

Economic regulation of Gatwick Airport Limited: consultation on new commitments

CAP 1973



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About this document

This consultation document seeks stakeholders' views on our proposed approach to updating the economic regulation of Gatwick Airport Ltd (GAL).

The current regulation of GAL is based on a set of commitments that expire on 31 March 2021. Following discussions with airlines and other stakeholders, GAL finalised a set of new proposed commitments earlier this year. Our initial assessment, for consultation, is that these commitments are consistent with protecting the interests of consumers and this document consults on accepting GAL's commitments for the four year period from 2021/22 to 2024/25.

Views invited

We welcome views on all the issues raised in this document.

Please e-mail responses to economicregulation@caa.co.uk by no later than 30 November 2020. We cannot commit to take into account representations received after this date.

We expect to publish the responses we receive on our website as soon as practicable after the period for representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to information under section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.

If you would like to discuss any aspect of this document, please contact Stuart Holder (stuart.holder@caa.co.uk).

Executive summary and introduction

Introduction

1. Since 2014 the economic regulation of GAL has been based on a set of commitments given by GAL during the 'Q6' price control review. As part of that review we decided that the commitments should be conditions of GAL's licence. The commitments cover, among other things, the maximum level of airport charges that GAL can levy over the seven years from April 2014 to March 2021, a system of rebates if GAL misses certain service quality targets, and a minimum level of investment that GAL will undertake.¹
2. The commitments framework was intended to be a proportionate and targeted approach to the economic regulation of GAL. By encouraging bilateral contracts it could support more targeted service offerings, better incentivise traffic growth and promote competition. All of these considerations suggested that the commitments would be in the best interests of consumers.²
3. We carried out an early review of the new regulatory framework in 2016, to consider whether any aspect of this framework was operating against consumers' interests. We found that many aspects of the framework appeared to be working well, and none of the airlines we spoke to suggested that there should be a return to the previous form of regulation. But we also identified some potential concerns about the progress of airfield investment projects, on-time performance and some aspects of GAL's relationships with airlines.
4. There had been a number of positive developments at Gatwick since 2014,³ including stronger than expected traffic growth and generally high levels of passenger satisfaction. For the first five years of the period GAL held its charges below the 'fair price' benchmark that we calculated during the Q6 review. However, on-time performance had been worse than it was in the period before 2014, particularly during peak summer periods.
5. Covid-19 has had a particularly strong impact on traffic at Gatwick. There was almost no traffic at all for several months, and in August 2020 the number of passengers was more than 80 per cent lower compared with August 2019. There is significant uncertainty about how quickly traffic will recover over the next few

¹ See Appendix B for a summary of the current commitments.

² In this document we use the term 'consumers' to refer to passengers and cargo owners. This is equivalent to 'users' of air transport services as defined in the Civil Aviation Act 2012.

³ See Appendix C for more details.

years. Nonetheless, it is clear that Gatwick airport, airlines and other aviation industry stakeholders will continue to face severe difficulties for a period of time.

The review process to date

6. In June 2018 we published a consultation document seeking stakeholders' views on the process and timetable for determining the economic regulation that would apply to GAL from April 2021.⁴ We said we would welcome a process designed and implemented by agreement between the airlines and GAL. But we also made clear that we would need to review any proposals that resulted from this process to consider whether they are in consumers' interests.
7. We received a joint response from GAL and the Airport Consultative Committee (ACC) saying that they would collaborate with each other and attempt to negotiate a new set of commitments, and setting out a proposed work programme and timetable.⁵ We responded by letter in October 2018 welcoming the proposed approach and noting our role in protecting the interests of consumers.⁶
8. GAL then made an initial proposal to airlines in December 2018. Subject to airline responses, GAL envisaged that these new commitments could be implemented in April 2019 for a period of six years (i.e. until March 2025). They would therefore supersede the existing commitments for the final two years of the current period.
9. Rather than accepting GAL's proposals, however, airlines said that they wished to see through to completion several workstreams that were underway, including new passenger research by GAL (with input from airlines and the Passenger Advisory Group⁷) and discussions of possible changes to the existing service quality metrics and targets. Among other things, the research highlighted that passengers would like to see improvements to the lounge, gate, immigration and baggage hall experiences. The joint work between GAL and airlines continued for much of 2019.
10. In October 2019, GAL consulted airlines and the Passenger Advisory Group on an updated set of proposals. It then issued its updated and finalised proposals for our review in January 2020. These proposals include:

⁴ CAP 1684.

⁵ Joint letter from Gatwick Airport Limited and the Gatwick Airport Consultative Committee, 25 September 2018.

⁶ Letter from Paul Smith, 8 October 2018.

⁷ The Passenger Advisory Group forms part of the Gatwick Airport Consultative Committee (GATCOM). For details see <http://www.gatcom.org.uk/passenger-advisory-group/>.

- a price commitment with a cap of Retail Prices Index (RPI) + 0% for published charges, but no separate cap on net charges (i.e. charges paid after allowing for discounts);
 - a number of detailed changes to service quality targets, including a switch from annual to quarterly moving averages for passenger survey scores, detailed changes to asset availability targets and a new runway availability measure; and
 - a minimum investment commitment of £120 million per year on average.
11. To inform our review of GAL's proposals, we wrote to airlines and the Passenger Advisory Group in February 2020 inviting formal submissions to indicate their degree of support for the proposals. However, as this period coincided with the onset of Covid-19 in the UK, we received only a single response plus multiple requests to extend the deadline for responses. Since then, we have maintained informal contacts and continued to engage with both GAL and its largest airline customers.

CAA's proposed approach

12. Our current view is that we should accept GAL's proposed new commitments. Viewed as a whole, and bearing in mind the impact of Covid-19 on the future outlook, the package of changes set out by GAL is likely to be in consumers' interests.
13. Regarding the individual elements of the proposals:
- our analysis suggests that GAL's proposed cap on published charges is now more likely to strike a reasonable balance between the interests of GAL and those of its passengers and airlines. While we cannot rule out scenarios under which the cap might allow GAL to earn relatively high profits towards the end of the next period, there are other scenarios under which GAL's profits might remain at a relatively low level throughout the period;⁸
 - the proposed changes to GAL's service quality targets and rebates reflect the outcome of detailed discussions between GAL and airlines, and should lead to a number of improvements compared with the current service quality targets. While GAL did not agree to every change put forward by airlines, we consider that the changes that GAL is proposing form part of an overall package that is likely to be in consumers' interests. There are also some issues on which GAL expects discussions with airlines to continue, and this flexibility is also helpful;

⁸ Higher than expected profits are not necessarily a concern within an economic regulation framework, particularly if they result from improved outcomes that benefit consumers, such as increased choice, better facilities and improved service quality.

