

121. There will also be additional ongoing resource requirements relative to the do nothing option. First, the CAA will require ongoing resources to monitor compliance and administer sanctions, where appropriate. Having consulted CAA we assume an estimated annual cost of around £0.08m arising from 1 FTE. This corresponds to a present value cost of £1.1m. We recognise that if the CAA were to monitor compliance intensively and follow up on a greater number of cases, the resource costs could be higher. Our high case assumes that as many as 2 FTEs are required, at an annual cost of around £0.2m (a total of £2.3m in present value terms). Conversely, were the reforms in other areas (for example airport operators having rights to object to licence modifications) to result in improved compliance requiring a minimal level of sanctions, the CAA could require as few as 0.5 FTE at an annual cost of £0.04m (a total of £0.6m in present value terms). Additionally, the CAA may incur legal and consulting costs relating to legal cases and outsourced auditing. Having consulted with the CAA, we assume this cost could amount to a further £0.1m per year, or a total of £1.4m in present value terms.

122. Second, the increased use of newly-available sanctions could result in appeals to the Competition Appeals Tribunal (CAT). It is difficult to anticipate in advance the extent to which sanctions will in practice be applied, the level of controversy they will attract, and so the number of such appeals that will result. It is possible that the associated cost will be negligible. We assume that an enforcement appeal occurs once every two years. We would expect the appeals to be less costly than appeals on 'minor licence modifications' (which we assume would cost in the region of around £170k per party (including the CAT) - see the section below on challenging licence modifications for more information). Therefore we assume a cost of £100k for the CAT and £100k for the appellant. We also assume that an appeal could be expected on average once every two years. Combining these assumptions leads to a best estimate of £1.4m in present value terms.

123. One might argue that substantial financial penalties could cause operators to face difficulty in carrying out timely investment. Though financial penalties are a sunk cost and would not normally affect forward-looking investment decisions, they are also a burden on cash flow. In practice, we do not believe that the enforcement regime will materially impact on investment for the following reasons: first, in line with the Macrory principles[35], the stated aim of any financial penalties will be to influence behaviour rather than to penalise per se; second, the CAA's proposed primary duty is to the interests of passengers, and any financial penalties that are levied should pay due regard to this; and finally, the CAA will be afforded maximum flexibility and discretion to secure compliance with licence conditions. This does not always encompass the use of enforcement orders and financial penalties, and may include giving the airport flexibility to remedy the consequences of its actions or fall back into compliance. The CAA's use of its enforcement powers will also be subject to a general duty to have regard to the principles of good regulation, and regard to a published statement of policy on penalties. This will ensure that the powers are used in a proportionate and targeted manner.

124. Finally, we assume that the combination of measures contained in this package does not materially affect operators' cost of capital. While in theory the threat of future financial penalties could introduce uncertainty, we believe it is sufficiently clear (and with precedent) that the largest financial penalties are reserved for the most serious licence breaches or persistent offenders. Indeed, the proposed suite of sanctions follows a sliding scale, which will enable the CAA to take 'proportionate' action in line with its statutory duties. The restriction of financial penalties, with reference to a cap based on turnover related to the regulated airport, is also helpful in this regard.

125. Our best estimate for the overall costs involved with this option is relatively small, at around £4.1m in present value terms. However this element of reform is expected to contribute to the delivery of the overarching benefits described above. In addition stakeholders support the policy to

[35] See: http://www.berr.gov.uk/whatwedo/bre/reviewing-regulation/compliance-businesses/page44102.html

bring CAA enforcement powers into line with those in other regulated sectors. As a result **option 1 is our preferred option**.

Concurrent competition law powers[36]

126. A number of sector regulators have powers to enforce competition law alongside the Office of Fair Trading (OFT) – this concept is known as 'concurrent competition powers'. Providing the regulator with concurrent competition law powers would therefore align airport economic regulation with other regulatory regimes in the UK such as for the electricity, water and gas sectors.

Option 0: Do nothing

127. Under existing legislation, airports are subject to scrutiny and (where appropriate) enforcement by a number of different competition authorities under a range of regulatory powers as follows:
- The CAA under sections 41(2) and (3) of the Airports Act 1986. Under provisions of the Act the CAA has powers to impose discretionary conditions on an airport operator's permission to levy charges if the airport is pursuing an anti-competitive course of conduct;
- The Office of Fair Trading (OFT) under Chapter I and II of the Competition Act 1998 and where the activities have an effect on trade between EU member states, under Articles 101 and 102 of the TFEU (Treaty on the Functioning of the European Union) (formerly Articles 81 and 82 of the EC Treaty);
- The European Commission under Articles 101 and 102 of the TFEU; and
- The OFT in relation to market studies carried out under section 5 of the Enterprise Act 2002.

128. Current arrangements do not allow CAA to use provisions in the Competition Act 1998 or Articles 101 and 102 of the TFEU to enforce competition law or to investigate anti-competitive behaviour in the sector it regulates.

129. Under this option the CAA would retain only its concurrent competition law powers relating to Air Traffic Services. No incremental costs or benefits would result.

Option 1[37]: Concurrent competition law powers granted for airport services at airports

130. Granting concurrent powers over the provision of airport services at airports would give the CAA (along with the OFT, through its existing powers) the ability to apply UK and EU Competition Law in respect of:
- Article 101 of the TFEU: Cartels Offence and Anti-competitive contracts; and
- Article 102 of the TFEU: Abuse of market dominance.

It would also give the CAA powers to make market investigation references (to the Competition Commission) under section 131 of the Enterprise Act 2002.

131. The proposed scope of the CAA's concurrent competition law powers would include both airport operators and third party providers of services within airports.

Benefits

132. The ability of the CAA to use concurrent competition law powers to make industry-specific trade-offs between sectoral regulation (i.e. the imposition of licence conditions) and competition law, and to make Market Investigation References (MIR), should contribute to the overarching benefits estimated above. The CAA will be able to use its judgement regarding the most effective mechanism to use, which should facilitate more proportionate regulation and potentially reduce regulatory burdens on industry that would occur through unnecessary use of sector specific regulation. Providing the CAA with concurrent competition powers could also increase transparency and reduce

[36] Concurrent powers refer to the powers to apply competition law in particular sectors, exercisable by either the relevant sector regulator or the OFT. At the time of writing, concurrent competition powers are currently subject of a review by BIS see http://www.bis.gov.uk/Consultations/competition-regime-for-growth?cat=open. The reforms set out here are subject to the outcome of that review.

[37] As explained in paragraph 16, the five options (options 1a to 1e) are identical for this policy area. Therefore, for simplicity we refer to the five options as option 1.

the risk that the OFT chose to act under competition law to address an issue that the CAA might seek to address under the current regulatory framework.

133. While CAA will require additional resources to meet its obligations with regard to concurrent competition powers, there will be a corresponding reduction in resource costs for the competition authorities (primarily the OFT). However, we expect relatively minor savings, noting that the recent (large and costly) BAA case was exceptional. We therefore assume for our best estimate that this could result in a modest saving of around 0.5 FTE, delivering a total present value benefit of around £0.6m[38]. This is smaller in magnitude than the likely increase in resource requirements at the CAA, which is discussed below.

Costs

134. Transition to a system whereby concurrent competition law powers is expected to result in a one-off cost to the CAA as it familiarises itself with the new powers and processes. Having consulted CAA we assume that this transition requires 0.5 FTE for a single year, at a present value cost of £0.04m.

135. Administering such powers would represent an increase in ongoing resource requirements for the CAA which, having consulted CAA, we estimate should cost around £0.12m per year based on an average need for 1.5 FTE. This amounts to a total cost of £1.7m in present value terms. We note that it is difficult to anticipate the level of work required, particularly as the cost would be driven by the number of cases (with one case officer and one lawyer assigned full time to each case). As a result, our high case incorporates an increased workload equivalent to 3 FTE at a present value cost of £3.4m. We also assume, again having consulted CAA that it accesses external legal support costing on average £0.1m per year, or £1.4m in present value terms.

136. We therefore assume in our best estimate that the reduction of 0.5 FTE at the OFT (see the 'Benefits' section above) would be more than offset by an increase of 1.5 FTE at the CAA. Broadly speaking, the CAA may be expected to be more active given its sector focus, as unlike the OFT it will not have to prioritise cases across the whole economy, although we also note that its sectoral knowledge will allow it to keep overall costs to a minimum. As is the case in other sectors we believe the prospect of dual regulation will be avoided by the CAA and the OFT entering into a Memorandum of Understanding setting out the basis on which each will act.

137. We assume that, other than the necessary costs to the CAA of setting up processes, the transition to concurrent competition law powers will be managed without imposing additional burdens on other parties. There are processes available to manage concurrent competition powers to prevent such burdens arising.

138. Our best estimate of the monetised net cost for this option is £2.6m in present value terms. However, given that concurrent competition powers could contribute to the delivery of the overarching benefits estimated above, **option 1 is our preferred option**.

Appealing CAA decisions on which airports should be subject to economic regulation

139. This section focuses on appeals of the regulator's decision about which airports should be subject to economic regulation. Under the new regime CAA's decisions on whether a specific airport operator should be subject to economic regulation, will be based on an airport operator satisfying a market power test, which is broadly based on:

- The airport operator, either alone or together with any other airport(s) in common ownership or control, has or is likely to acquire, substantial market power; AND
- Domestic and EU competition law would not be sufficient to address the risk that, absent regulation, the airport would increase and sustain prices profitably above the competitive level, or restrict output or quality below the competitive level; AND
- Regulatory intervention will deliver additional benefits for airport consumers (i.e. over and above competition law) that will exceed the costs or potential adverse effects of any regulatory intervention.

[38] See annex 7 for details of FTE costs.

140. This above wording has been taken from the DfT's 2007 decision document on the policy criteria that are applied by the Secretary of State under the current regime. It should be noted that the precise wording of the criteria that will be included in legislation will be drafted by Parliamentary Counsel and may be subject to further input in the Parliamentary process.

141. Under the new regime CAA will also make decisions about whether an undertaking comprises an 'airport operator'. For example new forms of airport ownership and operation could develop in the future and CAA may need to take decisions about which undertaking should be potentially subject to regulation. For the purpose of this impact assessment we refer to decisions about which airports should be subject to economic regulation as including decisions about which undertakings comprise airport operators as well as which operators satisfy the market power test.[39]

Option 0: Do nothing

142. Under the do nothing option, merits-based appeals are precluded. The only route of challenge available is via judicial review, which is not the equivalent to a merit-based appeal as it focuses mainly on the legality of the decision, its reasonableness and the way in which the decision was taken rather than the substance of the decision. Respondents to the consultation generally did not consider judicial review to be a sufficient basis on which to challenge the merits of the CAA's decisions. It is therefore generally agreed that the new legislative framework should provide specific appeal mechanisms for the regulator's decision about which airports should be subject to economic regulation, and therefore that option 0 is undesirable.

Option 1[40]: Rights for all parties with a material interest and the Secretary of State[41]

143. Under option 1, we propose that the CAA's decisions on which airports should be subject to economic regulation should be subject to a right of appeal over and above the right to apply for judicial review. This option provides rights to all affected parties to challenge CAA's decision to the Competition Appeal Tribunal (CAT).

Benefits

144. How a decision may be challenged can have a material effect on the process adopted for the making of that decision, and can affect the quality, certainty and robustness of that decision and therefore the regulatory system overall. As a result and in light of consultation responses, we believe there are benefits associated with symmetric rights to appeal (i.e. rights conferred such that appeals can reflect both the licensee's and passengers' interests), which should help encourage more better decisions that better serve passengers' interests – either as a direct outcome of appeals or as a consequence of the credible threat of an appeal.

145. The decision to subject an airport to economic regulation, or remove regulation at that level, is one of great importance, and carries with it potentially significant commercial implications for all those affected. If the regulator incorrectly removes an airport from regulation then such an airport could abuse its market power, which would create inefficiencies and transfer surplus from passengers to airports. On the other hand, if the regulator imposes regulation where this is not necessary this could result in unnecessary regulatory costs and crowd out commercial incentives which could undermine the achievement of efficiencies (e.g. in the delivery of opex and capex). Appeals which improve decision making are therefore expected to make a material contribution to the overarching costs and benefits estimated above.

146. Additionally this option provides the regulated company with a means to challenge inappropriate regulatory decisions, thereby reducing the regulatory risk for the regulated companies. As regulatory risk can affect the cost of capital that regulated companies face, having rights to appeal regulatory

[39] CAA decisions about which undertakings comprise airport operators will only be subject to appeal by the person(s) who are the subject to the decision.
[40] As explained in paragraph 16, the five options (options 1a to 1e) are identical for this policy area. Therefore, for simplicity we refer to the five options as option 1.
[41] In order to aid compliance with European legislation (Airports Charges Directive) we are currently proposing that the Secretary of State is granted a right of appeal.

decisions on their merits, combined with the new, clear set of statutory duties for the regulator, could have a positive effect on the cost of capital of regulated airport operators. This is another way in which this specific policy proposal is expected to contribute to the overarching benefits estimated above.

Costs

147. It is difficult in advance to predict the time an appeal would take, but for simplicity we assume that an appeal would last for around six months (the same amount of time as an investigation on a licence modification, although we expect appeals to the CAT to be less resource intensive). It is also extremely difficult to predict the frequency of appeals under this option. Due to the fact that permission stages and the award of costs should help to discourage and/or dismiss unmeritorious appeals, we assume that there would be one appeal every five years (i.e. four appeals over the 20 year appraisal period). Our low case assumption is that there are no appeals, and our high case assumption is that there are two appeals every five years (eight appeals over the appraisal period). We note that, since the only available option at present is judicial review, any resulting appeals would represent additional costs.[42]

148. Annex 9 describes the methodology used to estimate the costs of a Competition Commission appeal for both major and minor licence modifications. We assume the costs of an appeal to the CAT about whether an airport should be subject to economic regulation would be broadly equivalent to those associated with an appeal to the Competition Commission for a major licence modification. We believe this assumption is sensible because the form of appeal will be very similar and both decisions will have significant commercial consequences for a number of parties.

149. In summary total costs (in present value terms over the 20 year appraisal period) would be incurred by a range of parties, including the CAT (best estimate of £1.4m with a range of £0m - £2.8m), the appellant (best estimate of £1.4m with a range of £0m - £2.8m), appeal interveners (best estimate of £1.4m with a range of £0m - £2.8m) and the CAA (best estimate of £1.4m with a range of £0m - £1.4m). For our best estimate, the total cost in present value terms over 20 years would be £5.7m (ranging from £0m to £11.4m).

150. Given that option 1 is expected to make a material contribution to the delivery of overarching benefits estimated above and further that stakeholders generally supported the proposal to introduce merits based appeals for affected parties **option 1 is therefore our preferred option.**

Challenging CAA decisions to modify licence conditions

151. This section focuses on challenging CAA decisions to modify licence conditions (which include, but are not limited to, price controls). Licence modifications can have significant commercial implications for the regulated companies and they can also directly affect users. Under the current regime all price control proposals are automatically referred to the Competition Commission before CAA publishes its final decision - we propose to remove this and replace it with rights for certain parties to challenge the CAA's final decision on its merits.

152. There was agreement between consultees that the Competition Commission is well placed to consider challenges on airport licence modifications. Stakeholders also generally agreed that judicial review rights alone do not provide sufficient redress, and that further rights to object in respect of licence modification decisions – for some parties at least – were desirable. However there was no consensus about what form the challenge should take and who should have such rights.

153. This is the one policy area where previous consultations have not provided sufficient evidence to indicate what the preferred policy option should be. As a result this impact assessment considers five options in relation to challenging airport licence modifications[43]:

[42] It is worth noting that the profile of appeals over time may vary. In particular, it might be expected that more appeals are launched early on in the new regime, while in later years, when the system is more established (and precedents have been established through earlier decisions and appeals), appeals may be less frequent. The assumptions presented above reflect our best estimate of the likely average yearly burden over the first 20 years of the new regime. We assume that this average is broadly representative, and note also that, given the relatively small costs involved, any modest redistribution of appeals over time should have a very limited impact. The PV cost will increase (decrease) if more appeals are launched early (late) in the life of the new regime. However, these changes, which reflect the time value of money, would not significantly affect the overall balance of costs and benefits or the preferred policy option.

[43] As explained in paragraph 16, the options are identical for all the other policy areas.

- Option 1a: rights limited to the airport operator.
- Option 1b: rights for the airport operator and the Secretary of State.
- Option 1c: rights for the airport operator and a consumer body.
- Option 1d: rights for the airport operator and airlines[44].
- Option 1e: rights for the airport operator, airlines and a consumer body.

154. The evidence included in this IA draws on further evidence sought from airports, airlines and the CAA during a three month period in the first half of 2011. It also draws on evidence provided in previous public consultations.

