Report of the independent panel on airport regulation.

27 January 2009

Members[1]:

Chris Bolt
Martin Cave (Chair)
Philip Cullum
Anne Graham
David Gray
Dieter Helm
Adrian Montague
Andrew Sentance

Introduction

The panel was established in April 2008 to advise the Secretary of State for Transport on the reform of the economic regulation of airports in the UK.[2] It met six times, and held two public seminars in London and Edinburgh in June and September 2008, and a workshop in London in December 2008. It had further discussions with a number of stakeholders. The panel's deliberations ran along side the review of airport regulation undertaken by the Department for Transport, and had access to evidence submitted to that review. The panel is grateful to those who assisted it in its deliberations.

The panel understood its role as that of advising on a regulatory regime which may be in place for several decades - a period which is likely to see changes in the structure of ownership of airports in the United Kingdom. What is sought, therefore, is a general framework which can cope with a broad range of circumstances concerning the structure of ownership of airports and the balance of supply of and demand for capacity.

This document summarises the panel's proposals for the regulatory regime. It does not attempt to cover all aspects of the regime, but focuses on the most significant.

Summary

The panel acknowledges the competitive nature of the environment in which most (but not all) airports operate and supports efforts to extend the role of competition where possible. However, it also recognises that market failure can occur both in the cases where airports exercise persistent market power and, more widely, where externalities arise associated with environmental damage. For this reason regulation is required, and in the panel's view the regulator's primary duty should be should be the promotion of the

[1] Brief biographies of the members can be found in the Annex.
[2] For the purposes of the data in this report, airports in Northern Ireland are included.

interests of passengers and freight users. In practice this will require that the airports' proximate customers, airlines and freight operators, are fully consulted, and that their proper needs for airport services are met. The CAA, as regulator, would simultaneously undergo governance changes to adapt to this duty.

The panel proposes a licence-based regime in which airports with significant market power (currently Gatwick, Heathrow and Stansted) will be subject to price control, in a manner chosen and implemented (subject to appeal) by the CAA. The CAA will receive guidance from the Secretary of State requiring it to have due regard to the National Planning Statement as it concerns major airport runway developments. A second group of about ten airports, subject like the first to the Airport Charges Directive, would have obligations under that directive, including that of consulting users on airport charges. A further dozen or so airports, with more than a million passengers per annum, would remain subject to the conditions which currently apply to them.

The panel believes that the CAA, in response to its new primary duty, should focus on the passenger experience. This would entail a significant change of approach, possible internal re-organisation, and the creation of an independent consumer advocacy body. A special administration regime should also be introduced in respect of the small number of airports found to have significant market power.

The CAA will have a duty to protect the environment, and should be subject to guidance on specified environmental matters by the Secretary of State. The dozen or so largest airports should have an obligation to publish an annual environmental report.

The panel sees the above changes in statutory duties, governance methods and regulatory instruments as forming a package which limits regulation to where it is necessary, focusses on the passenger, encourages investment in airports where it is desirable, and is capable of achieving environmental objectives. It believes that the changes constitute a balanced package which has been designed to benefit all stake-holders and which should be seen as a whole.

.

The regulator

The Government has accepted Sir Joseph Pilling's recommendation concerning the future structure of the CAA. The panel notes that specific wording in the statute, relating to regulatory duties, for example, can only go so far in determining the outcome. The governance arrangements for the CAA will also play a major role in the operation of the regime in practice. In this respect the panel believes, on the basis of experience in other sectors, that the purposes of economic regulation will best be met by decisively replacing the current modus operandi of the CAA as, effectively, a federation of regulators by its operation as an integrated organisation, run by a Board headed by a non-executive Chairman, which has full responsibility for all CAA decisions, and led by a Chief Executive who will be its principal public face. The panel believes that this structure, adopted by other regulatory bodies in the UK is best placed to ensure full accountability.