- the new minimum investment commitment is slightly higher than the current commitment. We have not seen any evidence to suggest that the investment commitment should be changed or that additional specific obligations should be included, and in any case any such changes would be unlikely to be appropriate given the current uncertainty about how fast traffic will recover over the next few years. We currently monitor GAL's investment in airfield infrastructure and will continue to do so during the next period.
14. We also continue to consider that an economic regulation framework that facilitates bilateral discussions and contracts between Gatwick and airlines can be in the longer term interests of consumers. It allows the airport and airlines to develop price and service propositions that are tailored to their interests and consumers' interests, rather than being subject to a single set of overarching price and service settings.
15. During the next period it will be important that GAL and airlines continue their discussions on the unresolved aspects of service quality metrics and targets. These include security queues, for which GAL has committed to invest in new measurement technology, and airfield assets, where GAL has indicated its willingness to examine an alternative approach suggested by airlines. We stand ready to assist the parties in this process, if that would be helpful. And if there is not sufficient progress, we will consider whether any further action is required to protect consumers' interests.
16. We also plan to add two specific items to our ongoing monitoring of GAL's performance. These are:
- GAL's performance in relation to seating facilities in its departure lounges, which we will monitor both through GAL's monthly passenger survey scores and through any other feedback that is available. We intend to monitor this as it was one of the areas for improvement highlighted in GAL's 2019 passenger research, and the target score is lower than those for other service standards measured by passenger surveys. Although the new target has been tightened as a result of the switch from annual to quarterly moving averages, GAL resisted requests for a further increase and instead offered to report any survey score between 3.8 and 4.0 as amber rather than green; and
 - the average level of discounts that GAL offers to airlines, which will we monitor as we note there will no longer be a separate price cap on net charges.
17. Following the completion of this review, we will consider whether to carry out a 'lessons learned' exercise from this review and/or other work to support the continued evolution of the commitments framework at Gatwick.

Views invited

18. Views are invited on any of the issues raised in this document and, in particular, on the policy proposals summarised above and described in more detail in Chapter 2.

Our duties

19. In developing this consultation we have had full regard to our statutory duties under the Civil Aviation Act (CAA12), which are set out more fully in Appendix A.

Structure of this document

20. The structure of this document is as follows:

- Chapter 1 provides an overview of GAL's proposed new commitments;
- Chapter 2 sets out our policy proposals for the next regulatory period; and
- Chapter 3 discusses next steps.

Chapter 1

Overview of GAL's proposed new commitments

Introduction

- 1.1 This chapter summarises the main features of GAL's proposed new commitments. They are described in full in the document "GAL's finalised, extended Commitments", dated 27 January 2020, which has been distributed to airlines and is also available on CAA's website.⁹
- 1.2 The following sections highlight the main proposed changes to the price, service quality and investment commitments. Most other parts of GAL's proposals are unchanged from the current commitments, including the financial information commitment and the commitment to maintain and develop continuity of service, operational resilience and financial resilience plans.
- 1.3 One further proposed change is the removal of a provision¹⁰ that would have allowed GAL to recover certain costs related to its proposal for an additional runway to the south (which in 2014 was still under consideration by the Airports Commission). While GAL is no longer actively pursuing plans for this additional runway, in 2019 it published a new Master Plan which includes a proposal to bring its current standby runway into routine use for flight departures.¹¹ Under GAL's proposed new commitments, it would bear all of the planning, development and delivery costs associated with this project during the next regulatory period, with no impact on its proposed price cap.¹²

Price commitment

- 1.4 The main element of GAL's proposed new price commitment is a cap of RPI+0% on the annual increase in its published charges. Specifically the cap applies to GAL's 'core yield', which measures the average revenue per passenger from regulated services that would have resulted from applying GAL's published tariffs (rather than any discounted or alternative charges specified in bilateral contracts between GAL and individual airlines).

⁹ [https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/GAL_Extended_Commitments_\(Jan2020\).pdf](https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/GAL_Extended_Commitments_(Jan2020).pdf)

¹⁰ Paragraph 6.2 of Schedule 2 of GAL's Conditions of Use.

¹¹ <https://www.gatwickairport.com/globalassets/business--community/growing-gatwick/master-plan-2019/gatwick-master-plan-2019.pdf>.

¹² See p49 of GAL's finalised, extended Commitments.

- 1.5 The starting point for this cap is the outturn of £10.29 per passenger in 2018/19, excluding the permitted adjustment that allows GAL to recover most of the cost of any change in security standards. This outturn figure also excludes a small amount of revenue (less than £4 million in 2018/19) from 'selected ancillary services' which are covered by GAL's current price commitment but, for simplicity, are not included in the scope of proposed new price commitment. GAL will consult airlines annually on its proposed charges for these services, along with its proposed charges for other ancillary services which are already outside the scope of the price commitment.
- 1.6 While GAL may vary the structure of charges for different services and facilities connected with the landing, parking or taking-off of aircraft, the average charge per passenger should not increase in real terms under GAL's proposed cap.
- 1.7 Under GAL's new proposals, if it inadvertently exceeds the cap this will trigger an adjustment (to current or future charges) that will refund any over-recovery to airlines. In contrast, GAL will not be able to carry forward any under-recovery relative to the cap. This differs from the current commitments which allow both under and over-recoveries to be carried forward to future years within the regulatory period.
- 1.8 A further change from the current commitments is that GAL proposes there will no longer be a separate cap on its net charges, which measure the charges actually paid after taking account of discounts or alternative charges specified in bilateral contracts. GAL's stated reasons for this are that:
- the cap on net charges was an additional assurance at the start of the current period before there was experience of airline contracting in a regulatory environment. GAL states that it now has a clear track record of fair dealing in bilateral contracting, so such a cap would no longer serve a useful purpose; and
 - year on year movements in the average net charge may be difficult to control, as in practice they reflect the interaction of a number of different elements such as the discounts specified in different bilateral contracts, airline performance in meeting growth targets or punctuality incentives, and airline fleet mix.

Service quality targets and rebates

- 1.9 The current commitments include a set of detailed service quality targets for different aspects of the service that GAL provides to passengers and airlines, with provision for rebates to airlines in the event that GAL misses these targets. The potential amount of revenue at risk (if GAL were to continuously miss every target) is 6.75 per cent of GAL's revenues from regulated charges for airlines

using the South Terminal, and 7.25 per cent for airlines using the North Terminal.¹³

- 1.10 GAL's proposed new commitments include a relatively large number of changes to the existing service quality targets. Many of these reflect the outcome of extensive discussions with airlines and the Passenger Advisory Group during the course of 2019, which in turn were informed by new consumer research that GAL commissioned (with inputs from airlines and the Passenger Advisory Group) also in 2019.
- 1.11 Full details of the proposed changes can be found in section 7 and Annexes A1 and A2 of GAL's proposal document. In summary, they include the following:
- the targets for GAL's Quality of Service Monitor (QSM) passenger survey scores are unchanged, but they will now apply to quarterly rather than annual moving averages;
 - new 'reputational' targets (with no financial penalty) will apply to QSM scores for two measures that are not part of current system of targets – ease of using WiFi and Special Assistance services. In addition, QSM scores between 3.8 and 4.0 for departure lounge seating will attract a new 'amber' rating;¹⁴
 - GAL has committed to invest in new measurement technology for passenger security queues that will capture a greater proportion of passengers than at present. Following the installation of this technology, new targets will be agreed with airlines that are equivalent to the current targets;
 - other detailed changes for security queue targets, including the removal of the current 'core hours' restriction for most targets, tighter targets for staff search queues at two specific locations and for the northern control post, and a new target for the southern control post (where queues are not currently measured);
 - detailed changes to the availability targets for operational assets (these include passenger sensitive equipment such as lifts, escalators and conveyors, the inter-terminal shuttle, stands, jetties, fixed electrical ground power and baggage systems), including extensions to or the removal of 'core hours', new restrictions on the number of outages, an expanded list of priority assets for passenger sensitive equipment, tighter targets for baggage systems and airfield assets (stands, jetties and fixed electrical ground power) and a new target for the availability of flight information display screen systems;

¹³ The difference is because of an availability target for the inter-terminal shuttle system, with a maximum potential rebate of 0.5 per cent of revenues, which is relevant only to airlines using the North Terminal.