155. Our analysis implies that the decision on who should have rights will affect the form of the challenge. There are two alternative approaches used by the Competition Commission in other regulated sectors to consider challenges on licence modifications. We refer to the alternative forms as an investigation and an appeal.

156. An investigation means the Competition Commission effectively retakes the regulator's decision, without first having to conclude that the regulator made an error, and can vary the initial decision in either direction (so from an appellant's perspective an investigation is a 'two-way bet'). According to the Competition Commission under this approach the burden falls mainly on the regulated company, the Competition Commission and the regulator. Any third parties with rights to challenge would face relatively minor costs from objecting, especially since awarding costs is more difficult in an investigation. That said any appellant would face the risk of a worse outcome and the impact of this risk is greater the more the decision affects the appellants costs.

157. In contrast an appeal gives the Competition Commission less discretion – it must focus on the issues relevant to those raised by the appellant[45] and its powers to overturn the CAA's decision are far more constrained. Although this approach places a burden on the appellant from developing the case and carries the risk of costs being awarded, the appeal body is only likely to vary the decision in the direction of the appellant or not at all – as such appeals are sometimes described as a 'one-way bet'. If there is a lot to gain from a better outcome, appellants may be more incentivised to appeal. Despite this, when challenges do take place, an appeal approach should provide for more targeted cases and reduce the risk of the Competition Commission effectively replicating the role of the regulator. An appeal is closely aligned to the approach the CAT will use in hearing challenges about CAA decisions on whether an airport should be subject to economic regulation.

158. As explained more fully below, an investigation is more appropriate under option 1a because it should help to deter unmeritorious challenges from the airport operator. An investigation is also likely to be more appropriate under options 1b and 1c because it is unlikely that the Secretary of State or consumer body would have sufficient expertise or resources to develop and argue a case (which would be required under the appeal approach). Under option 1d a well designed appeal is considered more appropriate. Wider rights could lead to a greater number of challenges and an appeal should reduce regulatory uncertainty and reduce the risk that the Competition Commission replaces CAA as the airports regulator. Where stakeholders commented they generally agreed with this analysis. For the same reasoning, it is also appropriate that for option 1e that a well designed appeal is considered more appropriate for all parties including a consumer body. We note below (see paragraph 242) that this would mean that the consumer body would require greater resource per case because of the form of challenge. However, because the airlines would also have rights to challenge that the consumer body would not be expected to challenge as many cases and hence it is unclear whether the consumer body would need more or less resources under this option than option 1c.

159. This section makes a number of references to challenges which are 'unmeritorious'. For the purpose of this assessment the following types of challenge are considered to be unmeritorious:
    - challenges designed to delay implementation of the decision;

[44] Under this option and option 1e it is not clear whether the legislation would specifically state that airlines have rights or whether it would state that rights should be extended to matierially affected parties.

[45] In order to avoid the risk of 'cherry picking' for price control decisions, under this approach the Competition Commission would be empowered to consider other issues that need to be considered in order to take a decision on the specific issues raised by the appellant. The Competition Commission would have powers to commission expert advice and if the appeal is upheld, it could remit the decision back to the regulator with directions or retake the decision itself.

- challenges attempting to cherry pick certain aspects of the decision;
- challenges that are overly speculative (e.g. limited materiality or low prospect of success); and
- challenges that reflect narrow private interests.

Option 0: Do nothing

160. Under the current regime CAA is required to automatically refer its initial proposals[46] on an airport's price control to the Competition Commission for review before it makes it final decision. The reference itself lasts for 6 months and the CAA also spends time preparing for the reference beforehand and digesting the recommendations afterwards. The Competition Commission's recommendations on the price control are not binding; there have been cases where the CAA has followed the Commission's recommendation and others where it has not[47]. The Competition Commission is able to make 'public interest findings' if it finds that something has operated against the public interest, and these public interest findings are binding[48]. Under the current regime the only route to challenge is via judicial review.

161. Most stakeholders generally view the current system as bureaucratic and inefficient, as an automatic referral to the Competition Commission can be a lengthy process which is not always necessary. The airports believe the current process, where CAA refers its initial proposals to the Competition Commission, the Commission then publishes its recommendations and finally CAA publishes its decision, can create uncertainty and risk from an investor's perspective, which could affect a regulated airport's cost of capital. In addition, the new regime will give CAA a more flexible set of regulatory tools - in addition to regulating airport charges it will be empowered to set other obligations (e.g. in relation to airport resilience) to incentivise outcomes that better reflect those one would expect in a competitive market. Retaining the current system of automatic references in a regime where CAA has more flexibility would almost certainly result in a greater number of automatic references and exacerbate the inefficiency and regulatory uncertainty inherent in the current regime.

162. The airlines have told us that the automatic reference to the Competition Commission already provides a degree of accountability. Even though the Competition Commission's recommendations for price controls are not binding, the airlines believe they have persuaded CAA to drop proposals which would not have benefitted passengers[49]. However we note that it is not clear, in the absence of an automatic reference, whether CAA would not have dropped such proposals anyway. This could have been the case, for example, if CAA had used the time otherwise spent by the Competition Commission to further develop its own thinking on an initial proposal and as a result decided to drop it. In addition, it is not clear in many cases whose proposal was the 'correct' one.

163. For the five options, several key assumptions are made regarding the number of licence modifications and subsequently the range of challenges that may occur. We assume that the number of licence modifications is independent of who has rights to challenge but the number of objections may differ depending on who has rights. Table 7 below summarises these assumptions over the twenty year appraisal period, whilst the discussion under each option below explains the rationale behind each assumption.

164. We split our assumptions regarding the number of licence modifications into 2 categories: major modifications (which include changes to an airport's price and service quality conditions as well as any changes to financial resilience conditions); and minor modifications (which include changes to any other types of conditions[50]). We assume the costs associated with challenges to minor modifications are one third of those associated with major modifications. The CAA has verified that these are sensible working assumptions. Further details of how these assumptions were derived are set out in annex 7.

[46] For example in the last round of price controls for Heathrow and Gatwick, CAA recommended that the Commission consider airport charges of between RPI+4 and RPI+8 at Heathrow and between RPI-2 and RPI+2 at Gatwick.
[47] For example the CAA did not follow the Competition Commission's recommendation in 2002 not to move to individual airport regulation. However, it did follow Competition Commission's recommendation to adopt a single till approach.
[48] Public interest findings have, historically, included things like improving consultation and the provision of information to airport customers.
[49] For example in the 2002 review the Competition Commission did not support the CAA's proposals on a dual till approach and the CAA subsequently dropped this proposal. For more information see the Competition Commission's report - http://www.competition-commission.org.uk/rep_pub/reports/2002/fulltext/473c2.pdf
[50] This could include any conditions that make the licence operable, for example the relevant airport area covered

Table 7: Summary of Key Assumptions for Licence Modifications

	Option 1a			Option 1b			Option 1c			Options 1d and 1e		
Assumption	Low	Best	High	Low	Best	High	Low	Best	High	Low	Best	High
No. of 'major' licence mods	10	16	22	10	16	22	10	16	22	10	16	22
No. of objections[51]	0	3	7	0	5	11	0	6	13	0	8	18
No. of 'minor' licence mods	2	8	16	2	8	16	2	8	16	2	8	16
No. of objections[47]	0	2	5	0	2	8	0	3	10	0	4	13
Total number of objections	0	5	11	0	7	18	0	9	22	0	12	29
% of licences modifications objected to	0%	20%	30%	0%	30%	50%	0%	40%	60%	0%	50%	80%

Option 1a: Rights for the airport operator only

165. Under this option, rights to challenge airport licence modifications would be granted to the licensee (i.e. the airport operator) only. All other parties would have to rely on judicial review.

166. If rights are limited to the licensee we believe (and industry generally agrees) an investigation is the more appropriate model for considering challenges. This is because an appeal, which essentially provides the appellant with a one-way bet, may not be appropriate if rights are restricted to one party. The fact that an investigation tends to impose a significant burden on the regulated company and introduces the risk of a worse outcome (the impact of which is especially significant for the airport operator) should both help to deter unmeritorious challenges from the licensee.

167. This is the model that currently applies to the water, rail and air traffic regimes. Prior to legislation due to be introduced in 2011, it is also the model that has applied to the gas and electricity sectors since the late 1980s. Under these regimes, generally the regulator has to seek agreement from the licensee before making the licence modification. If the licensee does not agree then the regulator makes a reference to the Competition Commission who conducts an investigation and reaches its own decision on the necessary licence modification applying the relevant regulatory duty[52].

Benefits

Regulatory risk

161. There should be material benefits from providing the regulated company with a means to challenge inappropriate regulatory decisions and removing automatic Competition Commission references, thereby reducing regulatory risk for the regulated companies. In a paper prepared for Ofgem's RPI-X@20 review[53], John France (regulatory Director CE Electric UK Funding Company) argues that in a system where the regulator is required to pursue the public interest, "*the deleterious effects of any misdirection or disproportionality on the part of the regulator were effectively balanced by conferring upon the property owner certain protective rights*". He goes on to argue "*without secure property rights incentives are harmed. In the extreme, investors would not invest the sums necessary to secure the continuing provision of the service. Short of that extreme, investors will demand a higher return if they are to risk their capital*".

[51] Note, the number of objections is based on the percentage of licence modifications objected to (final row), which have been agreed with the CAA to be reasonable assumptions. These rows have been rounded to the nearest licence modification.
[52] In practice we understand that the CC does not seek to reopen issues on which there is consensus, although they do have the ability to look at all issues and take a holistic approach. However, if the CC reaches a different decision to the regulator, it is able to substitute the regulator's decision for its own.
[53] See http://www.ofgem.gov.uk/Networks/rpix20/Stakeholder/Documents1/RPI-X@20%20full%20list%20of%20paper.pdf

162. As regulatory risk can affect the cost of capital that regulated companies face, having rights to challenge licence modifications on their merits and removing automatic references could have a positive effect on the cost of capital of regulated airport operators. One airport told us that the current system of so-called 'two-tier' regulation, where all price control proposals are automatically referred to the Competition Commission for investigation, created considerable regulatory uncertainty. As a result we expect this to contribute significantly to the overarching benefits estimated above.

Cost savings from avoiding automatic referrals

163. There will be a direct quantifiable benefit resulting from the fact that price control decisions will no longer automatically be referred to the Competition Commission. Under the current regulatory regime, the cost of referrals to the Competition Commission have varied quite significantly depending on the complexity of the case and whether one or more price controls have been considered in parallel. Based on the cost of previous Competition Commission referrals (which have varied quite significantly) we employ a range of £0.8m to £1.6m with a best estimate of £1.2m per referral. We note this is higher than the Competition Commission's costs in the recent Bristol Water case, which amounted to approximately £0.65m. Furthermore, our best estimate assumes that there would be 10 automatic references under the counterfactual with a range between 6 and 12 for our low and high scenarios respectively[54]. Combining these assumptions, our best estimate is that the benefit related to avoiding these automatic referrals equates to a present value, over twenty years, of £8.5m (with a range of £3.4m to £13.6m).

164. We assume that the avoided cost to the airport would be similar to the costs imposed on it as a result of an investigation, which BAA believes would cost in the region of £2m-£3m. This estimate is very similar to the costs imposed on Bristol Water (£2.5m) from their reference to the Competition Commission[55]. We assume the automatic referral to the Competition Commission results in a significant amount of duplication but not 100%. So removing this element of the process will not result in the avoidance of 100% of the costs to the airport operator – but based on estimates from CAA we assume it could avoid at least 50%. Therefore our best estimate assumes the typical costs avoided would amount to around £1.25m (50% of the costs of a typical referral), ranging from £0.5m (25% of the lower end of BAA's estimate) to £1.5m (75% of the higher end of BAA's estimate). Combined with our assumptions regarding the number of avoided automatic references, our best estimate equates to a benefit of £8.9m in present value terms (ranging from £2.1m to £19.2m).

165. The net impact on CAA is likely to be that they will require more resources – although they will not have to prepare the Competition Commission reference, they will be required to do some of the work currently done by the Competition Commission. These additional resource costs are included in the costs estimated in the licensing section above.

Costs

Costs of challenges

166. If the right to object is limited to the airport operator and the Competition Commission is required to adopt an investigative approach, it is not clear whether there would be many challenges. According to the Competition Commission, an investigation tends to place a significant burden on the regulated company and it introduces the risk of a worse outcome which will have a significant impact on the airport operator because a large proportion of its revenues are at stake. Any regulatory risk arising from the fact the Competition Commission could tweak any aspect of the licence modification should be fully internalised by the airport. Combined, these factors should help to prevent unmeritorious challenges from the airport operator.

167. Experience in other sectors with similar approaches implies the number of expected challenges should be low – with the exception of telecoms there appears to have been only four references to the Competition Commission in the other regulated sectors since 2000 (three in the water sector and one in the energy sector). However during the period 1993 to 2000 the Competition Commission published eight reviews relating to electricity, gas and water price caps. There were no references to

[54] The lower end of the range takes into account that airports may fall out of economic regulation over the appraisal period and that for the next price control period it has not yet been determined whether the automatic referrals will take place. The upper end of the range assumes no airports fall out of economic regulation and that the automatic referrals are avoided for Q6.
[55] http://www.competition-commission.org.uk/rep_pub/reports/2010/fulltext/558_final_report.pdf

the Competition Commission in either rail or postal sectors during this period. According to recent DECC impact assessment[56], since 2003 Ofgem has made 97 changes to standard licences and has had a licence change blocked 4 times (i.e. 4% of the time).

168. Having consulted CAA, our best estimate is that there are around 16 major licence modifications over the 20 year period, with a range of 10 to 22. We assume there are 3 challenges (which equates to approximately 20% of major modifications being appealed), with a range of 0 to 7. We also assume there are around 8 minor licence modifications over the 20 year period with a range of 2 to 16 and that there are 2 challenges (ranging from 0 to 5). Although it is very difficult to predict numbers in advance, CAA agree these numbers appear sensible as a working assumption. Annex 8 describes the methodology used to estimate the costs of a Competition Commission investigation for both major and minor licence modifications.

169. In summary, total costs (in present value terms over the 20 year appraisal period) would be incurred by a range of parties, including the Competition Commission (best estimate of £3.1m with a range of £0m - £9.9m), the airport operator[57] (best estimate of £5.9m with a range of £0m - £20.0m) and the CAA (best estimate of £0.6m with a range of £0m - £1.4m). Under our best estimate, the total cost in present value terms over 20 years would be £9.6m (with a range of £0m to £31.2m).

Regulatory capture

170. Compared to the status quo, where no party has rights to challenge regulatory settlements on their merits, this option provides such rights for one party. This option therefore introduces asymmetry, which some stakeholders have argued could lead to unbalanced negotiations and increase the risk of regulatory capture.

171. First we consider stakeholders' views: In the 2009 public consultation[58] many of the airlines argued that this option could lead to unbalanced negotiations and increase incentives for CAA to err on the side of the airport. The airlines believe that the current automatic reference provides a degree of accountability on the regulator that would be lost under this option. More recently, and drawing on the insights of Game Theory, the airlines have developed a theoretical model which implies that for a regulator who is required to exercise judgement, under-correcting for market power will always strictly dominate over-correcting.

172. Theoretically one could see why CAA would want to intentionally avoid the Competition Commission retaking its decision – such processes can be lengthy, costly and the CAA may worry that the Competition Commission retaking its decisions could damage its credibility and reputation. On the other hand, one might argue that the airport operator would also want to avoid an investigation. Once an investigation is triggered the Competition Commission could change any aspect of the initial decision – as the airport operator has a lot at stake even small changes could have significant consequences. Given its primary duty to passengers and accountability to Parliament, airports believe the CAA's incentives to err (intentionally) on the side of the regulated company are low.

173. Secondly we consider the academic evidence. The most relevant paper we have identified is a paper on regulatory capture that was published in 2006[59] which reviews the various models that have been developed over the years on regulatory capture. This paper notes *"the empirical evidence on the causes and consequences of regulatory capture is scarce".* However the author also notes that the impacts of capture, where it does exist, are potentially significant.

174. An empirical paper[60] from 1996 focusing on the water industry finds some evidence that the regulator had appeared to *"balance the multiple, often conflicting interests of the various water*

[56] Proposals for implementation of licence modification appeals under the EU Third Package – http://www.decc.gov.uk/en/content/cms/consultations/resp_3rd_pack/resp_3rd_pack.aspx

[57] Includes both the costs incurred from launching an objection (which for other options is not necessarily a burden on the airport operator) and the remaining cost to the licensee from an objection (this cost is realised by the licensee regardless of who launches the objection) including information gathering costs, diverting management's time and resource burden costs.

[58] Reforming the framework for the economic regulation of airports – see http://webarchive.nationalarchives.gov.uk/+/http://www.dft.gov.uk/pgr/aviation/airports/reviewregulatioukairports/decisiondocument/

[59] For a review of the theoretical models see "Regulatory capture: A review", Ernesto Dal Bo, Oxford Review of Economic Policy, Vol 22, No 2, 2006.

