

Hannah Nixon
Director, Regulatory Review
Ofgem
9 Millbank,
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7 May 2009

Dear Hannah,

Response to Ofgem's February 2009 'RPI-X@20' consultation

1. The Civil Aviation Authority (CAA) welcomes the opportunity to comment on Ofgem's consultation 'Regulating energy networks for the future: RPI-X@20 Principles, Process and Issues'.
2. The CAA has not sought to comment on all of the issues raised in the Ofgem consultation document. Rather, this response focuses on how best to involve customers in the regulatory process. As the document states, the CAA considered this issue in preparation for the recently completed price control reviews of Heathrow, Gatwick and Stansted airports, introducing a process referred to as 'constructive engagement' (CE).
3. By way of background, it is first important to understand what CE was and – equally important – what it was not. CE was an attempt by the CAA to increase the role of airlines in the regulatory process. The key features of CE were that:
 - the CAA set the scope for airport-airline negotiations: confidential issues and areas where negotiations were 'zero-sum' in nature were excluded from the process¹;
 - airlines and the airport operator negotiated without the CAA taking an active involvement, mimicking more normal commercial negotiations and reducing the risk that either party might draw the CAA into the debate;
 - airlines and the airport operator worked towards a report that set out areas of agreement and disagreement; and
 - the CAA used this report as an important source of evidence to inform the ultimate price control decision.
4. In this process, the role of the CAA was to act as the final decision-maker, rather than to arbitrate between the parties in search of an agreement.

¹ These issues were then taken forward using more traditional regulator-led scrutiny and consultation.

Importantly, the CAA reserved the right not to adopt the outputs of the CE process, where this was not consistent with the CAA's statutory duties, including its duties to the end-user (i.e. passengers) and to future airport users. With this in mind, the participants to the CE process were encouraged to ensure that any agreements were consistent with the CAA's statutory duties. In practice, the CAA did not need to depart from the agreements reached by CE.

5. However, it should be noted that CE is not a form of arbitration. Nor – as it has occasionally been misinterpreted – is the central purpose of CE to secure agreement between the regulated company and its direct customers. Rather, its principal purpose is to inform the regulator, including through greater clarity about those areas where agreement is not possible. To help illustrate this distinction, we attach an annex which contains a diagram comparing and contrasting the features of a number of different approaches to involving customers in regulatory decisions.
6. The design of CE reflects the features of the regulated airports, not all of which will be directly comparable to the features of network monopolies. In particular, airports have the following features:
 - there are a number of large, informed customers (i.e. airlines) and a number of alliances and industry groups that can represent the interests of smaller customers;
 - the commercial interests of airlines can be expected to align with the interests of passengers in a number of respects, not least because the service offered by the airline to its customers is the product of the performance of both the airline and the airport operator;
 - airlines operating out of a regulated airport can compete with airlines operating out of other airports, meaning that airport-specific cost increases may not be passed fully onto passengers (achieving a degree of alignment between airline and passengers' interests on some issues); and
 - some regulated airports can face a degree of competitive pressure (achieving a degree of alignment between airport and passengers' interests on some issues).
7. The CAA is preparing a more detailed explanation of the CE processes and will make this available to the RPI-X@20 review when it is available. In due course, we would also expect to review the performance of CE via a structured lessons learned exercise. We would expect such a review to cover a range of issues, including:
 - how regulation affects the likelihood that CE can work, and, where regulation leads to a significant misalignment of incentives, its potential to undermine the potential for CE to deliver useful outputs²;
 - the rules and procedures governing the sharing of information can affect the likelihood of success; and

² CE was not successful at Stansted Airport. The CAA analysed the underlying causes for its failure and concluded that the combination of a large capital investment programme (i.e. the potential for a second runway at the airport) and the expectation of a RAB-based building-block price cap distorted the incentives faced by the airport operator and the incumbent airlines. The CAA's March 2009 price control decision explains this issue in more detail.

- the potential benefit that might be derived from the appointment of a third-party facilitator.
8. Overall, the CAA considers that the first application of CE – whilst not perfect – was a significant improvement on previous processes and ensured that there was considerably greater involvement of airlines in the decision-making process. The CAA will be looking to build upon the successes and to identify improvements in advance of the next price control reviews.
 9. It is also worth noting that the CAA has initiated a customer consultation process in connection with the 2011-2014 National Air Traffic Services (En Route) plc price control review. This process is now well underway, and due to report by the end of this calendar year. We would be happy to provide details of this process (including the accompanying CAA mandate, the code of conduct and schedule of meetings) if you would find that of interest.
 10. I hope these comments are useful. We look forward to continuing to participate in the debate as the RPI-X@20 project progresses.

Yours sincerely



Nick Fincham

Annex – Distinguishing between Constructive Engagement and other forms of supplier/customer/regulator negotiation

	Degree of delegation by regulator				
	HIGH ←			→ LOW	
	Ex post intervention (e.g. staying reliance on Competition Act or license enforcement)	Supplier-Customer negotiation (e.g. pendulum arbitration processes)	Constructive Engagement (e.g. unit for UK airport price controls)	Regulator-led negotiation with supplier and customers	Regulator-led consultation on regulator's proposal (i.e. 'traditional' approach)
Role of regulator	Limited to ex post intervention against inadequate outcomes (prices, service quality or investment)	Apparal body in the absence of agreement	Defines scope for CE discussions	Seeks agreement from customers and supplier Makes final decision	Seeks views of stakeholders Makes final decision
Nature of decision 'delegated' by regulator	All decisions delegated.	Parties invited to develop and agree the price control 'contract'	Parties encouraged to reach agreement and to set out areas of disagreement Regulator retains decision-making power	None	None
3 rd party facilitation	Could be used – unlikely to be facilitated by regulator	Could be used – unlikely to be facilitated by regulator	Not used for recent price controls, but 3 rd party facilitation of negotiation possible	Regulator leads negotiation and facilitates discussion	n/a
Status of any agreement	Binding. No ex ante regulator approval.	Any agreement would be binding on the regulator	Uniforms regulator's decision, but is not binding	Binding	n/a
Dispute resolution / process in the absence of agreement	Ex post enforcement if outcomes were inappropriate (agreement not necessary)	Regulator takes decision or use pendulum arbitration	Regulator takes final decision	Regulator takes decision, in light of views expressed	n/a
Appeals processes	n/a	Normal appeals processes (pendulum arbitration: probably process only)	Regulator's decision is subject to normal appeals processes (currently just Judicial Review in airports)	Regulator's decision is subject to normal appeals processes	Regulator's decision is subject to normal appeals processes