¹⁴ 3.8 is the existing target on a scale between 1 (extremely poor) and 5 (excellent).

- a new runway availability measure, with penalties payable if the runway is closed for more than 15 minutes, to replace the previous aerodrome congestion/availability term;
- new targets for average on time departure punctuality (at least 70 per cent in the summer season and 75 per cent in the winter season).¹⁵ While there are no financial penalties associated with these targets, GAL has stated that it will invest in a portfolio of operational initiatives and incentives for airlines and ground handlers, it will report to airlines and ground handlers shortly after the end of each season, and if it misses a target it will work with airlines to develop a punctuality improvement plan; and
- GAL's potential exposure to financial penalties is unchanged from the current commitments, though there is some minor rebalancing between the penalties associated with specific incentives. These changes are mainly to reflect airline feedback or to accommodate new financial penalties without increasing GAL's maximum potential exposure.

1.12 There are several areas where there is scope for discussions between GAL and airlines to continue. These include:

- security queues – as noted above, GAL will be installing a new measurement system and new targets will need to be agreed once this is complete. Airlines have proposed that the new target should be set on a per passenger basis, whereas GAL favours a target that is set (as now) on a per time segment basis. There are also some implementation details still to be addressed, such as the definition and treatment of 'operationally critical' vehicles in the context of control post queue time targets; and
- airfield assets – a relatively late development in the discussions on service quality targets was an airline proposal for a 'service delivery' approach rather than an asset availability measure. GAL stated in its proposal document that it is willing to continue to work with airlines to explore this concept further.

1.13 Discussions on these issues can continue after any new commitments are in place, as changes to service quality targets and rebates may be implemented at any time by agreement between GAL and a sufficient number of airlines (see Appendix B).

Investment

1.14 The main proposed change to GAL's investment commitment is to increase the minimum average spend from £100 million to £120 million per year, to reflect the

¹⁵ Punctuality is defined as the proportion of scheduled flights departing from their stand less than 16 minutes after their scheduled departure time. GAL has not previously set formal targets for punctuality.

impact of inflation since 2014. This average spend will be assessed over the six years from 2019/20 to 2024/25.

- 1.15 Another important part of the investment commitment – the requirement that GAL should maintain and develop the infrastructure of the airport to enable it to meet its service quality targets – remains unchanged.
- 1.16 In addition, GAL has agreed with airlines a number of changes to its future investment consultation process.¹⁶

¹⁶ See p46 of GAL's proposal document.

Chapter 2 CAA's proposed approach

Introduction

- 2.1 This chapter describes our current policy proposals and summarises our main reasons for putting these forward. It covers:
- the commitments that will apply from the start of the next period in April 2021, in particular that we are currently minded to accept GAL's proposed new commitments;
 - possible further changes to the commitments during the course of the next period, including those necessary to address issues that are not fully resolved at present; and
 - our proposed monitoring of GAL's performance during the next period.
- 2.2 Our approach has been significantly influenced by the impact of Covid-19 on the aviation industry in general and on traffic at Gatwick in particular. Among other things, this means that the traffic outlook for most and possibly all of the next period is substantially worse than it was when GAL issued its proposal. There is also significant uncertainty about many aspects of the next period, including for example the speed at which traffic will recover, how ongoing health requirements will affect GAL's operations, and how passengers' requirements and behaviour might change.
- 2.3 Even though GAL's proposals were developed before the onset of Covid-19, GAL has informed us that it is standing behind these proposals and that it regards them as commercially binding.

Commitments to apply from April 2021

- 2.4 Our current view is that we should accept GAL's proposed new commitments, as set out in the document "GAL's finalised, extended Commitments", dated 27 January 2020. Taken as a whole, our view is that the package of changes set out by GAL now strikes a reasonable balance between the interests of GAL and airlines, and is likely to be in consumers' interests. We discuss the main elements of GAL's new proposals below.

Price commitment

- 2.5 Feedback from airlines to GAL in December 2019 included comments that GAL had not presented any information to substantiate its price proposal and that the

proposed price was too high and/or not reflective of market conditions.¹⁷

Whatever the validity of those views in December 2019, the impact of Covid-19 has changed the outlook considerably. Regarding GAL's proposed price cap of RPI+0% on its published charges, we note that:

- our analysis suggests that this cap can strike a reasonable balance between the interests of GAL and those of its passengers and airlines;
- as stated above, the outlook for the next regulatory period is very uncertain. We cannot rule out scenarios under which GAL's proposed price cap might allow it to earn relatively high profits towards the end of the next period (as noted below, this would probably reflect the impact of strong performance by GAL). But it seems likely that GAL's profitability at the start of the period will be substantially lower than in recent years, and there are other scenarios under which GAL's profits will remain at a relatively low level throughout the whole period;
- as the next regulatory period lasts for only four years, there will be a relatively early opportunity to adjust future charges if they are significantly out of line with GAL's costs and it is not clear that consumers are benefiting from improved outcomes; and
- if GAL were to earn relatively high profits towards the end of the period, this would most likely reflect the impact of good performance across a number of different areas, including attracting and retaining traffic back to the airport, keeping its operating costs under control and maintaining service standards as traffic grows again, and constraining any increase in operating costs or reduction in commercial revenues as a result of Covid-related changes. Strong performance in these and related areas may well lead to better outcomes for consumers.

2.6 Regarding the other main elements of GAL's proposed new price commitment:

- we understand GAL's reasons for no longer having a cap on net charges (see paragraph 1.8 above), especially the potential difficulty of controlling year on year movements. Nevertheless, we also recognise airline concerns over the removal of this cap and therefore propose to include the average level of discounts in our ongoing monitoring of GAL's performance (see below); and

¹⁷ Section 13 of GAL's document summarises feedback from stakeholders on its October 2019 proposals and GAL's response to this.

- we welcome the greater certainty that will result from GAL no longer being able to carry forward any under-recovery relative to the price cap. We are aware that some airlines were concerned by the possibility of significant price rises as a result of under-recoveries carried forward during the current period. And we also welcome GAL's proposal to provide refunds to airlines in the event of any inadvertent over-recovery during the next period.

Service commitment

- 2.7 The proposed changes to GAL's service quality metrics and targets reflect the outcome of detailed discussions between GAL and airlines. These changes will lead to a number of improvements compared with the current service quality targets. For example, the switch from annual to quarterly moving averages for QSM survey score targets will reduce GAL's ability to still meet the target if it performs poorly during the busiest periods of the year, and so should drive improvements for passengers during those periods. And the changes to (or removal of) 'core hours' for certain asset availability targets will better reflect the nature of GAL's operation in recent years.
- 2.8 We recognise that GAL did not agree to every change proposed by airlines or the Passenger Advisory Group, and we also note that there are some issues on which GAL expects to continue discussions. As noted in the next section, it is important that this happens and that the discussions reach a satisfactory conclusion early in the next period.
- 2.9 Some of the airline proposals that GAL did not accept were for tighter targets for particular metrics, or proposals that certain targets should remain in force even when GAL is carrying out new investment. In principle, these are issues that could be considered further in future reviews, ideally based on evidence about the potential benefits to passengers and a discussion of the likely cost and any implications for GAL's charges.
- 2.10 At present, however, we consider that GAL's proposed changes to service standards and rebates are part of an overall package that is likely to be in consumers' interests. In most cases, we have not seen any evidence to suggest that further specific improvements would be particularly important for consumers, and in any case the impact of Covid-19 on aviation demand and operations has created additional uncertainty that would need to be considered.
- 2.11 One exception to this general view relates to QSM survey scores for departure lounge seating. As explained in more detail below, we will add this to our ongoing monitoring of GAL's performance. We are proposing to address this issue by monitoring, rather than by proposing a change to GAL's proposed new commitments, both because we view GAL's proposals as an overall package rather than a menu from which we can pick and choose, and also because of uncertainty over the future implications of Covid-19 and social distancing

requirements for passenger surveys in general and for departure lounge seating scores in particular.