[60] Balancing multiple interests in regulation: An event study of the English and Welsh water industry, John W. Sawkins, Journal of Regulatory Economics, Vol 9, No 3, 249-268.

industry stakeholders in his work, and that this balance was tipped in favour of companies and their shareholders by the statutory obligations of the Regulator". This conclusion is based on the author's understanding that the regulator's primary duty was to ensure the regulated company was able to operate. We note, however, this means it is difficult to distinguish between the hypotheses of regulatory capture or the regulator adhering to its statutory duties as both would be consistent with the empirical results demonstrating a bias towards shareholders.

175. A similar empirical paper from 1998 which focused on the electricity distribution industry[61] found that *"despite the existence of detailed and readily available information from OFFER and the financial press, regulatory initiatives were not normally fully anticipated by the market"*. In this respect their research *"shows no evidence of regulatory capture in this sector"*. However we note that the authors' results also indicate that regulatory proposals were often more lenient than expected. It is not clear whether such outcomes would be consistent with a primary duty to promote passengers' interests.

176. As we have been unable to identify any other relevant empirical research on regulatory capture we are inclined to agree with the 2006 review on regulatory capture - that the empirical (academic) evidence is inconclusive.

177. Turning now to practical experience in other regulatory regimes, there have been few references to the Competition Commission; this could demonstrate that regulators have erred on the side of the regulated company but it could alternatively demonstrate that regulated companies face significant disincentives to compel a Competition Commission investigation where the settlement is reasonable. Some regulatory commentators and experts have noted that there have been too few challenges under the regime where rights have been limited to the regulated company.

178. A report prepared by an independent consultancy on behalf of Ofgem as part of its RPI-X@20 review explains that regulatory decisions require judgement on a range of complex issues with conflicting interests[62]. Where rights are limited to the regulated company this could result in too little weight given to the interests of consumers at the margin. This appears to have been one of the main reasons for Ofgem proposing changes to the energy regime to enable third parties to request that licence modifications should be referred to the CC for investigation.[63]

179. A report prepared by an independent consultancy on behalf of a group of communications providers sets out a number of theoretical models explaining why a regulator might err on the side of the regulated company[64]. The report explains that a regulator might err for a number of different reasons and draws on the insights of behavioural economics to explain why persistent biases can exist.

180. To summarise the evidence on whether restricting rights to challenge to the licensee can lead to regulatory capture is inconclusive. That said we note that both the Competition Commission (in relation to airports) and Ofgem (in relation to the gas and electricity sectors) have both recommended that rights to challenge licence modifications should be extended more widely than the licensee. However it is not clear whether this is due to: i) the risk of regulatory capture where rights are limited to the licensee; or ii) the benefits of increased accountability where rights are extended more widely. As explained further below, the benefits of increased accountability include correcting decisions which do not result from regulatory capture, but which unintentionally bias the licensee because the regulator has made an incorrect regulatory judgement on the basis of (inevitable) imperfect information.

Option 1b: Rights for the airport operator and the Secretary of State

181. Under this option the licensee (i.e. the airport operator) and the Secretary of State for Transport would have rights to challenge airport licence modifications to the Competition Commission. All other parties would be limited to judicial review.

[61] "The effects of regulation and regulatory risk in the UK electricity distribution industry". T A Robinson and M P Taylor. Annals of Public and Cooperative Economics 69:3, 1998.
[62] Should energy consumers and energy network users have the right to appeal Ofgem price control decisions? If so, what form should the appeals process take? LECG, 7 October 2009.
[63] This process will not now be implemented given changes to legislation which are required to implement the EU third internal energy package – see following web link for further details http://www.decc.gov.uk/en/content/cms/consultations/resp_3rd_pack/resp_3rd_pack.aspx
[64] "Appeals from Ofcom decisions Time for reform?" Towerhouse Consulting, December2010.

182. The Secretary of State's power to object would be governed by the same statutory duties as the CAA and his or her decision to object (or not to object) would be subject to judicial review. In addition, it may be appropriate to further emphasise that the Secretary of State cannot exercise his or her power to object without reasonable grounds for believing the modification would be detrimental to the interests of passengers by including a specific provision in the legislation stating this. Some other regulatory regimes provide the Secretary of State with a power to direct that a licence modification should not take effect (essentially a veto power). We are not proposing such a power under this option.

183. If rights were limited to the licensee and the Secretary of State an investigation may once again be the more appropriate model for considering challenges. This is because the Secretary of State is unlikely to be sufficiently knowledgeable about the details of a specific licence modification to be able to construct and argue a case. Some may also feel that the Secretary of State using public funds to instruct lawyers and taking a case to court would be inappropriate. There is no precedent for this model in other regulatory regimes.

Benefits

Greater accountability

184. Under this option the Secretary of State would be empowered to challenge airport licence modifications if he or she believed the modification adversely affected passengers.

185. The airlines believe that given the inevitable information asymmetries there is a risk that a regulator could make an error in applying its regulatory judgement. One airline referred to the "Turner Review: A regulatory response to the global banking crises"[65] as an example of an expert regulator applying regulatory judgement and getting it wrong[66].

186. How a decision may be challenged can have a material effect on the process adopted for the making of that decision, and can affect the quality, certainty and robustness of that decision. Improved accountability should therefore ensure that any licence modification which unintentionally (due to the inevitable information asymmetries) favours the airport operator at the expense of passengers should be corrected – either before the CAA makes its final decision (via the threat of an appeal) or afterwards (via an appeal taking place).

187. Accountability is measured in terms of the quality of scrutiny that will be applied to CAA's decision making. More effective scrutiny should lead to licence conditions which better minimise levels of consumer detriment. The quality of scrutiny will depend on:

- how well appellants understand passengers' interests;
- alignment of appellants' interests with passengers;
- appellants' ability to engage with complex regulatory decisions; and
- ultimately how credible an appellant's threat to appeal is.

188. The quality of scrutiny is not necessary proportionate to the number of appeals. This is because the credible threat of an appeal can be sufficient to discipline regulatory decision marking. This could also be the case if there was a risk of unmeritorious appeals (which would not contribute to better decision making). Greater accountability of CAA's decisions will lead to better decision making by the CAA and should ensure that passengers get better value for money[67] (i.e. the level of consumer detriment is reduced). Improved accountability should therefore lead to licence modifications that better reflect the outcomes one would expect in a more competitive airports market. For example, improved accountability will increase scrutiny of the following types of requirements:

[65] http://www.fsa.gov.uk/pubs/other/turner_review.pdf
[66] Paragraph 88 of this reports reads *"the combination of these features, underpinned by the then dominant philosophy of confidence in self correcting markets, meant that even in the many cases where the FSA did meet high standards in the execution of its regulatory and supervisory approach, it was not with hindsight aggressive enough in demanding adjustments to business models which even at level of the individual institution were excessively risky and which pursued simultaneously by several banks, contributed to the build-up of system-wide risks"*
[67] In terms of lower prices, better service quality, greater reliability and/or investment in airport services that is better targeted towards passengers' needs.

- forecast capital and operating expenditure (to ensure outputs reflect passengers needs and are delivered efficiently);
- efficiency improvements in operating expenditure (to ensure the operator realises all potential efficiencies);

189. Increased accountability should also improve the likelihood of any reductions in an airport's cost of capital (resulting from other elements of the reform package) being passed on to passengers in the form of reduced prices rather than being retained by the airport operator in the form of increased profits. Therefore improved accountability and enhanced scrutiny of regulatory requirements is expected to make a significant contribution to the overarching benefits estimated above and overall reduce consumer detriment. That said the degree to which this option will contribute to those benefits will depend on how much accountability the Secretary of State can provide in addition to the airport operator.

190. Stakeholders do not believe this option would make CAA decisions on licence modifications more accountable to passengers for a variety of different reasons:
- the Secretary of State will not have a detailed understanding of how licence modifications impact on passengers interests;
- the Secretary of State may be motivated to challenge (or refuse to challenge) a licence modification for political reasons;
- an objection from the Secretary of State could be seen by many as a vote of no confidence in the CAA Board.

Regulatory risk

191. As for option 1a above.

Cost savings from avoiding automatic referrals

192. As for option 1a above.

Costs

Costs of challenges

193. Under this option rights to a merits-based challenge are wider so there may be a greater potential for appeals[68]. However, given that rights to object are limited to the licensee and the Secretary of State, we would not expect numerous appeals under this option.[69] We assume for our best estimate that there would be 5 challenges to major licence modifications (ranging from 0 to 11) and 2 challenges to minor licence modifications (ranging from 0 to 8) over the 20 year period. This equates to approximately 30% of all licence modifications being challenged. Although difficult to predict numbers in advance, CAA has confirmed that these appear to be sensible working assumptions.

194. The same assumptions as option 1a are employed on a cost per objection basis for the different parties involved in the objection process. Given these assumptions and the assumptions regarding the number of objections, costs (in present value terms over the 20 year appraisal period) would be incurred by a range of parties, including the Competition Commission (best estimate of £4.8m with a range of £0m - £15.5m), the airport operator (best estimate of £8.1m with a range of £0m - £29.1m) the appellant (either the airport operator or the Department for Transport – best estimate of £1.0m with a range of £0m - £2.4m) and the CAA (best estimate of £0.9m with a range of £0m - £2.1m). Under our best estimate, the total cost in present value terms over 20 years would be £14.8m (with a range of £0m to £49.2m).

[68] These objections would not necessarily come from the Secretary of State but could come from the airport operator, who given the more balanced negotiations outlined above, may face licence modifications that are not as favourable to it as compared to a system where rights to object are limited to the licensee only.

[69] Note we do not make assumptions regarding the party that triggers each investigation since we do not wish to add further uncertainty to the costs by making assumptions regarding who will object. It is possible that the presence of a party representing passengers with the right to trigger an investigation (the Secretary of State in this option) in addition to the licensee could generate more investigations from the licensee for the reasons set out in the "*Regulatory capture and errors in the exercise of regulatory judgement"* section for option 1a.

Regulatory risk

195. One could argue that there is a risk that providing the Secretary of State with a right to object could be perceived as political interference in the regulatory framework. For example one could argue that evidence from Moody's credit rating methodology shows that "unpredictability" and a "politically charged" regulatory framework can reduce the regulated industry's credit rating and hence increase the cost of capital. On the other hand it is possible that the credit ratings methodology may be more concerned with wider government objectives referring to the pursuit of social and environmental policy and more frequent legislative changes to the regulatory framework experienced in other countries or industries. If so, a power for the Secretary of State to object licence modifications, if properly explained to the market and the rationale made clear, might not affect a licensee's credit rating.

196. In some of the other regulated sectors (e.g. rail, water, air traffic, and until recently gas and electricity) the Secretary of State has a power to direct that a licence condition is not introduced (in effect a veto power). One could infer that since the credit ratings of other regulated companies have remained strong despite the presence of the veto in other sectors the risk of political interference must be perceived to be immaterial[70]. Some stakeholders have told us they do not think a power to veto can be compared to a right to object because the powers (and therefore the likelihood of them being used) are very different.

197. Stakeholders believe that this option could result in regulatory risk, although the airports believe the scale of the risk is potentially smaller than under option 1d, where rights are extended to airlines. Stakeholders have noted that Government policy has generally been to remove politicians from the process of economic regulation and providing the Secretary of State with a right to object would undermine this. They also believe that politically motivated challenges could occur and have drawn on a previous example in 2008 when the previous Government passed emergency legislation to enable the merger between HBOS Lloyds TSB[71].

DfT monitoring costs

198. The DfT will require additional resources to monitor CAA's major licence modification decisions in order to support the Secretary of State's right to object. These are assumed to be equivalent to the resources previously used by the DfT in taking decisions about which airports should be subject to economic regulation under the current legislative framework. For each major licence modification, we assume the DfT requires 0.8 FTE and £0.1m in external costs and for each minor licence modification, we assume the DfT requires a third of these resources. In aggregate, this is equivalent to £0.2m in present value terms per major licence modification and £0.1m per minor licence modification. Given the assumptions regarding the number of modifications and the monitoring cost per modification our best estimate results in additional costs of £4.4m to the DfT.

Option 1c: Rights extended to the airport operator and a passenger representative body

199. This option would involve giving a passenger representative body and the airport operator specific rights to challenge licence modification decisions on the merits to the Competition Commission.

200. To date there has been no independent body representing air transport passengers. In 2009 the previous Government announced its intention to give this remit to Passenger Focus but in 2010 the current Government took the policy decision not to make Passenger Focus the independent representative body for air transport passengers. The basis of the current Government's decision was that this was not the time to make additional structural changes which would add to the regulatory burden on the aviation industry[72]. The Government's announcement was welcomed by the aviation industry. The Government also said that it was exploring options for strengthening existing passenger representation arrangements which has led to the recent CAA consultation on the

[70] However, this is possibly because the veto in other industries is only very occasionally used and hence has not generated uncertainty in the regulatory system

[71] See http://www.bis.gov.uk/policies/business-law/competition-matters/mergers/mergers-with-a-public-interest/maintaining-the-stability-of-the-uk-financial-system

[72] The written Ministerial statement on economic regulation of airports is available at: http://www.dft.gov.uk/press/speechesstatements/statements/hammond20100721

proposal to create an aviation consumer advocacy panel for air passenger services[73]. The Government is also currently consulting on the proposal to abolish Consumer Focus and make the Citizens Advice service the lead national, publicly-funded consumer advocate[74]. The consultation states that it would be for the Department for Transport to decide whether transport forms part of this arrangement.

201. Government policy on consumer representation is currently being considered in light of the recent consultation on consumer empowerment and therefore is outside the remit of this IA; however, given the Government's 2010 policy announcement on passenger representation in the air transport sector, we assume the Citizens Advice Service's remit would not include air transport and that there will continue to be no independent air transport passenger representative body for the foreseeable future. Providing a consumer body with right to appeal airport licence modifications would therefore require the extension of an existing consumer body's remit to include air transport (although it would not extend to general passenger advocacy or complaints handling). Given that Consumer Focus has recently acquired rights to appeal energy licence modifications, it (or its successor) may be the consumer body best placed to take on such a role.

202. Under this option it is not entirely clear whether an investigation or an appeal is the more appropriate approach. The approach soon to be introduced in the energy sector is an appeal, which means the consumer body would have to develop the case and evidence base, pay the direct costs of the appeal and potentially pay other parties' costs if its appeal is unsuccessful. This would increase the costs needed to resource the consumer body's airport appellant role. In addition, it is not clear whether the consumer body would be sufficiently knowledgeable about the details of a specific licence modification to be able to construct and argue a detailed case. On the other hand although an investigation will minimise the resource costs, it would also make it relatively straight forward for the consumer body to challenge decisions without having regard to the costs incurred as a result.

203. Not all stakeholders had a view although some thought an investigation may be the more appropriate approach. We agree and therefore assume the approach under this option would be an investigation.

Benefits

Greater accountability

204. Under this option the consumer body would be empowered to challenge airport licence modifications if it believed the modification did not fully promote passengers interests. Some stakeholders believe that this option should make CAA decisions more accountable to passengers as long as the consumer body was sufficiently resourced to carry out its role effectively. As set out in paragraphs 187-189 above, increased accountability is expected to contribute significant to the delivery of overarching benefits estimated above and reduce consumer detriment.

205. The airlines do not believe that this option would make licence modification decisions more accountable to passengers unless the consumer body dedicated considerable additional resources to understanding the sector and in particular what passengers want. To quote one airline *"Airlines allocate significant resources to airport regulation, not only through the various processes orchestrated by the CAA and airports, but also in bringing their industry expertise from other parts of their businesses, in order to fully address implications which may not immediately be apparent".* The airlines believe this cannot be replaced by a consumer body.

206. As set out below we are assuming a relatively modest resource requirement for the consumer body under this option. On balance we assess the degree of accountability exerted under this option is likely to be greater than options 1a and 1b (see paragraphs 184-190 for the potential reasons why a Secretary of State appeal may not be accountable), but for the reasons outlined in the airline quote above, we assess it is likely to be smaller than under option 1d. However it is not clear to what extent the degree of accountability would be greater than under options 1a and 1b; similarly it is not clear to what extent the degree of accountability would be smaller than under option 1d.

[73] This panel will not be statutorily independent of the CAA.

[74] http://www.bis.gov.uk/Consultations/empowering-and-protecting-consumers?cat=open

207. This option is unlikely to provide any additional accountability to the forthcoming regulatory settlements, which are due to be introduced from April 2014 (as discussions with industry have already commenced). This is because legal constraints would restrict the consumer body from preparing for or carrying out its new functions until after Royal Assent (which is not expected until 2013). If the next regulatory settlements last for 5 years, this means the benefits of increased accountability would be not fully realised until 2019.