The panel understands that the Department for Transport favours the approach set out here, which chimes with the recommendations of Sir Joseph Pilling's 2008 Strategic Review of the CAA, implementation of which has begun.[3]

Competition law and policy

Airports are a potentially competitive sector, and outside the South-East and certain other exceptions, competition among then operates in a workable way –though there may be other grounds to regulate.
In these circumstances, it is reasonable that the 'first port of call' for dealing with market power issues, and also consumer protection, should be competition law, either European law or the Competition Act 1998, or the Enterprise Act 2002. The panel believes that, in airports as in other sectors, the balance between use of sectoral regulation and generic competition law is best struck by bestowing on the CAA concurrent powers with respect to competition law.

Objectives of regulation and duties of the regulator

The Airports Act 1986 established in statute four duties for the regulator – the Civil Aviation Authority – to pursue.

The panel believe that, in keeping with modern regulatory practice, these duties should be replaced by a primary duty of the following general kind[4] [5]:

> -to promote the interests of existing and future consumers of passenger and freight services at UK airports, wherever appropriate by promoting effective competition,

supplemented by further duties as follows:

> i)to secure, so far as it is economical to meet them, that all reasonable demands for airport services are met;
> ii)to ensure that licence holders are able to finance the activities which are subject of relevant licence obligations
> iii)to exercise its functions in respect of i) and ii) above in a manner which will make the best and most practicable contribution to the attainment of the NPS in respect of major airport developments, and to notify the Secretary of State in the event that the achievement of the NPS is impracticable;
> iv**)**to promote economy and efficiency;

[3] The panel also believes that consideration should be given to the Board following the example of other independent regulators by taking full responsibility for the internal organisation of the Authority and for all appointments apart from the Chair and non-executive members of the Authority, and possibly the Chief Executive.
[4] These formulations are not intended as precise drafting suggestions.
[5] As in other recent regulatory enactments, these duties would apply (with the obvious exceptions of the second part of ii) and v) below) both to the Secretary of State and to the CAA, in respect of their exercise of powers under the Act.

v)to have regard to the effect on the environment and on local communities of activities connected with the provision of airport services;
vi)to take account of guidance issued by the Secretary of State on environmental matters;
vii)to follow the principles of better regulation, including consultation with all relevant stakeholders.

In relation to the primary duty, the panel considers that the statute should require the regulator to owe a duty in the first place to consumers- ie airline passengers and customers of freight services. It recognises that, compared with the ambiguous language of the Airports Act 1986, this formulation removes the implied duty to promote the interests of airlines - the direct purchasers of airport services; yet the latter have expressed the view that their views are under-represented even under the present law.

The panel has reached its conclusion for two principal reasons. First it notes the practice in all other regulated sectors to set the regulator a primary duty owed to current and future end users, not an intermediate firm; in the panel's view, this accurately reflects the proper purpose of regulation.

Second, the panel is aware that the interests of airlines and passengers frequently co-incide, that airlines are capable in a good many cases of representing the interests of passengers; there are also some cases, involving technical airport activities which passengers do not observe, where they cannot be expected to express an opinion. Thus a duty on the regulator to promote the interests of end users necessarily includes the way in which the airport serves its airline and freight service customers and responds to their requirements. An airport which offers inadequate, inefficient and poor quality service to airlines- and does not pay attention to the views of the airline community-will not be properly serving the consumer interest.

Given the airlines' special role as holders of information and expertise, and proxies for end users in a range of important issues, they should, under the new arrangements, have additional rights in the process of regulation. Thus airports with significant market power and larger airports should have, as licence conditions, the obligation to provide information to and to consult airlines. As noted above, the regulator would consult airlines. And airlines would also have the right to appeal certain decisions taken by the regulator. The panel is of the view that the net effect of these and other changes would be to ensure that the views of both end users and airlines are more effectively articulated in the regulatory process.

The passenger experience of airports is greatly enhanced by good integration of the airport with rail and road links. Ensuring that airports are part of an integrated transport system is therefore a significant aspect of promoting the consumer experience.