Investment commitment

- 2.12 GAL has proposed only a minor change to its minimum investment commitment, with an increase from £100 million to £120 million per year in the average minimum investment required.¹⁸ This requirement operates alongside GAL's commitment to maintain and develop the airport infrastructure to enable its service quality targets to be met, which remains unchanged. In addition, GAL has agreed with airlines a number of changes to its future investment consultation process.
- 2.13 Some airlines commented to GAL that they believe it prioritises projects providing a commercial return above those providing cost reductions to airlines. Our main concern, however, is whether GAL is undertaking sufficient aeronautical investment, rather than the split of total investment (noting also that GAL invested significantly more than the minimum requirement during the first six years of the current period). Following our 2016 review, we already monitor GAL's planning and delivery of airfield investment projects as part of our ongoing monitoring of GAL, and will continue to do so during the next period.
- 2.14 Subject to GAL investing as necessary in the future to ensure there is sufficient airfield infrastructure to meet reasonably expected traffic levels, and the new investment consultation process working as intended, we do not believe that any specific changes to GAL's proposed investment commitment are required. We have not seen any evidence to suggest that the minimum investment commitment should be changed or that additional specific obligations should be included, and in any case any such changes would be unlikely to be appropriate at present given the current uncertainty about how fast traffic will recover over the next few years.

Our overall view

- 2.15 For the reasons stated above, our initial view is that GAL's proposed new commitments are in the interests of consumers, especially in the light of the impact of Covid-19 and the changed outlook for the next regulatory period.
- 2.16 Our current view is therefore that we should accept GAL's proposed new commitments. To address some specific issues, as explained in the next sections, we will encourage GAL and airlines to work together on unresolved service quality issues and we will add two specific items to our ongoing monitoring of GAL's performance.

¹⁸ This is over the six year period from 2019/20 to 2024/25.

Changes to the commitments during the next period

- 2.17 As noted above, there were some areas where discussions with airlines on service quality metrics and targets were still ongoing when GAL finalised its proposed new commitments. These include security queues, for which GAL has committed to invest in new measurement technology, and airfield assets, where GAL has indicated its willingness to examine an alternative suggested by airlines.
- 2.18 We understand that little or no progress has been made in these areas, mainly because stakeholders have been focused instead on dealing with the impact of Covid-19 on their respective businesses. This should not prevent us from implementing those changes that have been agreed, as the commitments contain change provisions which allow further changes to service standards and rebates to be introduced at any time by agreement between GAL and a sufficient number of airlines.¹⁹
- 2.19 It is important that discussions on these unresolved issues continue, and that there is no loss of impetus simply because a new set of commitments has been introduced. We strongly encourage GAL and airlines to continue to work together on these and any other unresolved issues. We stand ready to assist the parties in this process, if that would be helpful. And if there is not sufficient progress, we will consider whether any further action is required to protect consumers' interests.
- 2.20 As well as addressing specific unresolved issues, it will also be important for stakeholders to keep under review how the new commitments are operating in practice, and to work together constructively to address any problems arising or any cases where further improvements may be appropriate. This will be especially important where changes have been introduced, such as new ways of measuring service quality targets or changes to GAL's investment consultation process. And it also applies to cases where there may have been disagreement about certain details of some of the new metrics.²⁰
- 2.21 More generally, we encourage all stakeholders to keep the service quality metrics and targets under review, and to start discussions with other stakeholders if they believe a change would be beneficial. This could be, for example, as a result of changing passenger tastes or behaviours, because operational changes open up new possibilities, or it could reflect specific circumstances such as the ongoing response to Covid-19.

¹⁹ See Appendix B for further details.

²⁰ One example is the new metric on airfield travel time, which is a reporting metric only with no financial penalties. GAL has proposed measuring the time from Actual Start Request Time (ASRT) to when the aircraft enters the Hold (last Ground Movement Control), rather than the possible alternative of ASRT to 'wheels up'.

- 2.22 The change provisions in the commitments mean that such changes can be introduced at any time, provided there is agreement between GAL and a sufficient number of airlines. We see potential benefits from addressing such issues as they arise, rather than as part of a larger review when the commitments are renewed, as:
- it should enable consumer benefits to be delivered earlier; and
 - it will help spread out the demands on GAL and airline resources, as compared with a large, wide-ranging review of all service quality metrics and targets at the same time.

Monitoring the commitments during the next period

- 2.23 We intend to continue our existing monitoring of GAL's performance. This includes ongoing monitoring of a small number of specific issues, as described in Appendix B, together with regular meetings with stakeholders and information that is supplied by GAL each year. As part of this monitoring, we will be keen to understand how the changes introduced in GAL's new commitments (such as the new service quality targets and the new investment consultation process) are working in practice, and whether GAL and airlines are working together proactively to address any issues arising.
- 2.24 In addition, we plan to add two new specific items to our ongoing monitoring. The first addition is to monitor GAL's performance in relation to seating facilities in its departure lounges, both through the monthly QSM scores for the ease of finding a seat and also through any other feedback that is available. The reasons for monitoring this aspect of GAL's performance include that:
- the availability of seating in departure lounges was one of the areas highlighted in GAL's 2019 passenger research where passengers would like to see an improvement;
 - the existing target of 3.8 is lower than the target for other service standards measured by QSM scores; and
 - although the shift from annual to quarterly moving averages represents some tightening of the existing target, GAL resisted requests from airlines and the Passenger Advisory Group for an increase in the target score, offering instead to report any score between 3.8 and 4.0 as amber rather than green.
- 2.25 If scores fall within GAL's amber range, or we become aware of any other information that suggests that consumers are receiving poor service, it is likely that we will investigate the reasons for this and the potential impact on consumers. We may then consider whether any further action is required to protect consumers' interests.

- 2.26 The second addition is to monitor the average discount that GAL offers airlines compared with its published airport charges. GAL already provides information that allows airlines to calculate the difference between the average published charge and the average net charge (hence the average discount) each year. In addition to monitoring this figure, we will ask GAL to provide us with a short commentary each year that explains the main reasons for any material change in the average level of discounts, and also to say what it expects to happen to average discounts over the forthcoming year.
- 2.27 It is important to stress that the level of discounts is primarily a commercial decision for GAL. There are many legitimate reasons why the average level of discounts may change from year to year. Nevertheless, we recognise the possibility that removing the previous cap on net charges could allow GAL to raise its effective charges to airlines. Monitoring the average level of discounts each year appears to be a proportionate response to airline concerns and should give us early warning if any problems were to emerge during the next regulatory period.