Regulatory risk

208. As for option 1a above.

Cost savings from avoiding automatic referrals

209. As for option 1a above.

Costs

Costs of challenges

210. Some stakeholders feel that a consumer body would be more motivated to appeal than the Secretary of State. As a result we assume the number of challenges would be higher under this option compared to option 1b. We assume for our best estimate that there would be 6 challenges to major licence modifications (ranging from 0 to 13) and 3 challenges to minor licence modifications (ranging from 0 to 10) over the 20 year period. This equates to approximately 40% of all licence modifications being appealed. Although difficult to predict numbers in advance, CAA has confirmed that these appear to be sensible working assumptions.

211. The same assumptions as option 1a are employed on a cost per objection basis for the different parties involved in the objection process. Given these assumptions and the assumptions regarding the number of objections, costs (in present value terms over the 20 year appraisal period) would be incurred by a range of parties, including the Competition Commission (best estimate of £6.0m with a range of £0m - £18.6m), the airport operator (best estimate of £9.9m with a range of £0m - £34.8m), the appellant (either the airport operator or the Consumer body – best estimate of £1.2m with a range of £0m - £2.9m) and the CAA (best estimate of £1.1m with a range of £0m - £2.6m). For our best estimate the total cost in present value terms over 20 years would be £18.3m (with a range of £0m to £58.8m).

Regulatory risk

212. If this option results in a greater number of appeals it could generate some additional regulatory risk. An investigation, once triggered, enables the Competition Commission to tweak any aspect of the decision and can therefore create more risk than an appeal.

Costs to resource consumer body's appellant role

213. There is no consensus amongst stakeholders on the resources a consumer body would need to carry out its appellant role effectively. Some stakeholders have suggested that around 2-3 FTE employees plus a small consultancy budget would be sufficient. The airlines believe the resource requirement would be much higher than this.

214. We do not agree that the resource requirement would be as large as some stakeholders have suggested although we do acknowledge this means the consumer body would not have the same level of expertise and understanding of passenger interests as airlines. That said we would expect the consumer body to draw on the research and expertise of the airlines, airports and regulator.

215. For the purpose of the IA we assume that the consumer body would require 2 FTE and an annual research budget of £50k. Taking into account the additional costs (£0.5m per appeal) that would be incurred by the consumer body acting as an appellant, our resulting estimates are not dissimilar to those provided by some stakeholders, but they are much lower than the level of resources which the airlines think would be required. Given these assumptions, the cost (excluding appellant costs) in present value terms over the appraisal period is £3m.

216. Although the consumer body's appellant function would probably be industry funded (presumably through one of CAA's charging schemes), Treasury's consolidated budgeting guidance[75] means these costs would also need to be offset by a corresponding reduction in the Department for Transport's budgets. These rules aim to keep public sector costs under control by preventing individual departments from setting up their own revenue funding streams to supplement agreed budgets. This option would therefore require the Department for Transport to divert its spending budgets away from other Government priorities.

Option 1d: Rights extended to the airport operator and airlines

217. This option would involve giving individual airlines, in addition to the airport operator, specific rights to challenge licence modification decisions on the merits to the Competition Commission.

218. Under this option we believe that an appeal is the more appropriate approach. Although difficult to predict numbers accurately in advance, wider rights will almost certainly lead to more challenges. Although an appeal is a one-way bet[76], it reduces the risk of the Competition Commission effectively replacing the CAA as the airports regulator, which could create uncertainty and affect a regulated airport's cost of capital. This is because an appeal requires the Competition Commission to conclude that CAA has made an error before it can disturb CAA's decision; unlike an investigation it cannot simply say it would have taken a slightly different approach. Therefore there is less of a risk of the entire decision changing just because the Competition Commission has exercised its regulatory discretion in a slightly different way to the CAA. An appeal should also help ensure that an appellant internalises the costs of an appeal as it will have to develop the arguments and evidence base and potentially face cost awards. An appeal is consistent with other regulatory regimes (e.g. telecoms, post[77] and energy) where rights to challenge licence modifications are wider than the regulated company.

219. We envisage such an appeals regime would draw heavily on the legislative structures proposed in the energy and post sectors. We therefore envisage that the regime will include the following features which we should help to deter unmeritorious appeals:

- An appeal will not suspend the licence modification from coming into effect (although the appeal body will have powers to impose interim relief);
- There will be a permission stage. For example, this could include the appellant be required to demonstrate to the CC that its case has a reasonable prospects of success before the full case can be heard;
- The appeal body will focus on the arguments and evidence submitted by the parties but in order to avoid cherry picking it will be empowered to consider additional issues that need to be considered to reach a balanced judgement on the specific issues raised by the appellant;
- The appeal body could award costs.

220. In addition to the features listed above we are also considering the possibility of requiring the appeal body to conclude that CAA has made a material error before it disturbs the CAA's decision. We believe this could help to further deter speculative appeals. Overall these features will ensure that the appellant incurs material costs when launching an unsuccessful appeal and therefore the appellant will need to way up the merits of the appeal against the costs and probability of winning. Furthermore, an investigation is much less resource intensive for the appellant than an appeal and there is a wider scope for the CC to disturb the CAA's decision. Together these features of an investigation create a greater incentive for the appellant to launch speculative challenges than under an appeal regime.

Benefits

Greater accountability

221. Under this option airlines would be empowered to challenge airport licence modifications. We agree with CAA and the CC that airlines are better placed than anyone else (including CAA) to

[75] See paragraph 3.30 of http://www.hm-treasury.gov.uk/d/consolidated_budgeting_guidance201112.pdf
[76] Because the appeal body is only likely to vary the decision in the direction of the appellant or not at all.
[77] See clause 57 of http://www.publications.parliament.uk/pa/bills/lbill/2010-2011/0066/lbill_2010-20110066_en_7.htm#pt3-pb8-l1g57

understand the needs of their passengers; however we note that this does not necessarily equate to their interests being aligned. Airlines desire to maximise the future stream of their profits overrides passengers' price, quality and convenience preferences; as such there can be no automatic presumption that in all circumstances airlines' and passengers' interests will be aligned. That said, overall the interests of passengers and airlines are likely to be relatively well aligned where airlines are operating in a well functioning competitive market. Developments in the European aviation sector over the last ten to fifteen years bear out this view; therefore we conclude that airlines and passengers interests will align in many cases. There is still a risk, where they do not align, of unmeritorious appeals (or not appealing where passenger interests suggest they should); however, we believe a system of appeal can be designed to include safeguards aimed at deterring unmeritorious appeals (e.g. the award of costs). In theory the fact that an appeal would not automatically suspend the licence modification from taking effect combined with the requirement that the Competition Commission has to conclude CAA made an error (applying the same duties as CAA) before disturbing CAA's decision should further disincentivise unmeritorious appeals.

222. Where airlines' and passengers' interests are aligned providing airlines with rights to appeal will exert a significant degree of accountability on regulatory decisions. This is because airlines should also be sufficiently resourced and well versed in the detail of licence modifications to appeal decisions if they believe such decisions have detrimental impacts on their passengers (and therefore their profits). This credible threat of an appeal should incentivise the CAA to further scrutinise its licence modifications to ensure they reflect passengers' needs. As a result, this option is assessed to provide the highest degree of accountability of all the options. This is consistent with the Competition Commission's recommendation in its investigation on BAA airports that CAA decisions should be more accountable than under the current regime and that the best way to achieve this was to provide rights to appeal licence modifications to the licensee, airlines and any relevant passenger representative groups[78]. We do not interpret this to include the establishment of air transport passenger representative bodies where these do not already exist.

223. As described in paragraphs 187-189 above, greater accountability of regulatory settlements and licence conditions more generally is expected to contribute significantly to the overarching benefits estimates above and reduced consumer detriment.

Regulatory risk

224. As for option 1a above.

Cost savings from avoiding automatic referrals

225. As for option 1a above.

Costs

Costs of challenges

226. Under this option there are more parties with rights to challenge so there will almost certainly be a greater number of appeals. Although the post and energy regimes are proposing to give third parties rights to challenge licence modifications, these regimes have not yet been tested.

227. According to Ofcom, it has published 14 charge control decisions since the 2003 Communications Act introduced rights for all affected parties to appeal Ofcom's decisions. 5 of these have been appealed so far. However, the trend has been towards a greater proportion of decisions being appealed over time – for example 5 out of the 6 most recent charge control decisions have been appealed whilst none of the first 9 decisions were appealed on charge control grounds. Of the appeals that have been heard, some of the points have been upheld and others have been quashed. If we expected the experience in telecoms to date to be indicative of what would happen in the airports sector, this would equate to 36% of licence modifications being appealed. However, Ofcom are due to issue 4 more charge control decisions this summer – if all of these are appealed this would take the total to 50%. .

[78] http://www.competition-commission.org.uk/rep_pub/reports/2009/fulltext/545.pdf

228. A recent impact assessment by DECC[79], which considered the impact of introducing rights for all licence holders (including energy suppliers) and Consumer Focus to appeal energy licence modifications, noted that Ofgem has made 97 changes to standard licences since 2003. This equates to approximately 12 per year on average. DECC assumes that if rights to appeal are extended more widely, there would be 1 appeal per year on average, which equates to around 8% of decisions being appealed. This analysis includes modifications made to a great number of conditions and it also covers a number of different markets (e.g. supply, networks) within the gas and electricity sectors.

229. Although the competitive nature of the airline market means that airlines interests will align with those of passengers in many cases, we do not believe this will be the case 100% of the time. For example, incumbent airlines may not want to pay for the development of infrastructure which aims to attract different types of airlines to the airport. For airlines with substantial market shares, the benefits of a better outcome are likely to significantly outweigh the cost of an appeal. As a result, there may be a risk of appeals which seek to further private commercial interests rather than passengers'. However, there will be a number of safeguards within the system which aim to significantly reduce this risk. These include:

- An appeal will not prevent the decision from coming into effect (although the CC could introduce interim relief in extreme circumstances);
- The appeal body will have to conclude that CAA made a (possibly material) error before it could disturb the decision;
- The appeal body will be subject to the same statutory duties as CAA;
- The appellant will have to satisfy a permission stage and face the prospect of paying other parties costs if it loses.

230. We assume for our best estimate that there would be 8 challenges to major licence modifications (ranging from 0 to 18) and 4 challenges to minor licence modifications (ranging from 0 to 13) over the 20 year period. This equates to 50% of all licence modifications being appealed. Although difficult to predict numbers in advance, CAA agrees that these assumptions do not look unreasonable. Annex 9 describes the methodology used to estimate the costs of a Competition Commission appeal for both major and minor licence modifications.

231. In summary, total costs (in present value terms over the 20 year appraisal period) would be incurred by a range of parties, including the Competition Commission (best estimate of £3.3m with a range of £0m - £10.6m), the appellant (either the airport operator or the airline – best estimate of £3.3m with a range of £0m - £7.9m), interveners (either the airport operator or airline who is not the original appellant - best estimate of £3.3m with a range of £0m - £11.9m) and the CAA (best estimate of £3.3m with a range of £0m - £7.9m). For our best estimate, the total cost in present value terms over 20 years would be £13.3m (with a range of £0m to £38.4m).

232. Other than the direct costs associated with appealing CAA decisions, we do not expect the airlines to incur any additional resource costs under this option. This is because airlines already dedicate a number of resources to the process of agreeing regulatory settlements and we would expect this to continue to be the case going forward.

Regulatory risk

233. Some stakeholders have raised concerns about airlines having rights to challenge if these rights created a large degree of regulatory risk. Although the number of appeals and therefore the level of regulatory risk is likely to be higher compared to option 1a (where rights are limited to the airport operator), the design of the regime should help to reduce the likelihood of unmeritorious appeals and therefore the degree of regulatory risk. One airline noted that an appeal will not automatically suspend the decision from coming into effect and further that the Competition Commission can only change the initial decision if it first concludes (applying the same duties as CAA) that CAA got it wrong. As a result this airline believes wider appeal rights would only create additional regulatory risk that would affect the cost of capital if the markets believed CAA was too lenient on the airport operator in the first place.

[79] Proposals for implementation of licence modification appeals under the EU Third Package – http://www.decc.gov.uk/en/content/cms/consultations/resp_3rd_pack/resp_3rd_pack.aspx

234. Overall we believe the scale of regulatory risk will be greater than under options 1a, 1c and possibly even option 1b. However it is not clear whether the degree of regulatory risk would be sufficient to affect an airport's cost of capital.

Option 1e: Rights extended to the airport operator, airlines and a passenger representative body

235. This option would involve giving individual airlines, a passenger representative body and the airport operator, specific rights to challenge licence modification decisions on the merits to the Competition Commission. There is some precedent for this model in the energy sector, where in order to comply with an EC Directive DECC has recently introduced rights for all licence holders (including energy suppliers) and Consumer Focus to appeal licence modifications.

236. Given the large number of potential appellants under this option, an appeal is considered the more appropriate approach under this option. This is the approach that applies in the gas and electricity sectors, where all licence holders (including energy suppliers) and Consumer Focus have rights to appeal energy licence modifications.

237. As described more fully under option 1c above, this IA assumes there will continue to be no independent passenger representative body in the air transport sector for the foreseeable future. As a result, this option would involve extending an existing consumer body's remit to the air transport sector by providing it with rights to appeal airport licence modifications. However this option would not involve giving the consumer body any wider advocacy, research or complaints handling function in relation to air transport.

Benefits

Greater accountability

238. As set out above, we agree with the CAA and CC that airlines are better placed than anyone else to understand the needs of their passengers. Given the competitive nature of the airline industry, airlines interests should align with passengers in the majority of cases, although not universally. As described in option 1d above, giving airlines rights to appeal should therefore exert a significant degree of accountability on regulatory decisions. Furthermore, greater accountability of regulatory settlements and licence conditions more generally is expected to contribute significantly to the overarching benefits estimates above. The salient question is whether this option would deliver any additional benefits over and above option 1d.

239. In theory, a passenger representative body could improve accountability in those areas where passengers interests may not align with either airlines' or airports' interests and might have an impact on the behaviour of either party. As a result this option could make CAA decisions more accountable to passengers than option 1d, so long as the consumer body was sufficiently resourced to carry out its role effectively. This means it would need to have a good understanding of air transport passengers' preferences and the specific licence modification but without a wider advocacy, research or complaints handling function it is not clear how this would be achieved. In practice and given stakeholders views (which are described in option 1c) it is not clear whether, and if so to what extent, the benefits of option 1e would exceed those of option 1d.

Regulatory risk

240. As for option 1a above.

Cost savings from avoiding automatic referrals

241. As for option 1a above.

Costs

Costs to resource consumer body's appellant role

242. It is not entirely clear whether the cost of funding the consumer body's role would be higher or lower under this option compared to option 1c. On one hand this option assumes an appeal is the

more appropriate approach (compared to option 1c which assumes an investigation). An appeal will require the appellant to have sufficient expertise to develop the case and evidence base and it will also require the appellant to pay the direct costs of the appeal and potentially pay other parties' costs if its appeal is unsuccessful. This could increase the costs required to fund the consumer body's appellant role. On the other hand the airlines may be expected to appeal in most cases where a licence modification does not reflect passengers interests so the consumer body would only need to focus on those cases where airlines and passengers interests do not align (in contrast to option 1c where it would also need to focus on the areas where airlines and passengers interests do align). This could decrease the costs required to fund the appellant role. But there is also the possibility that the consumer body may join an airport's or airline's appeal.

243. In practice it is not clear what effect would dominate so for the purpose of this impact assessment we assume the costs are the same as under option 1c, which includes 2 FTE and an annual research budget of £50k or £3m in present value terms over the appraisal period. The CAA have agreed these are sensible working assumptions. Although the consumer body's appellant function would probably be industry funded (presumably through one of CAA's charging schemes), Treasury's consolidated budgeting guidance[80] means these costs would also need to be offset by a corresponding reduction in the Department for Transport's budgets. These rules aim to keep public sector costs under control by preventing individual departments from setting up their own revenue funding streams to supplement agreed budgets. This option would therefore require the Department for Transport to divert its spending budgets away from other Government priorities.

244. We note that the costs associated with giving a consumer body rights to appeal airport licence modifications exceed those associated with DECC's recent decision to give Consumer Focus rights to appeal energy licence modifications. This is because Consumer Focus already has a remit to represent consumers in the energy sector so the ongoing marginal costs associated with giving them rights to appeal energy licence modifications were assumed to be zero[81] because they could use existing resources to carry out this function. In contrast, if Consumer Focus was given rights to appeal airport licence modifications additional resources (i.e. full time staff and an external research budget) would be needed in order to develop an understanding of the sector as well as to participate (as an appellant or as an intervener) in appeals.