In relation to further duties i) and ii), the panel is aware that Parliament has passed the Planning Act 2008, which makes provision for the Government to produce National Policy Statements (NPS). The Government has stated its intention to produce a NPS for

airports, based on the Air Transport White Paper, which satisfies the requirements set out in the Planning Act. During the passage of the Planning Bill, ministers also made a commitment that the NPS would be location-specific as it applied to major airport runways. The panel understands that the inclusion of the location of an airport runway in the NPS would be subject to a regulatory impact analysis.

The question which then arises is how this designation should be treated in the airport regulatory regime. It is assumed that the NPS has been drawn up on the basis of a cost-benefit analysis which takes account of external and social benefits (positive and negative) and not simply of the commercial costs and benefits relating to the airport. So it would be inappropriate for the CAA to take a different view of the case for investment on public interest grounds at the time of publication of the NPS. The panel therefore recommends that the CAA should have a further (secondary) duty to exercise its functions in the manner that will make the best and most practicable contribution to the achievement of the NPS.

The panel recognises, however, that changes in demand or in costs (including financing costs) may make an investment uneconomic, or delay the date at which it is needed to meet reasonable demands for airport services. In such circumstances, achievement of the NPS as originally stated may not be possible or appropriate. To give ministers the opportunity to consider the implications of this before price review decisions are taken, the panel considers that the CAA should be under a further duty to so notify the Secretary of State, to allow the Secretary of State to consider whether to revise the NPS or not. The government might also consider whether a subsidy was appropriate.

Where the investment envisaged in the NPS continues to reflect reasonable demands and, in the view of CAA, can be financed, an airport operator subject to tier 1 licence obligations would be required as a condition of the licence to deliver that investment. Failure to do so would constitute a breach of licence which would be dealt with as specified in the licence. In the limit, it could lead to revocation of the licence.

The environmental duty- number v)- is discussed below.

The principles of better regulation (see secondary duty vii)) are proportionality, accountability, consistency, transparency and targeting. This includes the avoidance of over-regulation. This is particularly appropriate for a market place which is not a natural monopoly and where competition in the South East may become increasingly workable over time. The principles of better regulation also imply a duty to consult airlines and other stake-holders.

Should there be a licence?

Utility regulation in the UK relies generally upon subjecting regulated firms to licence conditions, the terms of which can be changed under a procedure established in the relevant Act, in respect of which there is an appeals process. Airports, by contrast are

currently regulated directly by statute. A licence has the advantage of flexibility as it enables a quicker response to new circumstances. A further advantage is that this due process around licence modifications is well developed, with reference to the Competition Commission in the event that a proposed licence modification is not agreed.

While the panel favours regulation by licence, airports of different size and market power should have different licence obligations. The 4-tier classification which the panel proposes is as follows:

Tier 1):those providing service to more than five million passengers per annum, and also exhibiting significant market power, requiring some form of price control (these currently number three); here the goal of controlling market power is a major factor;
Tier 2):those (currently ten) outside Tier 1 but providing service to more than five million passengers per annum, which under the Airport Charges Directive will have to consult on airport charges, provide financial information of certain kinds, and meet other obligations; this group contains airports such as Birmingham and Manchester, with major effects on passengers and on the environment;
Tier 3):those with more than one million passengers, and less than five million, passengers per annum (currently about a dozen). These will have obligations no more onerous than those presently imposed; hence the introduction of licensing would not change their position. There is one exception: the panel proposes that the CAA have the power to propose licence conditions equivalent to those relating to Tier 2 airports on a particular Tier 3 airport for which it was deemed appropriate. This group is smaller than those caught in the current classification of having more than £1 million pounds of aeronautical income per annum.
Tier 4):the remainder, which would not be licensed.

Where should the licences come from, and how can they be changed?