Chapter 3

Next steps

- 3.1 We now invite views from stakeholders on any of the issues raised in this document, but particularly the proposed approach set out in Chapter 2. In addition to seeking formal responses, we would be happy to have informal discussions with individual stakeholders or groups.
- 3.2 The timetable and process following this consultation will depend in part on the nature of responses received.
- 3.3 Once we have made our final decision, the new commitments will need to be implemented through a modification to GAL's licence, following the process set out in section 22 of CAA12. We will aim to complete this process by 31 March 2021, but if this is not possible then we will complete it as soon as possible in 2021/22.
- 3.4 Following the completion of this review, we will consider whether to carry out a 'lessons learned' exercise from this review and/or other work to support the continued evolution of the commitments framework at Gatwick airport.

Appendix A

Our duties

- A1 The CAA is an independent economic regulator. Our duties in relation to the economic regulation of airport operation services (AOS) are set out in the Civil Aviation Act 2012 (CAA12).
- A2 CAA12 gives the CAA a general ('primary') duty to carry out its functions under CAA12 in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of AOS.
- A3 CAA12 defines users of air transport services as present and future passengers and those with a right in property carried by the service (i.e. cargo owners). We often refer to these users by using the shorthand of 'consumers'.
- A4 The CAA must also carry out its functions, where appropriate, in a manner that will promote competition in the provision of AOS.
- A5 In discharging this primary duty, the CAA must also have regard to a range of other matters specified in CAA12. These include:
- the need to secure that each licensee is able to finance its licensed activities;
 - the need to secure that all reasonable demands for AOS are met;
 - the need to promote economy and efficiency on the part of licensees in the provision of AOS;
 - the need to secure that the licensee is able to take reasonable measures to reduce, control and/or mitigate adverse environmental effects;
 - any guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and
 - the Better Regulation principles.
- A6 CAA12 also sets out the circumstances in which we can regulate airport operators through an economic licence. In particular, airport operators must be subject to economic regulation where they fulfil the Market Power Test as set out in CAA12. Airport operators that do not fulfil the Test are not subject to economic regulation. As a result of the market power determinations we completed in 2014 the airport operators of both Heathrow and Gatwick airports are subject to economic regulation.

- A7 We are only required to update these determinations if we are requested to do so and there has been a material change in circumstances since the most recent determination. We may also undertake a market power determination whenever we consider it appropriate to do so.

Appendix B

Overview of our current economic regulation of GAL

GAL's licence and the commitments

- B1 In 2014, following the introduction of a new legal framework for our economic regulation of airports, we completed a market power determination for GAL. We concluded that GAL met the market power test set out in section 6 of CAA12 and should therefore be regulated by means of an economic licence. Since then our economic regulation of GAL has been based on a set of commitments given by GAL during the course of the 'Q6' price control review.
- B2 The commitments comprise a set of conditions, schedules and annexes from GAL's Conditions of Use. The main provisions include:²¹
- a price commitment – in summary this is based on price paths of RPI+0% for the net charge (which takes accounts of discounts agreed in bilateral contracts) and RPI+1% for the published charge.²² Any under or over-recovery against these price paths is carried forward to future years;²³
 - a service standards commitment – similar to the service quality rebates included in GAL's Q5 price control, there is a system of rebates payable if GAL misses certain service quality targets. The targets cover passenger satisfaction measures, security queues, passenger operational measures, airline operational measures and an aerodrome congestion term. GAL's performance is assessed monthly, and separately for each terminal. The maximum amount of revenue at risk is 6.75 per cent (South Terminal) or 7.25 per cent (North Terminal);²⁴

²¹ Various administrative clauses also form part of the commitments, including applicability and enforceability; variation; and dispute resolution procedure.

²² In each case, the "price" refers to the average revenue per passenger from services and facilities connected with the landing, parking or taking off of aircraft and from selected ancillary services. There is also provision for a pass through of some of the cost of any change in required security standards.

²³ This is subject to any cumulative over-recovery of published charges not exceeding £10 million in any year (and zero by the end of the seven years), and the average published charge not increasing by more than RPI+10% in any of the first six years.

²⁴ The Conditions of Use also include Airline Service Standards for check-in queues and arrival bag performance. Airlines that do not meet these standards may have any service quality rebates they would otherwise have received reduced by up to 1.5 per cent of GAL's revenues. These airline standards are not treated as conditions of GAL's licence.

- an investment and consultation commitment – GAL will maintain the airport to comply with safety/environmental requirements and develop the infrastructure to allow it to meet service quality standards. To achieve this, it will invest at least £700 million during the seven years of the commitments. It will also consult airlines and the Passenger Advisory Group on its investment programme;
- continuity of service plan, operational and financial resilience – an obligation to prepare and maintain plans on continuity of service and operational resilience. The continuity of service plan must be provided to us and amended in line with our reasonable requirements, and GAL must consult stakeholders (including us) annually on the operational resilience plan. It is required to have regard to any guidance that we issue on the operational resilience plan. In addition, GAL must provide an annual confirmation of adequate resources and obtain our approval before making certain changes to its finance documents; and
- a financial information commitment – GAL will ensure that it provides either statutory accounts or an equivalent audited statement so that airlines can understand whether charges are reasonable. Each year it will provide its assessment of the value of its asset base.

B3 GAL's licence identifies the parts of GAL's Conditions of Use that make up the commitments, and states that the commitments are conditions of the licence. This means, among other things, that the commitments are also enforceable by us.²⁵ In addition, GAL is not permitted to change the commitments except in the following circumstances:

- in accordance with specific modification provisions written into the Conditions of Use. These allow the price path for the published charge or the service standards and rebates to be modified if this is agreed by airlines carrying at least 67 per cent of passengers²⁶ and representing at least 50 per cent of airlines responding to the change request;
- if CAA modifies the licence,²⁷ GAL will make any necessary consequential changes to its Conditions of Use; or

²⁵ Any obligations placed on third parties in the commitments shall not be treated as conditions of the licence.

²⁶ This includes only passengers of airlines that either pay the published tariff or operate under bilateral contracts that reference the published tariff.

²⁷ The process for this is set out in section 22 of CAA12.

- to recover up to £10 million per year of costs related to the second runway if it receives Government support.²⁸

Our reasons for accepting GAL's commitments

B4 Our reasons for accepting GAL's commitments included:²⁹

- by the time of our final proposals, the price caps included in GAL's commitments were close to our view (developed during the Q6 price control review) of a fair price;
- the commitments would provide a better framework to diversify the service offering and incentivise volume growth, as they would encourage bilateral contracts that could be better tailored to the needs of individual airlines and their passengers;
- the commitments should promote competition by facilitating innovation and diversity of offer;
- the commitments would lock in lower future charges for longer (i.e. seven rather than five years), providing greater certainty to airlines and their passengers;
- the longer time period would provide GAL with greater incentives to reduce operating expenditure and outperform commercial revenue assumptions; and
- the commitments would facilitate efficient investment, as GAL would have flexibility to tailor investment to the needs of airlines.