Costs of challenges

245. It isn't clear whether this option would provide further accountability over and above that provided by option 1d. Therefore we assume that the number of appeals under this option would be the same as under option 1d, although note that some appeals taken forward by airlines or airports under option 1d could in theory be taken forward by the consumer body under this option. The CAA agrees that this is a sensible working assumption for the purpose of this IA.

246. In summary, total costs (in present value terms over the 20 year appraisal period) would be incurred by a range of parties, including the Competition Commission (best estimate of £3.3m with a range of £0m - £10.6m), the appellant (either the airport operator, the airline or consumer body – best estimate of £3.3m with a range of £0m - £7.9m), interveners (either the airport operator, airline or consumer body who is not the original appellant - best estimate of £3.3m with a range of £0m - £11.9m) and the CAA (best estimate of £3.3m with a range of £0m - £7.9m). For our best estimate, the total cost in present value terms over 20 years would be £13.3m (with a range of £0m to £38.4m).

Regulatory risk

247. As for option 1d above.

Summary

248. To recap, options 1a, 1b, 1c, 1d and 1e are the same in all aspects apart from different parties have the right to object to licence modifications across the options and options 1d and 1e have a different form of challenge. Table 8 presents a summary of the monetised costs and benefits associated solely with the four options (relative to option 0, do nothing). Table 9 illustrates the range

[80] See paragraph 3.30 of http://www.hm-treasury.gov.uk/d/consolidated_budgeting_guidance201112.pdf
[81] http://www.decc.gov.uk/assets/decc/Consultations/eu-third-package/1161-ia-third-package-licence-mods.pdf

of costs and benefits for each of option. Neither table takes into account the impact of the options on the overarching benefits estimated above.

Table 8: Summary of monetised benefits and costs of licence modification challenges options in PV terms (£m)

	Description	Realised by:[82]	Option 1a	Option 1b	Option 1c	Option 1d	Option 1e
Benefits	Avoided Cost of Automatic Referrals	Competition Commission	8.5	8.5	8.5	8.5	8.5
	Avoided Cost of Automatic Referrals	Licence Operator	8.9	8.9	8.9	8.9	8.9
	Total		**17.4**	**17.4**	**17.4**	**17.4**	**17.4**
Costs	Cost of Appeal	Appellants	0.7	1.0	1.2	3.3	3.3
	Cost of Appeal	Competition Commission	3.1	4.8	6.0	3.3	3.3
	Cost of Appeal	CAA	0.6	0.9	1.1	3.3	3.3
	Cost of Appeal	Intervener	-	-	-	3.3	3.3
	Information & Resource Burden	Licence Operator	5.2	8.1	9.9	-	-
	Monitoring Costs	DfT	-	4.4	-	-	-
	Monitoring Costs	Consumer Body	-	-	3.0	-	3.0
	Total		**9.6**	**19.1**	**21.2**	**13.3**	**16.2**

Table 9: Summary of monetised costs and benefits in PV terms (£m)

	Benefits			**Costs**		
	Low	**Best**	High	Low	**Best**	High
Option 1a	5.5	**17.4**	32.8	0.0	**9.6**	31.2
Option 1b	5.5	**17.4**	32.8	2.5	**19.1**	55.6
Option 1c	5.5	**17.4**	32.8	3.0	**21.2**	61.8
Option 1d	5.5	**17.4**	32.8	0.0	**13.3**	38.4
Option 1e	5.5	**17.4**	32.8	3.0	**16.2**	41.3

249. For our best estimate, option 1a is assumed to have a positive net present value of £7.8m; for option 1d the figure is £4.1m and for option 1e the NPV is £1.2m. Options 1b and 1c have negative net present values of £1.7m (option 1b) and £3.8m (option 1c).

250. The two tables above do not reflect the significant contribution that providing rights to challenge licence modification will make towards the achievement of the overarching benefits estimated above. These overarching benefits constitute the majority of the total benefits (approximately 89.6%) estimated. There are differences between the options which are not reflected in the monetised impacts and which will affect the levels of overarching benefits achievable under the new regime. Firstly there may be varying degrees of regulatory risk associated with the different options. Additional regulatory risk from an investor's perspective could theoretically result in a higher cost of capital, which would, reduce the level of the overarching benefits estimated. Although the airports believe that options 1b, 1d and 1e could create additional regulatory risk, they have not been able to provide any quantitative estimates that would enable us to quantify the difference in overarching benefits between the options.

251. Secondly, there are likely to be varying degrees of increased accountability associated with the different options. Increased accountability is expected to increase the level of overarching benefits

[82] Although, these are the organisations that directly realise the benefits or costs, in most cases the costs and benefits are passed on to passengers. See paragraph 26 for details. The exceptions are costs or benefits incurred by DfT (and hence realised by the tax payer).

through greater scrutiny of CAA decision-making. This is because it is likely to be an important driver of efficiencies in the delivery of opex and capex and it may also improve the likelihood of any improvements to an airport's cost of capital being passed onto passengers through the price control (for example in its most recent regulatory reference the CC concluded that Bristol Water's cost of capital should be 0.5% lower than Ofwat's allowance of 5.5%). See paragraphs 187-189 for further details.

252. To understand the differences in accountability between the options we need to consider how incentivised the different appellants would be to challenge licence modifications which do not fully reflect passengers' interests. Since it is unreasonable to assume passengers can represent themselves in the complex and time consuming process of making licence modifications, options 1b to 1e provide appellant rights to one or more third parties. We deal with each option in turn:

- Option 1a only results in challenges that are in the passengers' interests where their interests align with the airport operators. Given the lack of competitive constraints facing airports who are subject to economic regulation, the likelihood of airports and passengers interests aligning is very low.

- Option 1b and 1c provides a right to challenge (where this is in the interests of passengers) to the Secretary of State and a consumer body respectively. Some stakeholders believe that both of these options would need substantial resources to be involved in the licence modification process over a long period of time to effectively use the challenge right. Otherwise neither body would be sufficiently well versed in the detail to provide a credible threat of appeal. Some stakeholders believe that there is risk of politically motivated challenges particularly from option 1b and another highlighted the risk that interested parties with more information of the market could influence either the consumer body or the Secretary of State to take on challenges they would not take on themselves, since these interested parties do not bear any of the risk of the challenge. However, one benefit of providing these parties with a right to challenge is that they would be bound to the same statutory duties as the CAA and hence could only challenge in the interests of current and future passengers.

- Option 1d provides airlines with rights to challenge. Overall the interests of passengers and airlines are likely to be relatively well aligned where airlines are operating in a well functioning competitive market and developments in the European aviation sector over the last ten to fifteen years bear out this view. However, the overall aim for airlines to maximise the future stream of their profits can override passengers' price, quality and convenience preferences and means that there can be no automatic presumption that in all circumstances airlines' and passengers' interests will be aligned. Consequently, it is possible that airlines could be incentivised to undertake unmeritorious challenges[83]. However, we believe a system of appeal can be designed to include safeguards aimed at deterring unmeritorious appeals (e.g. the award of costs). Overall we consider that airlines are best placed, given their day-to-day interaction with passengers, to understand their interests and hence when acting in their interest will provide the greatest accountability to the CAA's decision-making. For example, we believe that airlines would bring forward meritorious appeals that the consumer body and Secretary of State may not because they do not have the airlines' industry expertise and their in depth understanding of their passengers preferences. Furthermore, in their market investigation into BAA's airports[84], the Competition Commission recommended giving airlines rights to challenge licence modifications and stated "we accept that on some issues relating to airport investigation, airlines' interests are likely to diverge from those of final consumers, but in our view the CAA is unlikely to be as good a position to judge the interests of end users as airlines, given the competitive market in which they operate".

- Option 1e provides airport operators, airlines and a consumer body with rights to challenge. This option will provide at least the same degree of accountability as option 1d; however it is not clear whether, and if so to what extent, the degree of accountability would exceed that of

[83] An unmeritorious challenge is a challenge brought forward that is not in line with the primary duty. For example, where an airline challenges a decision on the basis of its own narrower interests and not taking into account the interests of passengers of other airlines.
[84] BAA airports market investigation: A report into the supply of airport services by BAA in the UK". Available at http://www.competition-commission.org.uk/rep_pub/reports/2009/fulltext/545.pdf

option 1d. Overall therefore we conclude that options 1d and 1e will provide the greatest degree of accountability of all the options.

253. For some of the options it is not entirely clear whether the positive impacts of increased accountability outweigh the negative impacts of increased regulatory risk and stakeholders' views on this are mixed. As it is not possible to rank the four options in terms of their net effect on the monetised overarching benefits, we have not monetised the differences in overarching benefits between the options. Instead we consider regulatory risk and increased accountability as qualitative impacts.

254. A number of stakeholders have told us that they do not believe that option 1b (rights for the airport and the Secretary of State) would achieve the policy aim of increased accountability. They also argue that this option would introduce unnecessary political involvement. As a result we believe option 1b should not be pursued.

255. Government policy on consumer representation is currently being considered in light of the recent consultation on consumer empowerment and therefore is outside the remit of this IA; however given the Government's announcement in 2010 not to give Passenger Focus a new remit to represent air transport passengers we assume for the purpose of this IA there will continue to be no independent body representing air transport passengers in the foreseeable future. This means giving a consumer body rights to appeal airport licence modifications (options 1c and 1e) would involve extending an existing consumer bodies remit to air transport (although it would not extend to general passenger advocacy or complaints handling). Moreover the additional costs associated with the extension of an existing consumer bodies remit would, according to Treasury consolidated budgeting guidance, need to be met by an equivalent reduction in the Department's budget. Stakeholder views on the level of accountability that would be provided by a consumer body are mixed: airports believe this option would make decisions more accountable to passengers but airlines disagree due to the expertise required to engage meaningfully in regulatory decisions. In addition a consumer body is unlikely to provide any additional accountability to the forthcoming regulatory settlements, which are due to be introduced by April 2014[85]. Furthermore, in terms of the monetised impacts, options 1a and 1d are estimated to deliver a greater NPV of £163.7m and £160.0m respectively, than options 1c and 1e (£152.0m and £157.0m). Given that the cost benefit analysis does not provide a convincing, clear cut case for providing a consumer body with a right to appeal (i.e. pursuing either option 1c or 1e) – which would need to be the case to divert Departmental spend away from other Government priorities – options 1c and 1e have been discounted.

256. This leaves options 1a and 1d. Option 1a has a higher monetised net benefit than option 1d but this disregards the impacts and risks that have not been monetised. These include:

- Increased risk of unbalanced negotiations and regulatory capture under option 1a;
- Increased accountability under option 1d; and
- Greater prospect of regulatory risk under option 1d.

257. The difference between the (monetised) net benefits of options 1a and 1d is £3.7m over the 20 year period. Although option 1d could result in greater regulatory risk than option 1a, this needs to be offset against the fact that option 1d will provide the greatest accountability to passengers and guard against any increased risk of unbalanced negotiations and regulatory capture. As set out in the section on challenging licence modifications below, we believe the design of an appeals regime (e.g. the inclusion of costs awards and possibly limits on the appeal body's ability to intervene unless it concludes that the regulator has made a material error) should help to deter unmeritorious appeals and this should help to minimise any additional regulatory risk associated with option 1d. On the other hand improved accountability is likely to be an important driver of efficiencies in the delivery of opex and capex; it should also improve the likelihood that any reductions in an airport's cost of capital are passed onto passengers.

258. There is general agreement between stakeholders that airport licence modification decisions should be accountable to one or more parties who are incentivised to challenge such decisions where they do not benefit passengers. We conclude it is more likely than not that the unmonetised

[85] This is because legal constraints would restrict the consumer body from preparing for or carrying out its new functions until after Royal Assent (which is not expected until 2013). If the next regulatory settlements last for 5 years, this means the benefits of increased accountability would be not fully realised until 2019.

benefits associated with improved accountability under option 1d are likely to exceed the sum of i) any additional regulatory risk; and ii) the shortfall of £3.7m in monetised benefits. This is consistent with the results of Ofgem's analysis as part of its RPI-X@20 review[86] and the CC's recommendation in its investigation into BAA airports. It is also consistent with the Government's recent decision to provide affected parties with rights to appeal price control decisions in the postal services sector[87].

259. **Therefore our preferred option is option 1d**. However we emphasise that this assessment is based on the assumption that the design of the appeals regime will include a number of safeguards aimed at deterring unmeritorious appeals – if this were not the case then the above assessment would not necessarily hold.

[86] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=6&refer=NETWORKS/RPIX20/CONSULTREPORTS
[87] http://www.publications.parliament.uk/pa/bills/lbill/2010-2011/0066/lbill_2010-20110066_en_1.htm

Annexes

Annex 1 should be used to set out the Post Implementation Review Plan as detailed below. Further annexes may be added where the Specific Impact Tests yield information relevant to an overall understanding of policy options.

Annex 1: Post Implementation Review (PIR) Plan

A PIR should be undertaken, usually three to five years after implementation of the policy, but exceptionally a longer period may be more appropriate. If the policy is subject to a sunset clause, the review should be carried out sufficiently early that any renewal or amendment to legislation can be enacted before the expiry date. A PIR should examine the extent to which the implemented regulations have achieved their objectives, assess their costs and benefits and identify whether they are having any unintended consequences. Please set out the PIR Plan as detailed below. If there is no plan to do a PIR please provide reasons below.

Basis of the review: [The basis of the review could be statutory (forming part of the legislation), i.e. a sunset clause or a duty to review , or there could be a political commitment to review (PIR)]; The PIR plan represents a commitment to review the effectiveness of the proposed reforms after a full price control period.
Review objective: [Is it intended as a proportionate check that regulation is operating as expected to tackle the problem of concern?; or as a wider exploration of the policy approach taken?; or as a link from policy objective to outcome?] The PIR is intended to be a proportionate check that regulation is operating as expected, rather than a wider exploration of the policy approach taken. It will: (a) highlight any significant unintended consequences; (b) inform the CAA's approach in the subsequent price control period, including any elements that could be implemented differently; and (c) assess the extent of the overarching efficiency benefits as sets out above.
Review approach and rationale: [e.g. describe here the review approach (in-depth evaluation, scope review of monitoring data, scan of stakeholder views, etc.) and the rationale that made choosing such an approach] The proposed approach of the PIR is a stakeholder consultation, which would enable key stakeholders to air their views regarding the implementation of the reforms. As noted above the intention of the review is to be as efficient and light touch as possible. Provided there are no substantial and costly unintended consequences, canvassing stakeholders' views should support relatively minor changes to optimise implementation rather than another in-depth review of the regulatory framework.
Baseline: [The current (baseline) position against which the change introduced by the legislation can be measured] The baseline for the PIR is given by the 'do-nothing' option 0, i.e. retaining the relevant clauses contained in part IV of the Airports Act 1986 in relation to each distinct policy area.
Success criteria: [Criteria showing achievement of the policy objectives as set out in the final impact assessment; criteria for modifying or replacing the policy if it does not achieve its objectives] As noted above the primary objective of the proposed reforms is to support the interests of passengers; the extent to which the reforms support this in practice will therefore represent the key success criteria. Secondary to this, the PIR will assess the extent to which the reforms are successful in enabling the CAA to take a more flexible and less bureaucratic approach.
Monitoring information arrangements: [Provide further details of the planned/existing arrangements in place that will allow a systematic collection systematic collection of monitoring information for future policy review] It is planned for the CAA to gather, monitor and collate information necessary to inform the PIR. This will be supported to the extent necessary by a formal consultation of stakeholders' views.
Reasons for not planning a review: [If there is no plan to do a PIR please provide reasons here] N/A

Annex 2: Specific Impact Tests

Small firms

260. Currently only three airports are subject to economic regulation: Heathrow, Gatwick and Stansted. None of these airports could be classified as small firms. That said there is a theoretical possibility that at some point in the future an airport which is classified as a small firm could satisfy the relevant criteria and therefore be subject to economic regulation. However, the existence of the third criterion ("Regulatory intervention will deliver additional benefits for airport consumers (i.e. over and above competition law) that will exceed the costs or potential adverse effects of any regulatory intervention") should ensure that regulation is only ever imposed on any firm (including a small firm) if the benefits of regulation clearly exceed the costs. In practice the existence of this criterion will make it far less likely that a smaller airport will be subject to regulation – this is because the benefits of regulation at smaller airports (i.e. addressing the risk that the airport abuses its position of substantial market power) will be smaller because by its very nature a smaller airport will process fewer passengers. The smaller the benefits, the less likely it is that the cost-benefit test will be satisfied. The fixed costs associated with regulatory intervention will also reduce the likelihood of a small firm meeting this threshold and therefore being subject to regulation. As a result, we do not believe the reforms should have any material impact on small firms.