In the panel's view, the Department for Transport should issue the original licences, following a public consultation. They should reflect in licence conditions the obligations imposed on airports by the Airports Act 1986, except that those obligations should be subject to the 'better regulation' duty to eliminate what is disproportionate. The licence conditions would also reflect the requirements of the Airport Charges Directive. Any additional obligations should be subject to the procedures for a change of licence set out below. For the avoidance of doubt, price control arrangements currently in place on Heathrow, Gatwick and Stansted would be unchanged**.**

Licence conditions would thereafter be subject to change via a process similar to that adopted in other regulated sectors. That is: the CAA would propose a change to the airport or airports affected. If accepted by the airport(s), the change would come into effect.

If the change were opposed by the airport(s), the matter would be referred to the competition commission, which would reach its decision on the basis of the statutory duties applying to the CAA, and whose decision would determine the outcome. The

panel is attracted by a feature of UK energy regulation, which provides that a change in a licence condition applying identically to a number of licensees can be brought into effect if approved by a substantial majority of those licenses. (In the case of airports, this could be applied if, say, more than ten airports were affected, and the change were approved by more than 80% of those airports and by airports accounting for more than 80% of the total annual passengers of those airports.

Licence conditions relating to Tier 1 airports

This issue is currently dealt with via the 'designation system', with the Secretary of State determining the criteria for de-designation and making the relevant decision. Designated airports are subject to price and other controls, and the panel envisages that this would continue, in a more flexible way under the new regime. In order to ensure proportionate regulation, the basis on which this key determination would be made should be the subject of primary legislation, as is the case with telecommunications; it would be forward-looking dominance, to which the term 'significant market power' is attached in other sectors.[6] However, the decision itself to which airport or airports satisfied the statutory criteria would be made by the CAA. There would be a sunset clause for this type of regulation: the controls in relation to individual licensees would lapse unless the regulator had grounds to renew it.

The decision on which airports to designate at the start of the new regulatory regime would most sensibly be taken by the Secretary of State, in parallel with the issuing of licences containing the relevant price control provisions for designated airports. This would be consistent with the Secretary of State's commitment that current price caps for Gatwick, Heathrow and Stansted would be maintained.[7]

After this initial decision, there would be two-stage process for re-designating an airport or for extending designation to additional airports. In the first stage (mirroring the current criteria for de-designation) the CAA would decide whether there were grounds for applying a price control according to the following cumulative criteria:
-whether the airport currently holds and can be expected to continue over the forthcoming price control period to hold significant market power (or dominance);
-whether the matter can be adequately dealt with by competition law.

The panel envisages that, because of the cumulative nature of the criteria, the hurdle for additional designations would be high.

This decision by the regulator would be appealable to the Competition Appeals Tribunal by the airport to which it applied, by the consumers' representative body (see below), and by an airline or freight operator which is a direct customer of the airport. The fact that the CAT awards costs against unsuccessful appellants should act as a deterrent against appeals with a low probability of success.

[6] This would include cases of collective dominance.
[7] Subject to other provisions of the Airports Act 1986.

If any airport were found to meet the market power criterion to be eligible for price control, the regulator should have flexibility in determining the form and the process for setting a price control. The panel anticipates that, following past practice in the UK airport sector, and practice in other sectors, a price control based on the regulatory asset base, or RAB would be applied wherever the existence of persistent significant market power warranted it.[8] This should include licence conditions to ensure that the licensee has the necessary financial and other resources to carry on its regulated business. Such conditions are present in other regulated sectors and are known as the financial ring fence.

To protect users, licence obligations would also establish the outputs to be delivered by the airport, in terms of capacity, standards of service etc, and a framework for monitoring, thereby creating the ability for the regulator to take enforcement action if these outputs were not delivered. The CAA's duties and the airport's licence would establish requirements for effective consultation with both airlines, end users and other stake-holders in the course of this process.

Other remedies would, however, be available. These would include price and other controls based on incremental costs, safeguard caps, setting up a system of price surveillance etc. The CAA might even decide in rare cases that no remedy was needed. The duration of the control would be at the discretion of the CAA.