Monitoring the commitments

B5 We stated that we would implement a monitoring framework to review a number of areas. This would help ensure that GAL promotes passengers' interests and that any problems arising could be more easily addressed. We monitor a small number of areas on an ongoing basis. These include:

- the level of charges – rather than monitoring GAL's compliance with its commitments (RPI+1% and RPI+0% respectively for its published and net charges), we said we would monitor charges against our fair price benchmark. Specifically, we will compare the outturn net charge with our view of a fair price (RPI-1.6%);

²⁸ Higher amounts can be recovered with the agreement of airlines or through a licence modification proposed by us.

²⁹ See [CAP 1102, Economic regulation at Gatwick from April 2014: final proposals](#).

- service quality – if GAL misses a particular target for six months in a financial year then no further rebates are payable for that target during the rest of that year, thus reducing GAL's liability for repeated service failures. We said that we would undertake sufficient monitoring to enable us to identify an individual metric failing for more than six months; and
- operational resilience – GAL is required to consult on and publish its operational resilience plan by 1 October 2014, and then to review the plan annually.

- B6 In addition, following our 2016 review of the commitments framework, we added two additional items to our ongoing monitoring:
- airfield investment – we said we would monitor GAL's progress with its (then) current investment proposals, and its ongoing approach to identifying and addressing future capacity constraints; and
 - GAL's relationships with airlines and other stakeholders – this was in response to evidence of some poor relationships, particularly at the operating level.
- B7 GAL publishes annual performance reports, which are available on GAL's website and include information on traffic growth, service quality and on-time performance.³⁰

³⁰ Available at <https://www.gatwickairport.com/business-community/about-gatwick/company-information/regulation/>.

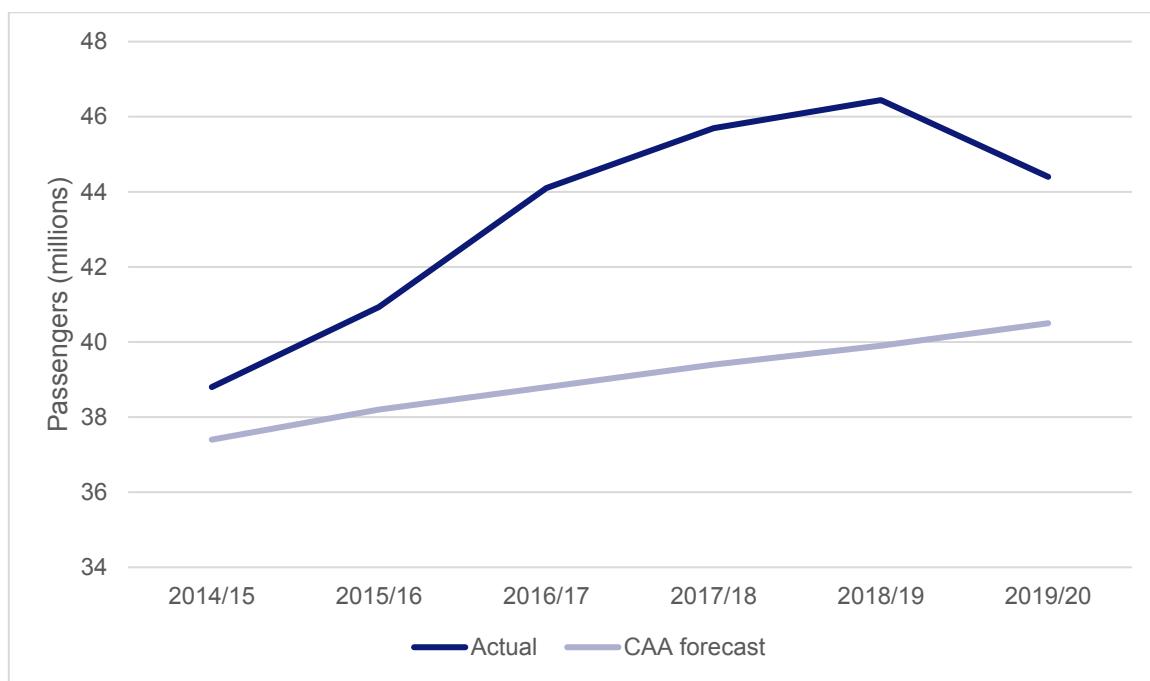
Appendix C

Overview of key trends since 2014

Traffic growth

- C1 When calculating our fair price benchmark during the Q6 review we adopted a set of passenger forecasts that showed an average growth rate of 2.1 per cent a year during the commitments period. In contrast, as shown in Figure 1, during the first five years of the period traffic grew at an average rate of 5.3 per cent a year, despite the loss of Monarch Airlines traffic from October 2017.
- C2 Traffic volumes then fell in 2019/20, reflecting both the loss of Thomas Cook traffic from September 2019 and the initial impact of Covid-19 in the first quarter of 2020. And the level of traffic in 2020/21 remains uncertain and is likely to be very much lower than any recent year.
- C3 The strong growth during the first five years of the period reflected a combination of factors. While GAL was already capacity constrained at peak times, from summer 2014 it increased the peak capacity of its runway from 53 to 55 movements an hour. Further traffic growth was then achieved mainly through a combination of greater use of off-peak slots, an increase in average aircraft size (some of which was due to an increasing share of long-haul traffic) and also higher average load factors.