Health and well-being

261. The proposed reforms to the system of economic regulation for airports will not have any significant impact on health outcomes. This is where 'significant' is defined as affecting the whole of population or major sub groups and outcomes are defined in relation to health, well-being or health inequalities. The potential environmental consequences are addressed in separate tests below. However, there will be no impact on wider determinants of health, such as income, crime, housing, education, employment, agriculture or social cohesion. Further, there will be no change to physical activity, diet, smoking, drugs or alcohol use, sexual behaviour, accidents and stress at home or work. For example, the distances travelled by plane by the general population will not mean that improved airport experiences will lead to less travel from modes that are associated with physical activity, such as walking or cycling. Accordingly, we do not anticipate that there will be any effect on the demand for any health or social care services.

Statutory equality duties

Race

262. As discussed above, the purpose of the reforms is to improve the framework of economic regulation for airports. Given the existing regime is proposed to be replaced by new legislation; we do not anticipate that these reforms will lead to a material incremental impact on different ethnic groups relative to the current regulatory regime. The reforms develop a framework for the CAA to implement. Under the Equalities Act 2010, the CAA have become subject to the new Public Sector Equality Duty in April 2011, so it will be for the CAA to consider how they will interpret the policy. However, we do not anticipate that these reforms will lead to:

- Different consequences according to people's racial group;
- People being affected differently according to their racial group in terms of access to a service, or the ability to take advantage of proposed opportunities;
- Discrimination unlawfully, directly or indirectly, against people from some racial groups;
- Different expectations of the policy from some racial groups;
- Harmed relations between certain racial groups, for example because it is seen as favouring a particular group or denying opportunities to another; or
- Damaged relations between any particular racial group (or groups) and the DfT.

Disability

263. We do not believe that there will be a material impact on disabled people from the proposals relative to the current regulatory regime. The Equality Act 2010 gives rights to disabled people in the provision of air services (amongst other things). The proposals apply equally to all passengers, and so we do not anticipate any disadvantages or discrimination against disabled people, in line with this Act. The primary duty to the passenger is consistent with the Equality Act 2010 and could improve elements of the passenger experience delivered through wider reforms of economic regulation across UK airports. Furthermore, there are specific safeguards which ensure that people with disabilities and reduced mobility should be given assistance to meet their particular needs at the airport as well as on board the aircraft. In particular, the European Regulation EC No: 1107/2006 (which came into force on 26 July 2008) puts a legal obligation on air carriers and airport managing bodies in the European Union to take the necessary steps for disabled and reduced mobility passengers to be able to move through an airport from a designated point of arrival to departure, including boarding, disembarkation and transit between flights.

264. In addition, in carrying out its activities, the CAA is covered by the Disability Equality Duty, which requires public bodies to have schemes and action plans designed to actively anticipate and prevent disability inequalities, and to ensure that the body's policies, procedures and practices contribute to achieving that goal. The CAA has published its own Disability Equality Scheme which is available on its website.

Gender

265. We do not believe that there will be a material impact on different genders from the proposals relative to the current regulatory regime. The primary duty to promote passenger interests will apply to all passengers. The reforms develop a framework for the CAA to implement. Under the Equalities Act 2010, the CAA have become subject to the new Public Sector Equality Duty in April 2011, so it will be for the CAA to consider how they will interpret the policy. However, we do not anticipate that these reforms will lead to:

- Different consequences according to people's gender;
- People being affected differently according to their gender in terms of access to a service, or the ability to take advantage of proposed opportunities;
- Discrimination unlawfully, directly or indirectly, against genders; or
- Different expectations of the policy from different gender groups.

Rural proofing

266. We do not believe that the proposed reforms to the economic framework will have a different impact in rural areas, because of their particular circumstances or needs. This is conducive to proposed reforms which give the CAA flexibility to carry out its duties and to tailor solutions to the particular airport's circumstances, which might include its rural location.

267. Although some responses to the consultation raised issues about protecting access to London airports, specifically Heathrow, for services from UK regional airports these issues are not related to economic regulation of airports which is about protecting passengers from an abuse of substantial market power. As a result, having taken into consideration stakeholders' responses, we see no reason to revise this assessment.

Justice system

268. A justice impact test has been undertaken and submitted to the Ministry of Justice (MoJ) to judge whether the proposals have the potential to impact on the justice system: changing the funding for prosecution powers; giving the Secretary of State power to grant the CAA civil sanctions; and civil sanctions accompanying new publication powers for the CAA (e.g. sanctions for failure to provide information under notice). MoJ have assessed that the changes to airport economic regulation will have a **negligible impact on the justice system**.

Competition

269. This section provides the competition assessment for the package of reforms generated from the Review of Economic Regulation. It follows the structure suggested by the OFT's guideline for policy makers on 'Completing competition assessments in impact assessments'. It indicates that the proposed policy options will not harm competition and is in fact aimed at improving competitive outcomes in the British airport market. The proposals target those airports with substantial market power which could potentially restrict output, reduce service quality and investment and raise prices, ultimately to the detriment of consumers/end users. Economic regulation aims to remedy the risk that such airports abuse their market power and, as far as possible, reflect the outcomes that would prevail in a well functioning, competitive market. Giving the regulator powers to target regulation, remove regulation where it is not necessary and enforce competition law should facilitate the development of competition in the British airport sector.

Background

270. Heathrow, Gatwick and Stansted airports in Great Britain are price controlled, or have maximum prices set by the CAA, due to concerns about the extent of their market power. Further, the airports also have minimum service quality standards set by the regulator, following adverse public interest findings by the Competition Commission. However, there is evidence that many other airports in Great Britain do function in a competitive environment. The CAA has carried out two reviews of regional airports and its results indicate that these airports are likely to face strong competitive pressures. In fact, the CAA refers to competition between neighbouring regional airports as being accepted by the industry as a 'given'.

Direct limitation on the number or range of suppliers

271. The proposed package of reforms does not directly limit the number or range of suppliers. In particular, none of the proposals lead to:

- the award of exclusive rights to supply;
- procurement from a single supplier or restricted group of suppliers; or
- a fixed limit (quota) on the number of suppliers.

272. The movement from the existing rules based regime to a licence based system could raise concerns regarding competition and the ease of market entry. Whilst it is accepted that the creation of a licensing scheme which limits the number of market actors to those with a licence, it is not clear how relevant it is to market entry in this particular sector. This is because airports will only require a licence to operate if they satisfy the three relevant criteria – all other airports will not require a licence to operate. In this way, we do not believe that the proposed licensing regime will directly limit the number or range of suppliers in the market.

Indirect limitation on the number or range of suppliers

273. Indirect limitations on the number or range of suppliers might occur if the costs for the proposals are excessive or targeted at particular groups. We do not believe the costs associated with the package of reforms are excessive. We would expect the CAA to recover their costs through licence fees, with higher fees being directed at airports which have the more detailed requirements in their licences.

Limitation on the ability of suppliers to compete

274. The package of proposals does not limit the ability of suppliers to compete in any of the following ways:

- controlling or influencing (beyond those already in place to deal with the abuse of market power of 'licensees') either the price(s) a supplier may charge, or the characteristics of the product(s) supplied, for example by setting minimum quality standards;

- limiting the scope for innovation to introduce new products or supply existing products in new ways;
- limiting the sales channels a supplier can use, or the geographic area in which a supplier can operate;
- substantially restricting the ability of suppliers to advertise their products; or
- limiting the suppliers' freedoms to organise their own production processes or their choice of organisational form.

275. Further, contrary to limiting the scope for innovation to introduce new products or supply existing products in new ways, the new regulatory framework will not preclude the development of inter-terminal competition by allowing the CAA to consider commercial cases to develop and operate terminal facilities separately from the rest of the airport infrastructure, if it believed this would be in the passengers' interests.

Reduction in suppliers' incentives to compete vigorously

276. The proposals do not reduce suppliers' incentives to compete vigorously. They do not:

- exempt suppliers from general competition law;
- introduce or amend intellectual property regime;
- require or encourage the exchange between suppliers, or publication, of information on prices, costs, sales or outputs; or
- increase the costs to customers of switching between suppliers.

277. The package of reforms will give the regulator powers to target regulation, remove regulation where it is not necessary and enforce competition law - this should increase suppliers' incentives to compete vigorously.

Sustainable development

278. Sustainable development entails the current generation satisfying its basic needs and enjoying an improving quality of life without compromising the position of future generations. The proposals do not have an adverse affect the resources available to future generations, and are therefore compatible with sustainable development.

Greenhouse gas assessment

279. This proposal involves a number of changes to the regulatory framework for UK airports and as such may indirectly lead to changes in the environmental impacts associated with the operation of airports. However, any changes (which could be positive or negative) will be subject to the limits imposed by existing legislation as well as any relevant limits imposed by the planning authorities as a condition of planning consent.

280. There are a number of Government policies in place to ensure that the aviation sector plays its part in helping to reduce emissions. In relation to airports, the implementation of Carbon Reduction Commitment Energy Efficiency Scheme (CRC) will mean that all but the smallest airports will be required to purchase carbon allowances annually to cover their carbon dioxide (CO_2) emissions. This should ensure that the climate change costs associated with CO_2 emissions are appropriately priced into airport investment decisions, either directly through the additional costs from purchasing permits reflected in higher airport charges, or indirectly through the impact of higher air fares.

281. In relation to aviation, domestic aviation emissions have been included in the UK's carbon budgets, legislated for in the Climate Change Act 2008. There are a number of policies in place to help deliver the emission reductions:

- domestic and international aviation will be included in the EU emissions trading system (ETS) from 2012, which will place a cap on net EU aviation CO_2 emissions;

- the UK continues to push for an ambitious international agreement to a global sectoral target for aviation, as part of a wider global deal on emissions; and
- support for alternatives to travel; helping to make improvements in air operations, both in terms of more fuel-efficient practices and air traffic management; and support for the use of alternative fuels, provided these can be produced sustainably.

Wider environmental issues

282. This proposal involves a number of changes to the regulatory framework for UK airports and as such may indirectly lead to changes in the environmental impacts associated with the operation of airports. However, any changes (which could be positive or negative) will be subject to the limits imposed by existing legislation as well as any relevant limits imposed by the planning authorities as a condition of planning consent.

283. There are a number of Government policies in place to ensure that air quality and noise are kept at appropriate levels. The new framework for economic regulation of airports will work consistently with these policies, which are discussed further below.

284. European Directive 2002/30/EC of 28 March 2002 reflects and implements the 'balanced approach' regulatory framework to aircraft noise management recommended by the International Civil Aviation Organisation (ICAO). Under this directive – which has been incorporated into UK legislation by The Aerodromes (Noise Restrictions) (Rules and Procedures) Regulations 2003 – major airport operators (i.e. above 50,000 aircraft movements per year) must have regard to a number of rules and procedures when introducing noise related operating restrictions.

285. In addition, the Civil Aviation Act 1982 provides the Secretary of State with powers to impose regulations governing aircraft noise at airports designated for noise control purposes. So far these powers have only been used in respect of Heathrow, Gatwick and Stansted airports. However, the Civil Aviation Act 2006 introduced statutory powers for non designated airport operators to develop noise control schemes, fine aircraft that breach noise control measures and introduce charges that reflect the pollution generated by each aircraft type.

286. European Directive 2002/49/EC requires all major airports to develop strategic noise action plans. These plans – which need to be produced in consultation with the local community – will set out action by airports to mitigate aircraft noise. These plans are expected to be completed and agreed in coming months.

287. Local air quality is regulated by EU and national legislation which sets fixed limits that need to be adhered to for a range of emissions (including benzene, 1,3-butadiene, carbon monoxide, led, nitrogen oxide, oxides of nitrogen, PM10 and sulphur dioxide). The national legislation states that the Secretary of State should take measures to ensure that concentrations do not exceed the specified limit values.

288. As with noise management, the Civil Aviation Act 2006 introduced statutory powers enabling airports to levy airport charges in line with local emissions. BAA has used these powers at a number of its airports. The Secretary of State also has powers to direct airports to levy such charges.

289. In terms of airport development, airport operators are required to take local air quality impacts into account at the planning stage of the development process via an environmental impact assessment and are required to determine the extent of any predicted excess over the local air quality targets.

Human rights

290. The proposals include provisions allowing for the imposition of financial penalties for breach of licence conditions, for price controls on some airport operators, and for ring-fencing provisions which may affect property rights. Accordingly, these proposals appear to engage ECHR convention rights in respect of property (Protocol 1, Article 1) and the right to a fair trial (article 6).

291. The imposition of civil penalties on regulated bodies for breach of regulatory requirements is not unusual. The penalties will need to be reasonable. There will be a right of appeal against the making of enforcement orders to the Competition Appeals Tribunal. The appellate body is to be empowered to quash the Order or any part of it, or uphold it. It is intended that the imposition, timing and/or

amount of any penalty may be appealed. It is intended that the appellate body will be empowered, inter alia, to quash or substitute a lesser sum. This will provide appropriate right of access to an independent and impartial tribunal.

292. The right to property is not an unqualified right. Deprivation of property in the public interest and subject to the conditions provided for by law is allowable. So, too, is the enforcement of laws to control the use of property in accordance with the general interest. These proposals will also empower the CAA as regulator to interfere with property rights in various ways. However, these powers are to be exercised in the public interest and in accordance with relevant statutory duties which include a primary duty to promote the interests of existing and future end consumers of passenger and freight services at UK airports, wherever appropriate by promoting effective competition. The CAA also has supplementary (subordinate) duties which include a duty to ensure that licence holders are able to finance the activities which are subject of relevant licence obligations. Further, economic regulation can only be imposed on airports with substantial market power and for which regulatory intervention is justified.

Annex 3: Annual profiles of monetised costs and benefits for the non-preferred options

Annual profile of monetised costs and benefits* – (£m) constant prices – Option 1a

	Y_0	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7	Y_8	$Y_{9\text{-}20}$
Transition costs	0	0.6	0	0	0	0	0	0	0	0
Annual recurring cost	0	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Total annual costs	0	2.8	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Transition benefits	0	0	0	0	0	0	0	0	0	0
Annual recurring benefits	0	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7
Total annual benefits	0	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7

Annual profile of monetised costs and benefits* – (£m) constant prices – Option 1b

	Y_0	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7	Y_8	$Y_{9\text{-}20}$
Transition costs	0	0.6	0	0	0	0	0	0	0	0
Annual recurring cost	0	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Total annual costs	0	3.4	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Transition benefits	0	0	0	0	0	0	0	0	0	0
Annual recurring benefits	0	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7
Total annual benefits	0	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7

Annual profile of monetised costs and benefits* – (£m) constant prices – Option 1c

	Y_0	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7	Y_8	$Y_{9\text{-}20}$
Transition costs	0	0.6	0	0	0	0	0	0	0	0
Annual recurring cost	0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Total annual costs	0	3.6	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Transition benefits	0	0	0	0	0	0	0	0	0	0
Annual recurring benefits	0	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7
Total annual benefits	0	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7

Annual profile of monetised costs and benefits* – (£m) constant prices – Option 1e

	Y_0	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7	Y_8	$Y_{9\text{-}20}$
Transition costs	0	0.6	0	0	0	0	0	0	0	0
Annual recurring cost	0	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Total annual costs	0	3.2	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Transition benefits	0	0	0	0	0	0	0	0	0	0
Annual recurring benefits	0	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7
Total annual benefits	0	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7	13.7

293. Note the final column displays the annual profile for each of the final 12 years – since these costs are identical for each of these years. In practice some of the on-going costs (e.g. those associated with the number of proposed licence modifications and the number of objections to the licence modifications) will be lumpy. However, due to the fact that it is difficult to predict in advance when exactly such costs would be incurred, the tables above smooth the on-going costs over the 20 year period.

Annex 4: How the Airport Economic Regulation reforms will adhere to the Principles for Economic Regulation

294. The Government has recently reaffirmed its commitment to stable and predicable regulatory frameworks through the publication of its Principles for Economic Regulation[88]. The six principles of accountability, focus, predictability, coherence, adaptability and efficiency (see annex 5 for definitions of each Principle) are key to the high level design of the frameworks for economic regulation. The table below sets out how the options either conflict or comply with each of the principles[89]. We have also used a system of + and – to illustrate the degree of adherence and conflict for each option with the Principles. We conclude that the preferred option fully adheres to the six principles. Note the final column sets out any differences in compatibility with the Principles the three non-preferred options have compared to option 1d[90].