The CAA's decision in this case would be appealable in its entirety to the Competition Commission, but only by the airport affected. This is the practice in respect of price controls in other regulated utilities, and in the panel's view is necessary to prevent the CC becoming the effective sector regulator.[9] The alternative avenue of appeal via judicial review would, of course, be available to any qualified party. Where a licence imposed a price control on an airport, the presumption would be that it would also place obligations on the airport to deliver the investment and standards of service which underpinned the price control. Failure to deliver these would allow the regulator to take enforcement action, and in appropriate cases to levy a financial penalty, as in other regulated sectors.

However, there are two aspects of the price control decision in respect of which the panel proposes a different approach. These relate to cases where the issue is a major one of principle rather than a rather than one of computation. In respect of these two matters, the panel believes that the appeal process should be open to anyone with a sufficient interest, including airlines. Both concern cross-subsidies between airport users.

[8] Under a RAB-based price control, a trajectory of charges over several years to come, a price cap, is set which is calculated to permit the recovery of a rate of return on and depreciation of the airport's efficiently installed capital employed, known as its regulatory asset base or RAB, and of its efficient operating costs. This method is widely used in UK price control regulation.

[9] In this respect, the panel's view differs from that of the Competition Commission in its *Provisional decision on remedies*, December 2008, pp75-84.

The first is the till. Choice of the till (either a single till, in which both aeronautical and non-aeronautical revenues together determine price-controlled aeronautical charges, or a dual till in which non-aeronautical revenues are left out of the equation) has been controversial. The definition of the till goes to the heart of the definition of what constitutes an airport. The CAA has changed its view on the matter, currently favouring a single till. This position has been shared by the Competition Commission in its reviews of the last two price controls for Gatwick, Heathrow and Stansted airports.

The panel has not considered in any detail the merits of the arguments for different approaches. What is clear, however, is that the incentives on BAA to invest in different facilities and the balance of charges to different airport users could be materially affected by the approach adopted. .

Unravelling these relationships in full is a highly complex business, which depends crucially on competitive conditions within the relevant market place. Accordingly, the panel believes that, rather than being enshrined in legislation,, the choice of the till is better left to the regulator to decide, within the context of its general duties. Nonetheless, it believes that the regulator's decision of principle over the till should be more widely appealable.

Secondly, the panel has discussed issues relating to airport charges, including whether there is sufficient clarity and transparency in how charges are set and whether there is scope for improvement in this regard. Under the current RAB-based regime, the CAA sets a maximum average charge per passenger which a designated airport is permitted to levy under its price control. The actual charges for individual users are then set by the airport operator subject to the overall average price cap and to the provisions of the Airports Act 1986 and the Competition Act 1998. The final charge is made up of various components, which may themselves vary by time of day, aircraft size, etc.

An extension of this approach, already in place to a degree in some airports, would offer airlines a greater choice of services, where it is possible to do so, subject to charges being cost-reflective . This could, for example, allow an airline to purchase access to more or less space to accommodate passengers waiting to check in or to access passenger accommodation at a more convenient location or of higher quality. The panel considers that the CAA should investigate whether, in the case of airports subject to price control, such alternative approaches effectively promote the interests of customers and promote competition. This exercise would have to take account of passenger interest as well as airline views.

If the approach were adopted, as a first step, certain Tier 1 airports should be required under their licence to publish a statement of charging principles. This should make it clear which aspects of airport are covered by regulated charges[10] and which were not, and, ahead of each price review, should explain how regulated charges are to be set. A statement should be prepared ahead of each price review, and the airport would have a

[10] Non-regulated charges would be subject to investigation by the CAA using its concurrent competition law powers.

duty to keep it under review. The panel would expect the approach to charging to reflect the principles of non-discrimination and cost-reflectiveness, as well as that of efficiency of provision. The CAA should be required to approve (or not disapprove) such statements. This decision should be appealable by the airport operator, airlines and passengers' representatives.

This issue is related to that of the till, as in the case of a single till, cross-subsidies from retail revenues have to be set against the costs of aeronautical activities. The airport's statement will show how this is done.