Figure 1: CAA traffic forecast vs actual traffic

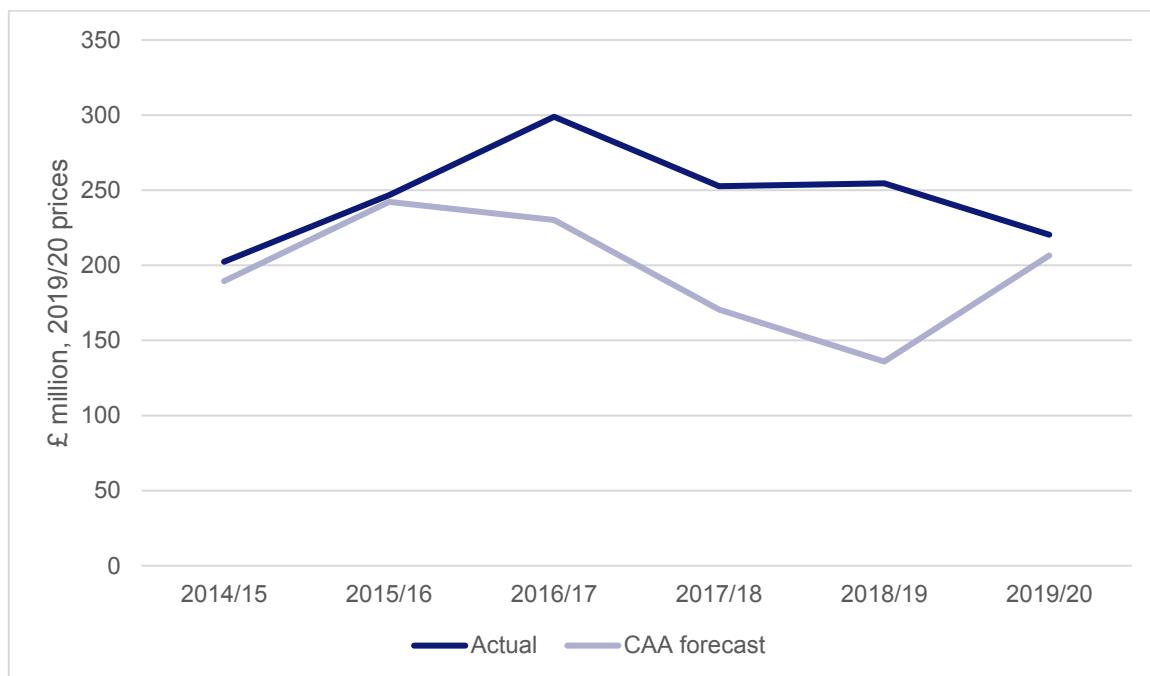


Source: CAA (CAP 1152), GAL monitoring reports

Investment

- C4 GAL's total investment during the first six years of the commitments period, which is shown in Figure 2, comfortably exceeded both the forecasts that underpinned our fair price calculation and the minimum average investment of £100 million per year set out in the commitments.
- C5 In our 2016 review we expressed a concern that GAL had not yet expanded airfield capacity in response to stronger than expected traffic growth. We reported that there seemed to be relatively slow progress on projects to provide additional pier capacity and to accommodate arrivals from the Common Travel Area (CTA) in the South Terminal.
- C6 Work on both of these projects has since started, and the South Terminal CTA arrivals project has now been completed. However, along with many other investment projects, work on the Pier 6 extension project has been put on hold due to the impact of Covid-19.

Figure 2: CAA forecast core capital expenditure vs actual capital expenditure



Source: CAA (CAP 1152), GAL monitoring reports

Airport charges

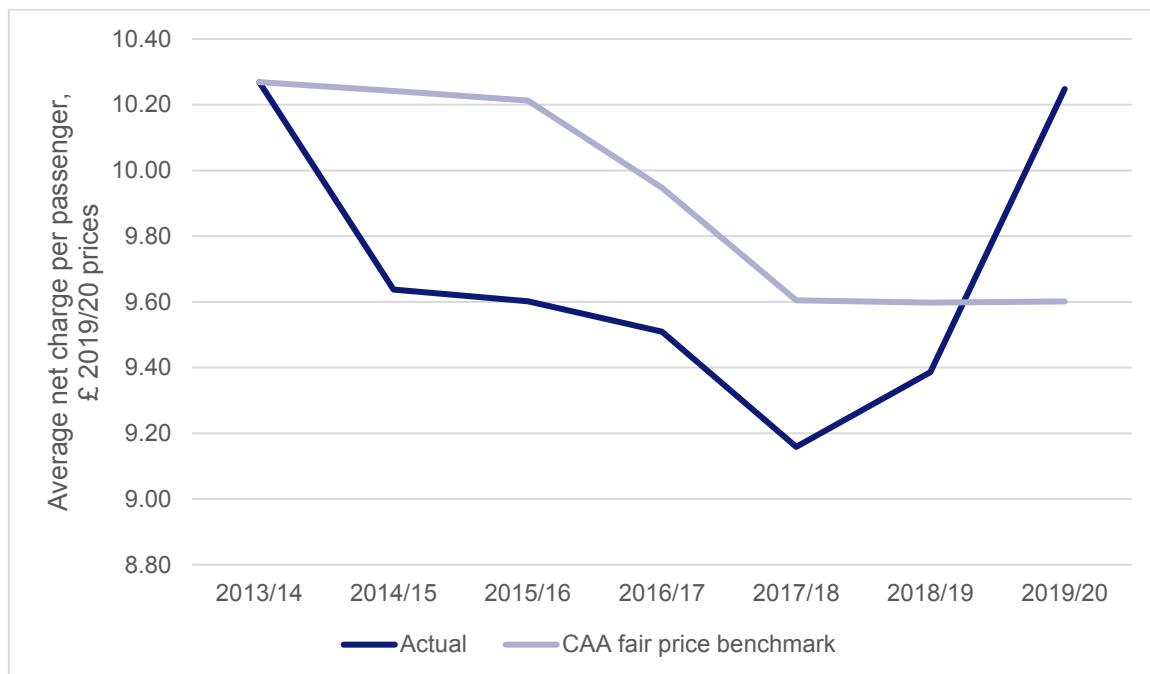
- C7 As shown in Figure 3, during the first five years of the commitments period GAL held its net charges below our fair price benchmark (RPI-1.6%),³¹ and even

³¹ The fair price benchmark shown in Figure 3 is modelled as a formal price cap of RPI-1.6%, calculated using the change in the RPI over the 12 months to the previous August, rather than a simple real reduction of 1.6% each year. It also includes an additional allowance for costs associated with new security requirements. This

further below the average price path (RPI+0%) set out in the commitments. Despite this, the impact of strong traffic growth means that GAL's total revenues from regulated charges over the first six years of the period were more than 10 per cent higher than the forecast that underpinned our fair price calculation.

- C8 The increases in charges in 2018/19 and 2019/20 reflect both GAL's pricing decisions³² and also the additional costs associated with new security requirements (EDS Standard 3). These additional costs can be passed through to users in addition to any increase allowed under the commitments (or compliance with our fair price benchmark).
- C9 For 2020/21, even though the new commitments period has not yet started, GAL stated that it would set charges consistent with its proposed new price commitment (i.e. a cap on published charges of RPI+0%, starting from the outturn level for 2018/19). Excluding the impact of security costs, the planned increase in its published charges was only 0.2%. In practice, however, the outturn level of charges will reflect a number of different aspects of the impact of Covid-19.

Figure 3: Real terms comparison of net airport charges



Source: CAA analysis, GAL monitoring reports

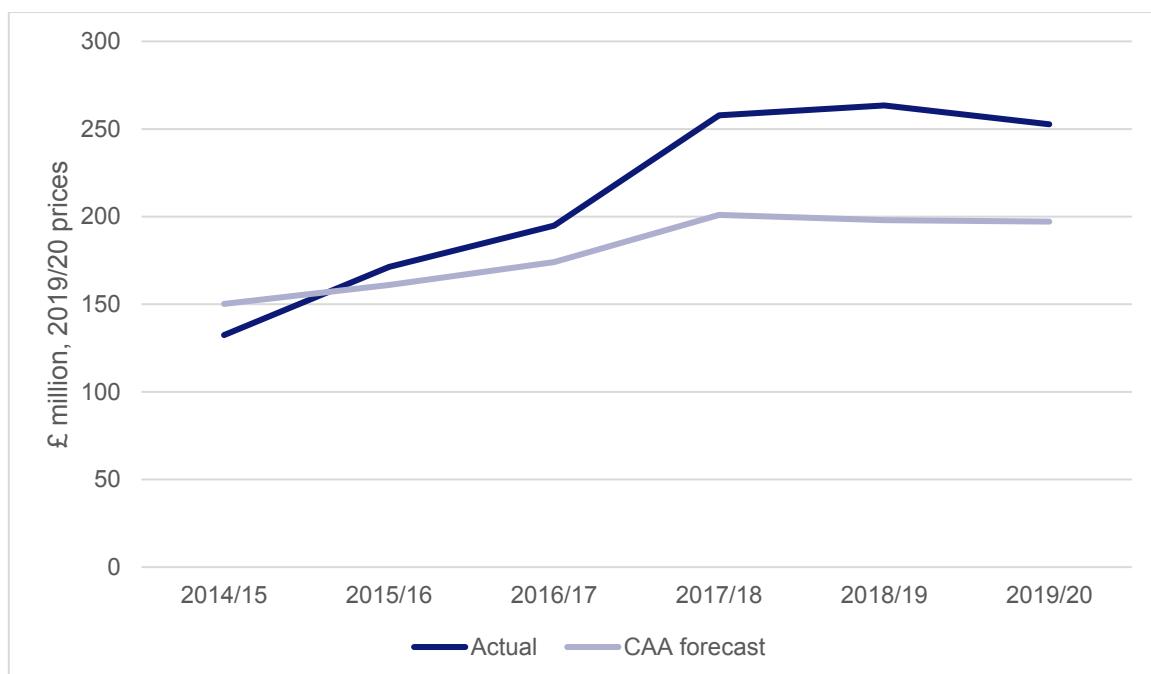
mirrors the approach we used in GAL's previous price caps, and also the way that compliance with GAL's commitments is assessed.