Table 9: Compatibility of the Options with the Principles for Economic Regulation

Principle	Option 0 – Current Regime	Option 1d – Preferred Option	Options 1a to 1c and 1e
Accountability	**CONFLICTS WITH PRINCIPLES** (---) • The CAA has a discrete set of statutory duties for economic regulation. This provides a framework for independent regulation, although we believe the duties need to be updated to ensure compatibility with the Principle of Focus (next row). • Significant regulatory decisions, such as decisions on which airports should be subject to economic regulation, are taken by the Secretary of State. This is a direct conflict with the 2nd part of this Principle. • The only route of challenge for regulatory decisions is via judicial review. Consultees generally did not consider judicial review to be a sufficient basis on which to challenge the decisions' merits. Also, the non-binding automatic reference to Competition Commission for price control decisions is widely regarded as inflexible and bureaucratic. The lack of scrutiny and challenge does create predictability in the regime, which supports the Principle of predictability (see the 3rd Principle). However, we do not believe that there is the correct balance between predictability and accountability.	**ADHERES WITH PRINCIPLES** (+++) • The CAA will have a new set of statutory duties for economic regulation of airports. This will continue to provide a framework for independent regulation but will also be compatible with the Principle of Focus (see next row). • All regulatory decisions will be taken by the CAA including decisions for whether an airport is subject to economic regulation. This will address the direct conflict that currently exists with this Principle (outlined in the 2nd bullet of the previous column). • Merits-based appeals will be introduced in addition to judicial review for several key CAA decisions. These decisions include licence modifications (including price controls), enforcement decisions and decisions over whether an airport is subject to economic regulation. This should ensure that the regulator's decisions are subject to sufficient scrutiny and challenge. The improvement in scrutiny and challenge will create some uncertainty in the regime, which conflicts partially with the Principle of predictability (see the 3rd Principle). However, we believe that this increase in accountability will create the correct balance between predictability and accountability.	**ADHERES WITH PRINCIPLES** (++) • Same as for option 1d. • Option 1b provides a greater role for Government. This only gives the Secretary of State a role to challenge and not take the decision, so this still fits within the Principles. • Each option offers arguably different levels of scrutiny and challenge to CAA licence modification decisions. We believe the evidence shows that options 1a to 1c provide less scrutiny and challenge than the preferred option (see paragraphs 240). Despite these options providing a greater degree of predictability (see the 3rd Principle) than option 1a, we do not believe that these options would provide the correct balance between predictability and accountability. Although, they would offer an improvement to the current regime.

[88] Available at http://www.bis.gov.uk/assets/biscore/better-regulation/docs/p/11-795-principles-for-economic-regulation.pdf
[89] Each bullet of each Principle (as set out in Annex 5) is addressed in the order in which they appear in Annex.
[90] Note the options only differ on who has a right to challenge licence modifications – see paragraphs 15 and 16 for details.

Principle	Option 0 – Current Regime	Option 1d – Preferred Option	Options 1a to 1c and 1e
Focus	**CONFLICTS WITH PRINCIPLES** (---) • The current duties of the regulator are in direct conflict with this Principle since they do not concentrate on protecting end users but all users. This will include intermediate users as well as end users. • The CAA's statutory responsibilities are governed by duties under which it must judge the best manner to carry out its functions. These are focussed on outcomes rather than tools. However, the CAA is restricted in carrying out its functions (can impose 5 year price controls only) and some stakeholders have expressed that it is not clear how the CAA balances its current duties. • The existing regime provides no flexibility in terms of the form of economic regulation the CAA can apply. The CAA must apply five year price controls to airports designated by the Secretary of State.	**ADHERES WITH PRINCIPLES** (+++) • The new duties will reflect the Principles and will focus on end users of airports (passengers and end users of cargo). • The single primary duty (with supplementary duties) will bring clarity to the CAA's responsibilities. The duties will be focussed on outcomes rather than tools. Furthermore, the new licensing regime will allow the CAA greater flexibility in the selection of regulatory tools. • The new licensing regime will grant the CAA greater flexibility in the selection of different forms of regulation. Furthermore, by empowering the CAA with concurrent competition powers, the CAA will be able to balance sectoral regulation with competition law, which could facilitate more proportionate regulation and potentially reduce regulatory burdens on industry that would occur through unnecessary use of sector specific regulation.	**ADHERES WITH PRINCIPLES** (+++) • Same as for option 1d. • Same as for option 1d. • Same as for option 1d.
Predictability	**ADHERES WITH PRINCIPLES** (++) • The current regime is twenty five years old. Although industry fully understands the process, industry has expressed that there is considerable uncertainty on the outcomes that the process generates. This comes from the impact of the non-binding reference to the Competition Commission. Some stakeholders have expressed that the presence of the Secretary of State in the decision-making process generates regulatory uncertainty. • It is very difficult to unravel past decisions, since judicial review is the only route of challenge to CAA's decision making. Hence this Principle is consistent with the current regime. However, this lack of merits based challenge that	**ADHERES WITH PRINCIPLES** (+) • The introduction of economic licences will bring the regime in line with other regimes. In the short run there may be increased uncertainty in outcomes whilst investors learn how the system operates in the airport industry. However, in the long run this will improve predictability for investors who are more familiar with this type of regime. Furthermore, the removal of the Secretary of State from decision-making should provide a more stable environment for investment. • The introduction of merits based appeals will provide greater scope for CAA's decisions to be challenged. However, allowing for merit based appeals brings greater accountability to CAA's decision making (see the 1st Principle) and was generally supported by	**ADHERES WITH PRINCIPLES** (+/++) • Same as for option 1d. • Appeal rights across the four options differ for licence modification challenges. These options offer arguably less accountability than option 1d but greater predictability since there would be fewer appeals under these options. These options would provide a shift towards a greater balance between accountability and would be better than the current regime. However, we do not believe this provides the correct balance, which the preferred option offers.

Principle	Option 0 – Current Regime	Option 1d – Preferred Option	Options 1a to 1c and 1e
	creates predictability conflicts with the Principle of accountability (see 1st Principle). We do not believe the current regime provides the correct balance between accountability and predictability.	stakeholders so long as it did not result in numerous speculative appeals. We believe the proposed reforms will provide the correct balance between accountability and predictability.	
Coherence	**ADHERES WITH PRINCIPLES** (++) • DfT is calling for evidence on the future direction of aviation policy[91] with the view of setting out the Government's policy on aviation in Spring 2012 for consultation. We expect this to be fully coherent with the current regime for airport economic regulation. • Presently, airport economic regulation is incoherent amongst wider Government policy on economic regulation, since it is widely regarded as being out of date and not following regulatory best practice.	**ADHERES WITH PRINCIPLES** (+++) • We expect wider Government policy on aviation to be fully coherent with the proposed regime for airport economic regulation. • The new regime will follow regulatory best practice and hence will be coherent with other sectors' regimes. Furthermore, granting concurrent competition powers to the CAA will align the regulator with other sector regulators who already have these powers.	**ADHERES WITH PRINCIPLES** (+++) • Same as for option 1d.
Adaptability	**CONFLICTS WITH PRINCIPLES** (---) • The current regime is widely considered as inflexible and out of date and because of this is considered to conflict with this Principle. For example, all designated airports must be subject to 5 yearly price caps – the CAA cannot use less burdensome forms of regulation (e.g. price monitoring) even if it would benefit passengers. Nor does the current regime provide flexibility to amend the quality standards within the 5 year price cap period.	**ADHERES WITH PRINCIPLES** (+++) • The new regime will allow the CAA to implement more appropriate forms of regulation and be adaptable to changing circumstances. The reforms will bring the regime into line with this Principle.	**ADHERES WITH PRINCIPLES** (+++) • Same as for option 1d.
Efficiency	**CONFLICTS WITH PRINCIPLES** (--) • A cost benefit test is part of the criteria for the Secretary of State determining whether an airport is subject to economic regulation. This ensures these decisions are cost effective. However, the stringent form of regulation set every five years	**ADHERES WITH PRINCIPLES** (+++) • The cost benefit test will be retained as part of the criteria applied by CAA to determine whether an airport should be subject to economic regulation. CAA will also have more flexibility in imposing different forms of regulation and the licensing	**ADHERES WITH PRINCIPLES** (+++) • Same as for option 1d.

[91] http://assets.dft.gov.uk/consultations/dft-2011-09/consultationdocument.pdf

Principle	Option 0 – Current Regime	Option 1d – Preferred Option	Options 1a to 1c and 1e
	does not allow for timely decision making whilst unnecessary bureaucracy in the current regime means interventions are not as cost effective as they could be.	regime will enable the CAA to respond in a more timely fashion. Unnecessary bureaucracy inherent in the current regime will be removed.	

295. Alongside the Principles, the Government has set out nine commitments to ensure the principles are enshrined in Government's policy making on economic regulation (see annex 5 for full details of each commitment). In particular, commitment 8 - assessing any proposed changes to the regulatory framework against these principles - is discharged by this Impact Assessment. With regard to the other relevant commitments, moving to the proposed regime will mean the Government meets commitments 1, 2, 4, 5 and 6 for airport economic regulation.

Annex 5: Government's Principles for Economic Regulation

Principles

Accountability

- independent regulation needs to take place within a framework of duties and policies set by a democratically accountable Parliament and Government
- roles and responsibilities between Government and economic regulators should be allocated in such a way as to ensure that regulatory decisions are taken by the body that has the legitimacy, expertise and capability to arbitrate between the required trade-offs
- decision-making powers of regulators should be, within the constraints imposed by the need to preserve commercial confidentiality, exercised transparently and subject to appropriate scrutiny and challenge

Focus

- the role of economic regulators should be concentrated on protecting the interests of end users of infrastructure services[92] by ensuring the operation of well-functioning and contestable markets where appropriate or by designing a system of incentives and penalties that replicate as far as possible the outcomes of competitive markets.
- economic regulators should have clearly defined, articulated and prioritised statutory responsibilities focussed on outcomes rather than specified inputs or tools
- economic regulators should have adequate discretion to choose the tools that best achieve these outcomes

Predictability

- the framework for economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence
- the framework of economic regulation should not unreasonably unravel past decisions, and should allow efficient and necessary investments to receive a reasonable return, subject to the normal risks inherent in markets

Coherence

- regulatory frameworks should form a logical part of the Government's broader policy context, consistent with established priorities
- regulatory frameworks should enable cross-sector delivery of policy goals where appropriate

Adaptability

- the framework of economic regulation needs capacity to evolve to respond to changing circumstances and continue to be relevant and effective over time

Efficiency

- policy interventions must be proportionate and cost-effective while decision making should be timely, and robust

[92] i.e. current and future consumers, and in some sectors taxpayers, who ultimately pay for the services.

Commitments

Commitment 1

The Government commits to ensure that responsibilities are clearly divided between Government and regulator on the basis that high level decisions that involve political judgement are taken by Government and day-to-day regulatory decisions are undertaken by regulators.

Commitment 2

The Government will preserve the independence of economic regulators. It will ensure that:

• regulators are legally distinct and functionally independent from any other public or private entity when carrying out their functions

• regulators' staff and management act independently from any market interest and do not seek or take direct instructions from any government or other public or private entity when making regulatory decisions

• regulators can take autonomous decisions, independently from any political body, and have separate annual budget allocations, with autonomy in the implementation of the allocated budget, and adequate human and financial resources to carry out their duties.

The Government will continue to ensure that it does not interfere with day-to-day regulatory decision making.

The Government will ensure regulators have discretion to choose the regulatory tools to deliver their objectives.

The Government will ensure that future changes preserve the independence of regulators.

Commitment 3

The Government therefore commits to put in place, for each regulated sector, strategy and policy statements for the individual regulators to provide context and guidance about priorities and desired outcomes.

When it sets out the policy context, the Government will use that opportunity to reaffirm the fitness for purpose of the regulators' responsibilities, pursue changes where they are required to keep the system effective and clarify the respective roles and responsibilities of regulator and Government.

The Government expects to do this no more frequently than once a Parliament.

The Government will avoid making piecemeal and ad hoc changes to the system for economic regulation outside of this process to provide stability.

Relevant departments will set out the details of how this process will operate, taking into account the differing needs of the sectors.

There may be circumstances or specific triggers that would necessitate Government action outside of this once-a-Parliament process. This will be done only on an exceptional basis, for example implementation of European legislation, as the emphasis should be on providing predictability about Government's approach.

The Government will have particular regard to the effect on investor confidence when assessing changes to the regulatory policy and regulatory frameworks. This will be addressed in the impact assessments of any proposed changes.

Commitment 4

The Government expects regulators to follow consultation best practice in their decision making, including the use of impact assessments and the publication of the reasoning underpinning regulatory decisions.

The Government strongly encourages regulators to disclose the methods and financial models used to inform regulatory decisions, with appropriate removal of commercially confidential information.

The Government will ensure appropriate and proportionate mechanisms exist to challenge regulatory decisions to an independent third party.

Commitment 5

The Government will ensure that regulators' objectives are clear and appropriately prioritised (including through broader guidance) to reflect the issues that the regulators should take into account in their decisions.

The Government will take opportunities to simplify and clarify regulators' objectives where appropriate as and when the frameworks are reviewed.

The Government will not seek to add objectives, responsibilities or duties to regulators' remits without detailed consideration of the impact of the addition on the overall framework, and consideration of cross-sector impacts and even then only when it is clear that the addition is the optimal way to achieve the outcome sought.

Commitment 6

The Government will apply the duties and obligations of Part IV of the RES Act to the economic regulatory functions of the CAA and Monitor[8] in upcoming legislation.

The Government will keep the effectiveness of Part IV of the Regulatory Enforcement and Sanctions (RES) Act 2008 under review.

The Government expects regulators to adopt best practice to improving their efficiency.

The Government will investigate the possibility for an independent third party to regularly assess the efficiency of regulators.

Commitment 7

The Government strongly encourages the Joint Regulators' Group to adopt a more systematic approach to issues of cross-sector coherence and best practice.

Commitment 8

The Government will assess any proposed changes to the regulatory frameworks (either statutory changes or changes to the to the general policy direction set out in the strategy and policy statements) against the Principles for Economic Regulation and demonstrate how the changes adhere to these Principles.

The Reducing Regulation Cabinet Committee will be responsible for clearing proposed changes and policing the fulfilment of Government's commitments for the application of the Principles for Economic Regulation.

The Department for Business, Innovation and Skills, within its existing cross-sector responsibilities for Economic Regulation, will have ownership of these Principles, and will scrutinise the Government's adherence to them. It will advise the Reducing Regulation Committee accordingly, and particularly on how the interests of consumers, other end users, regulated firms and investors are being promoted.

Annex 6: One-in, One-out

296. The Government is committed to cutting regulatory red-tape with the One-in, One-out (OIOO) approach to regulation, whereby new regulation cannot be introduced without a greater cut in regulation elsewhere. **The recasting of this policy through repealing Part IV of the Airports Act 1986 and replacing it with a less burdensome regime is an OUT.** The reforms will make a positive contribution to this policy, since the reforms will generate a positive net benefit to business from replacing the existing regulatory framework. Further evidence and analysis is required to validate the value of this OUT and consequently, at this stage the OUT has not yet been quantified. The DfT with the assistance of the CAA have identified an approach to quantify this OUT but this quantification will not be possible until the CAA have completed further work on the next price review during the next two years. However, this will be ready to be included in the Statement of New Regulation for when the policy is implemented in April 2014.

297. The Regulatory Policy Committee (RPC) scrutinised the "Reforming the framework for economic regulation of airports" impact assessment in July and August 2011 and gave the impact assessment an AMBER rating. The RPC's opinion stated "that it is difficult to conclude … that the estimated benefits to business are robust for the purposes of One-in, One-out. Since the IA provides sufficient evidence to suggest that the benefits to business will outweigh the costs, we propose that this is treated as an OUT with a value of zero." The RPC recommended "further evidence and analysis, for example from the CAA in anticipation of the next price review, is gathered on the benefits when they begin to accrue prior to the OUT appearing in the relevant Statement of Regulation. The value of the OUT can then be validated at that stage." Consequently, at this stage we have not been able to quantify the OUT but the CAA has agreed to assist DfT in gathering this evidence during the Q6 price review.

298. DfT's preliminary analysis suggests that for the preferred option (option 1d) the best estimate is that the Equivalent Annual Net Cost to Business (EANCB) is -£10.7m with a range of £4.6m to -£61.2m. Note, as in line with the OIOO guidance, the estimates presented here (and in the summary sheets) are in 2009 prices and have a 2010 present value base year.

299. To derive the above estimates we need to determine which costs and benefits are realised by business. The Better Regulation Executive has confirmed that the OIOO calculations should only take into account the direct costs and benefits to business. Consequently, we do not consider any benefits or costs that are indirectly passed on to business in these calculations.

300. On the benefits side, the efficiency benefits (in terms of operating expenditure, capital expenditure and an airports lower cost of capital); the reduced burden on unlicensed airports[93]; the avoided cost to the airport from the removal of the automatic reference of price controls to the Competition Commission and the resource savings to the CAA and CC (which are directly funded by industry through the CAA charges)[94] are all benefits directly to business. Consequently, the equivalent annual benefit to business for option 1d (preferred option) is £12.8m for the best estimate (with a range of £0.4m to £61.7m).