Licence conditions relating to Tier 2 airports

These comprise the 10 airports outside Tier 1 and with more than 5 million passengers a year. Like the Tier 1 airports, they will be subject to the forthcoming Airport Charges Directive. Under the Directive, such airports have to consult on airport charges. The panel considers that this process should be accompanied by the provision of a report on the passenger experience at the airport. The panel also recommends that they (and Tier 1 airports) be subject to a licence condition requiring them to prepare and consult with the local community, passengers and airlines and others on a Master Plan for the airports development. (See also the section on environmental regulation below.)

The CAA's concurrent powers under competition law can also be deployed to deal with market power issues arising in relation to Tier 2 (and any other) airports.

Licence conditions relating to Tier 3 airports.

These airports, currently about a dozen in number, and serving between one and five million passengers per annum, would have a licence but be subject to no more regulation than they are at present. There is a possibility that an airport in this category (located on an island, for example) would be in a position to exercise an unacceptable level of market power. In those circumstances, the CAA should have a power to make it subject to certain licence conditions relating to tier 2 airports, particularly an obligation to consult its stake-holders in setting airport charges.

Airports below this threshold would not be subject to economic regulation by the CAA.

Regulating to improve the passenger experience

Improving the passenger experience is one of the review's key objectives.

The panel is aware of how regulatory instruments, backed by fines and bonuses, are now or will shortly be used at Heathrow, Gatwick and Stansted to influence quality of service to passengers. It believes that this provides a foundation for further improvements in the

case of airports subject to price control. Certain matters may require further careful analysis, such as:

- Are the metrics used adequately capturing passengers' main concerns?[11]
- Is there a risk of oversupply of quality resulting from the bonuses BAA can earn from raising quality?
- Do the rebates provide an incentive of appropriate strength for the airport to modify its behaviour, by suitably reflecting the detriment suffered by airlines and passengers as a result of quality degradation?[12]
- Since many of these detriments are suffered by passengers, is it appropriate that the rebates should go in their entirety to airlines? [13]

The panel believes that the introduction of a licensing system should further the objective of improving the passenger experience, as it will introduce greater flexibility and speed of response to new conditions than under the current system where targets are set for five years. The panel does not believe that this gain would be outweighed by any regulatory uncertainty created by this new approach.

The CAA has developed its experience in this area as a result of the above-noted developments in quality regulation, through a series of dialogues with service providers at four airports during 2008, and by research into passengers' experience of airports and airlines, conducted for the Department for Transport. It also has important statutory duties in the field of consumer protection under European law, and will shortly take over additional functions from the Office of Fair Trading.

The panel sees the prospect of synergies from combining the expertise of the CAA's divisions of economic regulation and of consumer protection, as was also identified in Sir Joseph Pilling's review..

Despite these significant developments, the panel considers that the CAA can and should go significantly further in the direction of becoming a consumer-focussed regulator. This will amongst other things require arrangements for a more powerful and independent consumer input into both economic regulation and wider consumer policy matters.

As far as consumer representation is concerned, in the early 1970s the CAA established an Air Transport Users Council (AUC) to assist it in its duty to further the interests of users of air transport service. The memorandum of understanding between the CAA and the AUC notes that the AUC will focus primarily on aspects falling outside the CAA's regulatory remit; with the result that the AUC concentrates on dealing with consumer complaints. The General Consumer Council for Northern Ireland plays a complaints role too. There are also consultative committees for each airport, focusing mainly on

[11] For example, they capture the operational time of baggage carousels (an input variable), but not how long passengers have to wait for their bags (the output variable).
[12] Some airlines claim that the rebates do not adequately cover their losses, let alone passengers'.
[13] If the airline market were competitive, any such rebates paid via airlines should ultimately 'trickle down' to passengers. But this cannot be relied on to take immediate effect.

community issues but with a small element of passenger input, and at the biggest airports these have a passenger service sub-committee.