³² Excluding the impact of additional security costs, the average planned increase in GAL's published charges was RPI+1.1% in 2018/19 and RPI+2.5% in 2019/20.

Operating profits

- C10 In addition to higher revenues from regulated charges, GAL also generated higher commercial revenues than our forecast, in part at least because of the impact of strong traffic growth. Operating costs were also higher than our forecast, but not by enough to offset the impact of higher than expected revenues.
- C11 As a result, GAL's operating profits have been higher than those we forecast when calculating our fair price benchmark. Figure 4 shows 'regulatory' operating profit, which is calculated using the regulatory depreciation allowances we used in our 2014 analysis rather than accounting depreciation.³³

Figure 4: CAA forecast (regulatory) operating profit vs actual (regulatory) operating profit



Source: CAA analysis, GAL monitoring reports

Service quality

- C12 GAL's service quality commitments include a set of rebates that are payable if it misses certain service quality targets. In our 2016 review we reported that GAL had missed only 45 of the 1240 targets measured during the period from April 2014 to October 2016. Since then, GAL has continued to perform well in these aspects of service quality and for several years did not miss any targets at all.³⁴

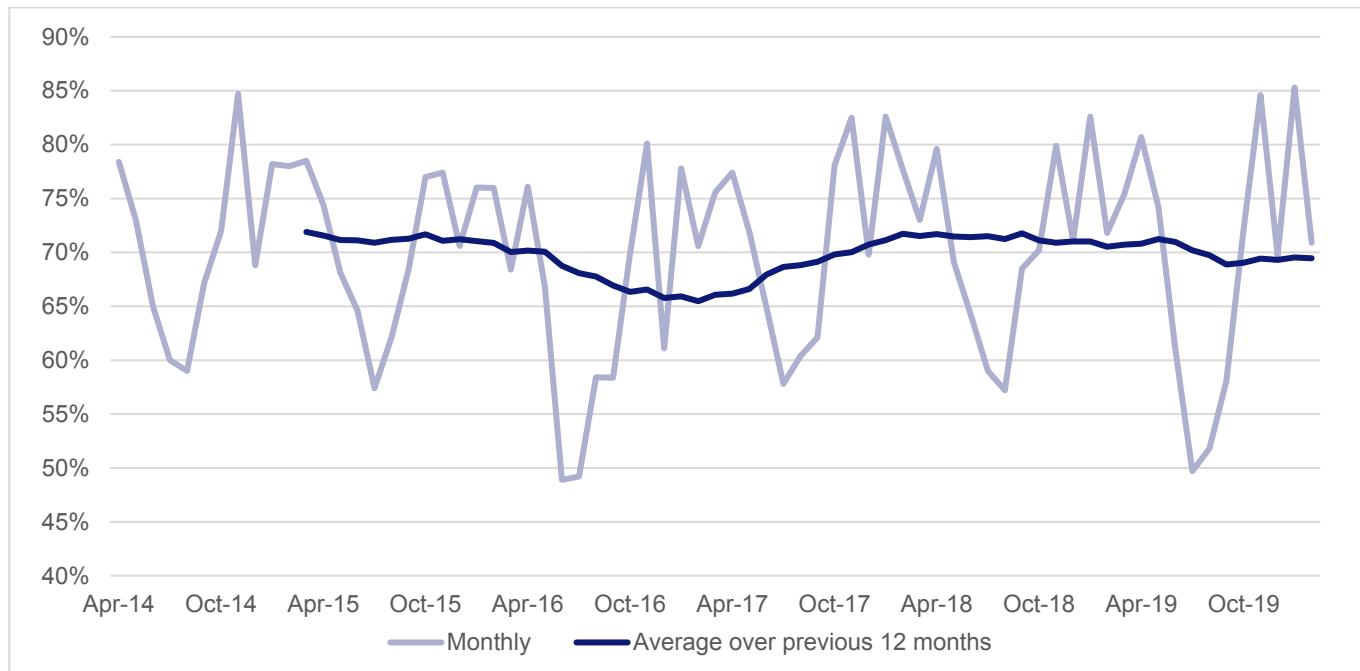
³³ In a standard price cap calculation, the same regulatory depreciation allowance is used both in the 'building blocks' calculation of allowed revenues for each year and also to depreciate the regulatory asset base.

³⁴ GAL paid rebates to airlines for a baggage system fault in 2017 that resulted in poor service for passengers

It then missed 10 targets in 2019/20 before the service quality targets were suspended (by agreement between GAL and airlines) as a result of Covid-19.

- C13 On-time performance is not included in the service quality targets in GAL's current commitments.³⁵ One reason for this is that it is affected by the actions of a number of different parties, including GAL, airlines, ground handlers and air traffic control. As shown in Figure 5, on-time performance in the peak summer periods declined during the first three years of the commitments period. This was due to factors including air traffic control strikes, weather-related disruption, and staffing problems experienced by certain ground handlers in each of the first two summers.
- C14 There was some improvement in 2017 and 2018, as GAL continued to work with airlines and ground handlers to identify operational measures that could help to improve punctuality, especially during the peak summer months. However, on-time performance was poor again during summer 2019, in part reflecting a combination of air traffic control problems and problems affecting one ground handler.

Figure 5: Departure punctuality (% of flights departing within 16 minutes of scheduled time)



Source: GAL monthly performance reports

and airlines but was not reflected in the automated performance measurement. There were three similar events in 2019.

³⁵ While there are targets for on-time performance in GAL's proposed new commitments, there are no financial penalties associated with these targets.

The Impact of Covid-19

- C15 Some of the early impact of Covid-19 at the end of 2019/20 can be seen in the charts above. Since then, Covid-19 has had a very significant effect on GAL's business during the first part of 2020/21. Passenger numbers between April and August 2020 were more than 90 per cent lower than in the same period in 2019, and this will have affected both aeronautical and commercial revenues.
- C16 In response to this situation, GAL has taken a number of measures to reduce operating costs, which fell from £87 million in Q1 2020 to £54 million in Q2.³⁶ And it has stopped, changed or suspended many of its investment projects, leading to an expected reduction in capital expenditure of £157 million between March and December 2020.
- C17 Despite these cost saving measures, GAL's half year results showed an operating loss of £103 million for the first half of 2020, as compared with a profit of £81 million during the first half of 2019.³⁷ Over the same periods, EBITDA (before exceptional items) fell from £185 million to just £3 million.

³⁶ See <https://www.gatwickairport.com/globalassets/business--community/investors/june-2020--mid-year/investor-presentation---results-for-the-period-ended-30-june-2020.pdf>.

³⁷ These are accounting rather than regulatory operating profits, and therefore cannot be compared directly with the profits shown in Figure 4.