301. On the costs side, there are costs to airports from the appeals regarding decisions over enforcement decisions; decisions over whether an airport is subject to economic regulation and licence modifications; also costs to the interveners for option 1d (either airlines or airports) and resource costs to the CAA and CC (see footnote 95). There are also costs to appellants, which could be realised by business (airlines or airports) or could be realised by the taxpayers (Secretary of State for option 1b). As explained in footnote 99, we do not attempt to apportion these costs to different parties. Consequently, we conservatively assume that all these costs are to business. Therefore, the equivalent annual cost to business for option 1d (preferred option) is £2.2m for the best estimate (with a range of £0.5m to £5.0m).

[93] Note, this only applies to the high case scenario (see paragraph 100). For the best estimate, we assume there is no impact.

[94] The CAA funds its activities through charges to industry and the CC currently (and will continue to under its new functions in the new regime) to recover its costs from the CAA, who will subsequently pass these on to industry through its charges.

302. The same methodology has been used to calculate the net benefit to business of the other options. Table 10 below presents the range of the net benefit to business for each of the options:

Table 10: Range of estimates for the Equivalent Annual Net Cost to Business across the four options

Option	Parties with rights to object	Low	Best	High
Option 1a	Airport operator only	£4.2m	-£10.9m	-£61.2m
Option 1b	Secretary of State and airport operator	£5.3m	-£10.6m	-£61.2m
Option 1c	Consumer body and airport operator	£6.2m	-£10.1m	-£61.0m
Option 1d	Airlines and airport operator	£4.6m	-£10.7m	-£61.2m
Option 1e	Airlines, consumer body and airport operator	£4.8m	-£10.5m	-£61.0m

Annex 7: Methodological assumptions underpinning the estimates of costs and benefits

303. This annex provides details of some of the key methodological assumptions used in this IA to estimate the costs and benefits.

304. In order to reflect future uncertainty (in the overall benefits section as well as in the seven specific policy areas) we have presented both costs and benefits in many cases as a range, which reflects low case and high case assumptions. Where we focus on a single number, this represents our best estimate assessment taking into account our best estimate for each cost and benefit. This does not necessarily correspond to the mid-point between our low and high case assumptions. We provide detailed discussion of low and high case assumptions only when they drive significant differences in the overall balance of costs and benefits. The overall range of costs, benefits and net benefit provided in the summary pages above (pages 2, 4 6, 8 and 10) take the lowest costs and highest benefits in present value terms for the high end of the range and *vice versa* for the low end. The overall best estimate constitutes the best estimates for each of the individual assumptions in this impact assessment, each of which is explained in the evidence base above.

305. For the costs and benefits the following generic assumptions have been used. A CAA Full Time Equivalent (FTE) is assumed to cost £80k per year; this cost is used as the basis for cost assumptions for comparable staff at other organisations. All labour costs also include non-wage labour costs, such as employers' contributions to National Insurance. NPV calculations are performed over a period of 20 years using a real discount rate of 3.5%. Where we have estimated costs and benefits, we have, wherever possible, consulted the organisations (including BAA, CAA, Competition Appeals Tribunal and Competition Commission) to which these costs and benefits apply to ensure these estimates are as accurate as possible.

306. Previous versions of this IA have used a 10 year appraisal version. For this version, we have changed to a 20 year appraisal period. This is because we expect that given the present regulatory regime has lasted over 20 years; we expect the proposed system to last at least that long. Furthermore, this period is more appropriate as it better reflects the length of asset lives in this sector (which in some cases can exceed 20 years). However, since very few of the costs or benefits are one-off in nature, the choice of time period is not significant in determining the overall balance between costs and benefits and the ranking of the options.

307. Table 7 above sets out the key assumptions for the number of licence modifications (constant across the options) and the proportion of those licence modifications challenged, which varies depending on who has a right to challenge. These assumptions are based on email correspondence and face-to-face discussions between the CAA and Department for Transport in May 2011. The CAA's initial advice to the Department for Transport outlined the following assumptions for the number of licence modification (based on a ten year appraisal period):

	Low	Mid	High	Assumptions on Mid numbers
Operator	0	0	0	Assuming a revocation would not count as a modification for these purposes as it would be to the CAT not CC
Area	0	0	0	As above plus I think the likelihood of there being multiple operators at an airport in the next 10 years is quite low
Operable parts	0	2	4	Assume one change at each remaining operator
Accounts	0	0	0	Pretty standard so low risk of a change
Price regulation	5	5	5	Assume one every 5 years: three first time round then two
PI	5	5	5	Historically been an addition/removal or tweak of some sorts along with the price control. So my assumption is that this will continue.
Financial resilience	1	3	5	As there will be c10 obligations within this condition, I'm assuming one will be changed per remaining operator plus an extra one at LHR
Operational resilience	1	2	4	Assume one change at each remaining operator
Total	**12**	**17**	**23**	

308. Discussions with the CAA following this initial advice led to the following changes to these assumptions being agreed, which generated the final assumptions for the number of licence modifications in Table 7:

- Despite the PI (public interest) and price regulation licence modifications being separate licence conditions, in practice these will be linked and any appeal would cover both so for the purpose of the IA the CAA thought it was sensible to consider them as one (appealable) licence modification for each PI/price regulation licence modification.
- The CAA agreed that there was uncertainty regarding the number of these licence modifications going forward (for example an airport may fall out of economic regulation in the future) and so the CAA agreed it was sensible to increase the range to 4-5-6 instead of 5-5-5.
- Because the appraisal period to 20 years from 10 years the CAA agreed it was sensible to double the number of licence modifications.
- CAA believed that it would be sensible to separate the modifications into major (PI/price reg, financial resilience) and minor (operational resilience, operable parts).

309. Between May 2011 and July 2011 the CAA and DfT also discussed the proportion of the licence modifications that would be appealed. The 50% proportion for the best estimate for option 1d is based on the proportion of actual appeals to date in the telecoms industry (and to be conservative also assumes all four telecoms price control decisions made this summer are appealed). The CAA agreed that this was a sensible working assumption. The assumptions for the remaining options were based on discussion between CAA and DfT on the relative differences between these options and option 1d. The CAA agreed that option 1a would likely generate the lowest proportion of appeals and that 20% was a sensible working assumption. The CAA was confident that the proportion of appeals for options 1b and 1c would fall between the 20% of option 1a and 50% for 1d. However, the CAA agreed that there was considerable uncertainty of where in this range the assumptions for the options should fall. Despite this uncertainty, the CAA agreed that option 1b would provide the next lowest proportion of appeals and that 30% was a sensible working assumption for this option. For option 1c the CAA agreed that it was likely to provide a greater proportion of appeals than option 1a and 1b but less than 1d and the CAA agreed that 40% would be a sensible working assumption. Finally, the CAA agreed that it was not clear whether the proportion of appeals taken forward would increase by giving a right of appeal to the consumer body over and above airlines and therefore, agreed that 50% was an appropriate working assumption. In addition to these assumptions, it was agreed with the CAA that given the difficulties in predicting the number of appeals in advance that large ranges would be required to reflect this uncertainty in the proportions of appeals.

Annex 8: Costs associated with Competition Commission investigations under option 1a

310. This annex outlines the assumptions behind the costs of the Competition Commission investigations for option 1a. Note options 1b and 1c have exactly the same assumptions regarding costs per investigation. The only difference is with regard to the number of licence modifications that are challenged. The costs for these options are summarised above (see paragraphs 194 and 212).

311. Estimating in advance the additional resources required by the Competition Commission and other parties is difficult, since the number and complexity of objections is highly uncertain. We assume for our best estimate that the direct cost to the Competition Commission of an objection is equivalent to the cost of a referral under the current regime, which costs around £1.2m. We note this is significantly higher than the Competition Commission's costs in the recent Bristol Water case, which amounted to approximately £0.65m. Our low case assumes a cost of £0.8m, while our high case assumes a cost similar to that of a typical referral, at around £1.6m. Combined with our assumptions regarding the number of objections, the best estimate of the costs incurred by the Competition Commission amount to £3.1m in present value terms (consisting of £2.6m for major modifications and £0.6m for minor modifications and a total annualised cost of around £0.2m). Our low case and high case present value costs are £0m and £9.9m respectively.

312. As mentioned above, an investigative approach can place a significant burden on the regulated company. For consistency with the other options (where an objection is not necessarily initiated by the licensee), we have split the appeal costs for the airport operator into two: the costs incurred from launching an objection (which for other options is not necessarily a burden on the airport operator) and the remaining cost to the licensee from an objection (this cost is realised by the licensee regardless of who launches the objection) including information gathering costs, diverting management's time and resource burden costs[95].

313. For the first set of objection costs, under an investigative approach the costs to the objector (the licensee in this case) from launching an appeal should be much lower. As a result, we assume the costs to an objector under an investigatory approach would be around half those incurred by an objector launching an appeal. Our best estimate assumption is therefore that objector costs would be around £0.25m per objection. Combined with our best estimate assumption of 3 objections to major and 2 objections to minor licence modifications over the 20 year appraisal period, expected annualised objector costs are £0.05m or £0.7m in present value terms (£0.5m for major modifications and £0.1m for minor modifications). Present value costs for the low and high cases are £0m and £1.5m respectively, reflecting our assumptions on both objector costs and the likely number of objections.

314. For the costs always incurred by the licensee as a result of an objection i.e. irrespective of who objects, BAA has told us that the costs imposed on them could be broadly similar to the costs imposed on them currently under the present system as a result of an automatic referral to the CC. BAA indicated that costs of a six month challenge could range from £2m to £3m (with resources required for up to one year to prepare for the investigation). Given the design of the investigation there would be limited time to prepare for an investigation, since an investigation will be launched very soon after the CAA decision, so we take the lower bound of £2m as our best estimate[96]. However, we do assume that for the high case scenario that the cost could be as high as the upper end of the BAA's estimate of £3m and for the low case we assume £1.5m. Combined with our assumptions regarding the number of objections, the best estimate costs incurred by the airport amount to £5.2m in present value terms (consisting of £4.3m for major modifications and £0.9m for minor modifications and a total annualised cost of around £0.4m). Our low case and high case present value costs are £0m and £18.5m respectively.

315. Our assumptions regarding the ongoing costs to the CAA have been developed through consultation with the CAA. This reflects a single FTE covering appeals on which airports should be

[95] We realise there is a possibility that with this approach of double-counting, since there may be some overlap between these two distinct costs for the licensee. However, we believe this overlap should be small particularly as the costs of launching an objection are relatively small at £0.25m in present value terms (for a major modification) and furthermore, we do not wish to add further uncertainty to the costs by making assumptions regarding who will object. Nevertheless, it is worth recognising that there may be marginally lower costs for option 1a than option 1b, 1c, 1d and 1e where there is a possibility that a party other than the licensee can object.

[96] Furthermore, unlike investigations in other regulated industries which typically provide a power for the regulator to extend the investigation period for up to 6 months. If an investigation was adopted for airports, then the extension period would be short (for up to 3 months), which would also support our best estimate for the lower end of BAA's estimate.

subject to economic regulation as well as, standard licence modification objections. We assume that, given the number of objections assumed, 0.5 FTE would be required, alongside £0.05m per year in external ad-hoc advice. This is equivalent to £0.2m per investigation. Our best estimate assumption is therefore that the CAA's present value costs would amount to £0.6m in total (consisting of £0.5m for major modifications and £0.1m for minor modifications and a total annualised cost of £0.04m).

316. We note that it is unlikely that the CAA could improve decisions (as a result of potential objections) at zero marginal cost. Once again we assume that any costs related to this argument are already included in the above estimates for administering the licensing regime.

317. Finally, under an investigative approach, the Competition Commission will have regard to evidence submitted by all interested parties (and any evidence the Competition Commission goes out and obtains itself). As a result there could be resource costs incurred by other parties (including airlines for example). However, these parties could normally contribute to the automatic referral process, and so the overall net effect is unclear. We assume that any additional costs imposed on wider parties under this option (over and above the status quo) will already be captured by the estimated costs to the objector discussed above[97].

318. Overall, the total cost of an investigation amounts to £3.7m per investigation. This is more expensive than an appeal (£2m), which is a more efficient process but for reasons outlined in the main text is the only appropriate system of challenge for options 1a, 1b and 1c.

[97] The above objection-related costs are highly uncertain, dependent as they are on the eventual number of objections. We believe our assumptions to be representative, but we note that the NPV calculations are high-level and illustrative. We again note that the profile of objections over time may vary, and the assumptions presented above reflect our best estimate of the average yearly burden. We assume that this average is representative, and note that any modest redistribution of objections over time should have a very limited impact. This is also the case when considering the assumption regarding the number of objections for options 1b, 1c, 1d and 1e.

Annex 9: Costs associated with Competition Commission appeals under option 1d

319. This annex outlines the assumptions behind the costs of the Competition Commission appeal for option 1d. Option 1d operates an appeal rather than an investigation (which is proposed for option 1a to 1c). As explained in paragraphs 155-158, an appeal is either unfeasible or undesirable for options 1a to 1c. However, an appeal is more appropriate and desirable under this option and option 1e. Note option 1e has exactly the same assumptions regarding costs per appeal. The only difference is with regard to the number of licence modifications that are challenged. The costs for this option is summarised above (see paragraph 246).

320. Like an investigation, estimating in advance the additional resources required for an appeal is difficult, since the number and complexity of objections is highly uncertain. In some ways, there is greater scope for uncertainty on the costs for an appeal compared to an investigation given that an investigation reopens the decision and the Competition Commission retakes the entire decision, whereas an appeal can be (but not necessarily) more focussed on the salient issues. We assume for our best estimate that the direct cost of an appeal to the Competition Commission is £0.5m per major licence modification appeal. This is much lower than for the investigation (£1.2m), since the burden falls more on the appellant and the CAA to bring the evidence to the appeal and also because there is scope for more efficient hearings. This is because the whole decision does not require being completely re-examined (although in practice this may be the case for price controls where the decision is a package and some elements of the decision can often not be examined in isolation), Our low case assumes a cost of £0.3m, while our high case assumes a cost at around £0.7m. Combined with our assumptions regarding the number of objections, the best estimate of the costs incurred by the Competition Commission amount to £3.3m in present value terms (consisting of £2.8m for major modifications and £0.5m for minor modifications and a total annualised cost of around £0.2m). Our low case and high case present value costs are £0m and £10.6m respectively.

321. The burden of the appeal falls more on the appellant[98] (who under this option can be an airline or the airport operator) than under a Competition Commission investigation. This is unlike under an investigation since it is the appellant who needs to build and argue the case to the Competition Commission. Consequently, we assume the costs to an objector under an appeal approach would be around double those incurred by an objector launching an investigation. Our best estimate assumption is therefore that appellants' costs would be around £0.5m per objection. Combined with our best estimate assumption of eight major and four minor objections over the twenty year appraisal period, expected annualised objector costs are £0.2m or £3.3m in present value terms (£2.8m for major modifications and £0.5m for minor modifications). Present value costs for the low and high cases are £0m and £7.9m respectively.

322. Unlike an investigative approach, which places a significant burden on the regulated company, we assume that for an appeal there are no additional separate costs to the airport operator (in addition to the appellant costs outlined in the previous paragraph). However, we do assume that there are costs to interveners. Interveners are parties (either airlines or airports) who are not appellants for the particular objection but can provide evidence to the Competition Commission to support the appellant or CAA as defendant. Our best estimate assumes that the interveners' costs would be around £0.5m per objection with a low case of £0.25m and high case of £0.75m per objection. Combined with our assumptions regarding the number of objections, the best estimate of the costs incurred by the interveners amount to £3.3m in present value terms (consisting of £2.8m for major modifications and £0.5m for minor modifications and a total annualised cost of around £0.2m). Our low case and high case present value costs are £0m and £11.9m respectively.

323. We assume an appeal will also put a greater burden on the CAA than an investigation, since the CAA will have to defend its licence modification decision to the Competition Commission. This is in contrast to the investigation where the burden largely lies with the Competition Commission who retakes the decision. Consequently, we assume the costs to the CAA under an appeal approach would be around double those incurred by the CAA in an investigation. Our best estimate assumption is therefore that there is a cost of £0.5m per appeal. Combined with our assumptions regarding the number of objections, the best estimate costs incurred by the CAA amount to £3.3m in

[98] Note we do not make any assumptions regarding which party (airline or airport operator) appeal each licence modification, since we do not wish to add further uncertainty to the costs and therefore we implicitly assume the costs are the same regardless of the appellant.

present value terms (consisting of £2.8m for major modifications and £0.5m for minor modifications and a total annualised cost of around £0.2m).

324. As with investigations and as discussed under appeals costs associated with CAA decisions on which airports should be subject to economic regulation above, we note that it is unlikely that the CAA could improve decisions (as a result of potential objections) at zero marginal cost. Once again we assume that any costs related to this argument are already included in the above estimates for administering the licensing regime.

325. Overall, the total cost of an appeal amounts to £2m per appeal. This can be a more efficient system of challenge than an investigation (£3.7m).