Most of the complaints to the AUC relate to airline issues, but the panel does not regard the relatively low level of complaints concerning airports submitted to the AUC as an indication that passengers are in general satisfied with airport services. In fact BAA's own customer satisfaction data from 1999 to 2007 show a decline in overall satisfaction at six of its seven airports, and no change in the seventh.

On the basis of experience in other sectors, and having considered the particular needs in this sector, the panel recommends that the institutional arrangements for measures to improve the passenger experience should meet the following criteria:

- There should be an independent *policy advocacy* function, which has authority and credibility with government, the CAA, the industry and the public. This should be sufficiently well-resourced to allow it to develop sector-specific expertise and underpin its analysis with insight into the needs, aspirations and experiences of passengers. This should be able to tackle a wide range of issues, including at European and international level, and have the skills and knowledge to be able to provide consumer input to regulatory strategies and decisions. Given the connection between economic regulation and service quality issues, and the difficulty for passengers in determining who is responsible for which service, this should cover both airport and airline related issues.

- *Complaints handling* should be conducted by a body which has legitimacy and visibility, and with the expertise to engage effectively with airport operators and airlines. The information gathered should form an important, but not the only, input into consumer advocacy.

- Consumer policy perspectives – including the interests of freight users as well as passengers – should be reflected within the *CAA's organisational culture.*

There are a number of alternative ways of providing these functions.

The policy advocacy function could be provided by an entirely new organisation, or it could go to an established body such as Passenger Focus or Consumer Focus. We do not think it should remain with a revised version of the AUC, even if the Council were given a stronger and clearer role backed by statute, as it needs to be demonstrably independent of the regulator. The panel considered carefully whether air transport is so different from rail and bus that it requires a separate body. It is not convinced that it is, and believes that existing consumer bodies – with the kind of consumer policy expertise and advocacy skills which do not currently exist within this sector – are well-placed to expand their role to cover air travel issues. Clearly this would involve developing new industry expertise; but this is not unusual for such organisations.

This function could be funded through the licence fee system, as happens in other sectors. If the advocacy body were to have responsibility for other sectors too, internal arrangements would need to be established to prevent cross-subsidy; this is what happens at Consumer Focus, for example, where there are three funding streams.

We consider there is scope for more use to be made of the passenger service committees. These presently exist only at a small number of airports, but they have the potential to provide valuable consumer intelligence about issues relating to each airport. We are not convinced that a formal 'committee' model is necessarily the right approach, but there could instead be a passenger panel at each airport, independently facilitated and recruited and with the membership refreshed periodically. This model has been used for some time by leading businesses and other regulators. The body chosen to take responsibility for passenger advocacy could perhaps take on the role of supporting this network of airport-specific passenger panels.

There are also options with regard to complaints handling. We do not think the current arrangement, with the AUC handling complaints from within the CAA, should continue, as, for reasons of resource constraints, it is not sufficiently visible. However the advocacy body mentioned above could take on this responsibility – a number of consumer bodies in other sectors, including Passenger Focus and Consumer Council for Water, already do this. Alternatively, the CAA could handle complaints, although this is a relatively unusual role for a regulator and does not necessarily sit comfortably with the CAA's regulatory responsibilities in terms of enforcing EU passenger legislation.

In terms of changing the CAA's organisational culture, we have already mentioned the potential benefits of bringing together the CAA's divisions of economic regulation and of consumer protection. The regulator will also need to demonstrate that it is underpinning its approach and decisions with insight into the experiences and needs of airport users. This is likely to involve a programme of consumer engagement and research, and engagement with relevant organisations (including the airlines). Some other regulators have found it useful to have a consumer panel acting as a 'critical friend', providing a safe space for ensuring that consumer policy issues are addressed properly. This can be done informally, or created by statute, as the Consumer Panel is in Ofcom. Following Sir Joseph Pilling's proposal, this might be performed by a revamped AUC, possibly created by statute.

Having considered all of these issues and options, the panel recommends the following approach:

1. Passenger Focus to be given responsibility for consumer policy advocacy with regard to airports and airlines, funded through airport licence fees. This should include developing and supporting a network of consumer panels at leading airports.
2. Passenger Focus to handle complaints. This should include taking on legal responsibility from the AUC for complaints handling with regard to some EU passenger law.

3. CAA to develop a programme of consumer and stakeholder engagement, and to consider re-constituting the AUC as a 'critical friend' on regulation and consumer protection issues, covering both passenger and freight user interests.

.

Regulation of financial structures and of performance

There is debate over whether a special administration regime is necessary to ensure continuity of service the event of a major airport encountering financial difficulties or exhibiting persistently poor performance, which breaches its licence conditions. Such regimes are in place in other utilities.

The panel is aware of the argument that such a regime is unnecessary, because, an ordinary administration regime would ensure continuity. However it believes that a special administration regime does provide a valuable additional safeguard. In the panel's view, it should apply to the Tier 1 group of airports on which a form of price control may be applied on the ground that they exercise significant market power. Those airports are chosen on the ground that users, by definition, have no adequate substitute**.** Careful consideration will have to be given to the method of introduction and implementation of such a regime, in the light of the airports' current financing arrangements.

Airports and the environment

The panel is aware of and sympathetic to Sir Joseph Pilling's recommendation that the CAA have an environmental duty as a whole. In relation to economic regulation of airports, this is captured by secondary duty v) above.

At the same time, many aspects of airport activity will be subject to regulation from other sources- noise, by limits established by local or central government and the planning regime; by the impact of economy-wide measures on carbon emissions; by obligations concerning local transport; and so on.

However, there are probably gaps in this process. Thus when the CAA is considering alternatives means of constructing facilities at regulated airports, the panel would expect it to follow guidance by the Secretary of State concerning shadow price for carbon and other key environmental variables

The CAA may also play a role in enforcement of some environmental obligations, if it proves desirable to impose them as licence conditions.

The panel also believes that Tier 1 and Tier 2 airports should be subject to a licence condition requiring them to submit an annual report to the CAA and other environmental regulators on how they have met their environmental obligations, what are the likely environmental consequences of their Master Plans and what further steps they intend to make to limit environmental damage**.** In the panel's view, such reports would in the first

instance be subject to a publication obligation. However, it would be open to the CAA to seek to impose additional obligations by means of a change in licence considerations if it believed that such a change was necessary to enable it to fulfil its duties.

In the panel's view, the above can be accomplished without turning the CAA into a regulator requiring a large specialised environmental staff with all of its employment and cost implications. This is because most of the objectives can be achieved in collaboration with other specialist regulators.

Annex: panel members' biographies;

Chris Bolt is chairman of the Office of Rail Regulation and Arbiter of the London Underground Public Private Partnership Agreements.

Martin Cave is a professor at Warwick Business School. He is the author of independent reviews for government of the regulation of social housing and of competition and innovation in the water sector.

Philip Cullum is deputy chief executive of Consumer Focus. He chairs the Food Standard Agency advisory committee on consumer engagement and is a member of the Risk and Regulation Advisory Council

Anne Graham is senior lecturer in air transport at the University of Westminster; she has been involved in teaching, research and consultancy in air transport for over 20 years.

David Gray was a member of the Gas and Electricity Markets Authority (GEMA) and Managing Director, Networks Division at Ofgem from 2003 to 2007, where he was responsible for all aspects of the regulation of the electricity and gas transmission and distribution networks.

Dieter Helm is a Fellow of New College and Professor of Economics at Oxford University. He is an economist specialising in utilities, infrastructure, regulation and the environment.

Sir Adrian Montague is chairman of Friends Provident and non-executive chairman of British Energy Group, Michael Page International plc, Infrastructure Investors Limited and CellMark Holdings AB of Gothenburg.

Andrew Sentance is a member of the Bank of England's Monetary Policy Committee,, a professor at Warwick Business School, and a member of the Committee for Integrated Transport. He has been chief economist and head of environmental affairs at British Airways.