COMPETITION COMMISSION

BAA AIRPORTS MARKET INVESTIGATION

Points from hearing with Gatwick Airline Operators Committee and Airline Consultative Committee

Introduction

1. The Airline Operators Committee (AOC) and Airline Consultative Committee (ACC) said that Gatwick was unique in Europe. It was host to every variation of airline operation—long- and short-haul scheduled, long- and short-haul charter and long- and short-haul low cost. At 50 movements per hour in the peaks, it had the highest use for a single runway anywhere in the world; and although not a major hub, 15 per cent of its traffic was transfer traffic.

2. The AOC and ACC had a good open relationship with BAA management locally, although there were occasional disagreements. Most of Gatwick's current problems stemmed from under-investment in Q3, which the Q5 capital investment plan (CIP) was intended to address and on which the airlines were largely aligned. BAA tended to emphasize a table showing that Gatwick's charges were half those at Schipol (Amsterdam). However, what it omitted was that Schipol had a CIP significantly larger than Gatwick's, around three to four times the size; BAA also ignored the fact that Munich and Barcelona had similar charges to Gatwick and had recently benefited from £1 billion new terminal developments.

3. Explaining the differences between the AOC and the ACC, they said that both were bodies constituted under the aegis of IATA. While the ACC was charged with looking at the more strategic aspects of airport operation, such as the five-year capital plan and charges, the AOC was designed to handle day-to-day issues and liaison with the airport. There were 44 or so airlines at Gatwick and all had the opportunity to participate. In practice, however, it was the top 10 to 15 carriers that mostly came to the meetings, as others did not have sufficient local staff available.

4. The airline community generally arrived at a consensus for traffic forecasts including open skies forecasts by the end of Q5. However, the potential for disagreement existed where individual airlines were unable to reveal schedule information to competitors. It was hoped that the constructive engagement process would find a solution in the future. Despite general agreement on forecasts there was uncertainty around the detailed impact of Open Skies, which made it difficult to agree on a schedule of flights for the future and on whether the Pier 7 project was needed in Q5 or Q6.

Constructive engagement: communications

5. Communications had been hampered by managerial turbulence in BAA, resulting in a great deal of management change and managers who were new to the job and in some cases new to airport roles. However, things were improving and the airline community considered it was able to build a more constructive relationship with the airport. BAA regarded constructive engagement as a success that enabled the airlines to get a better insight into how BAA ran its business and into BAA's thinking. The airlines' perspective on strategic choices was now being heard. But there was a significant way to go. The majority of airlines did not have dedicated staff that could

be part of the constructive engagement process. BAA was still reluctant to hand over data until it was pressed for or the airlines sought CAA assitance; and even then it arrived late or was often inappropriate. Also the process in place for constructive engagement, including the sub-committees that reported to the joint steering group, could do with improvement so as to make consideration of choices for the airport—capex or opex—more efficient.

Constructive engagement: capex

6. There had been a good deal of over-optimism about the initial estimates for the CIP at Gatwick. This explained the recent increase from the £450 million level. There were, however, areas of disagreement with BAA that were unlikely to be resolved in the CAA's timetable for submitting a report. The key ones were:

   (a) The airlines agreed with BAA that the north terminal needed development but were not agreed on the rate at which new infrastructure should be provided. While BAA was promoting the whole development in Q5, the majority of airlines favoured deferring the bulk of the work till Q6. Some required a pier service which would argue for building Pier 7 in Q5. Others, and the feedback from them was still being sought, could be content to go 'off pier'. The AOC and ACC were looking at the possibilities of sustaining a 90 per cent plus pier availability service in Q5 without Pier 7. The difference was substantial; if Pier 7 was included in Q5, the CIP quantum would be £845 million. While the airlines could support £50 million of preliminary works for Pier 7 in Q5, they contended that the balance of the £187 million cost should be deferred till Q6, meaning delivery of the pier in 2015, rather than 2012.

   (b) Another problem was that BAA would not share its commercial revenues forecast with the airlines. This impacted on a proposal for a 10,000 to a 15,000 sq metre floor plate rail interchange and terminal departures forecourt development, modelled on Frankfurt's, where BAA was asking for £49 million but saying simultaneously that there few offsetting retail revenues. The airlines found it hard to credit this.

7. When building a business case, BAA was not good at considering the opex effects on airlines. This was in contrast to an airport like Munich which developed cases with positive pay-offs for the airlines. BAA despite the CE process still felt it was not required to ask for airlines' support for projects. On passenger segregation, BAA seemed to be trying to ignore the impact on airline opex of failure to invest in vertical segregation. The airlines had had to argue strongly to get this included for Pier 2 in the CIP.

8. BAA had said that it did not want to be bound to deliver any particular five-year investment plan and the airlines understood that—given the potential for change at Gatwick.

9. What the airlines wanted in return, however, was a commitment by BAA to agree a quantum of spend and not to change the agreed plan unilaterally, but to come back and consult with the airlines. Also for BAA to agree triggers for the key infrastructure projects. The AOC and ACC were pleases that CAA consultants were to be reviewing elements of the CIP, including risk. The airlines were concerned that all projects apparently required 25 per cent risk uplift, even where standardized projects, such as baggage systems and piers, were being proposed by BAA. They also thought that there might be value in BAA pursuing a risk approach based on a portfolio so that risk money was held centrally and allocated only as and when

needed; as opposed to being held at project level where there could be more temptation to let project costs rise to absorb the risk element.

Constructive engagement: security and baggage

10. The airline community was still pressing BAA for the information necessary to reach a decision on the appropriate service quality regime for security. It was unlikely that the CAA deadline would be met. The issue was the efficiency of the security process and the appropriate opex and capex totals accompanying a decision on a clearance standard. The current target for security clearance was less than 10 minutes measured, though BAA had unilaterally announced a standard of 95 per cent within 5 minutes without any consultation. The airlines had asked for information to enable them to understand the costs, but it had not been forthcoming. At Heathrow some figures had been produced for alternative performance levels but there had been some supporting data and even this had not been produced for Gatwick.

11. The principle of a new baggage system for the south terminal had been agreed; however, BAA had insisted on doing the initial design concept itself, whereas the airlines would have preferred the design outsourced.

12. At the last review GAL had committed to the CC to introduce an SLA for outbound baggage but had taken four years to reach agreement by often delaying discussion. Even then the SLA was only introduced for BA in North Terminal in January 2007.

Other service quality issues

13. Among subjects mentioned by the ACC and AOC were:

(a) inclusion of *external control posts* in the service quality system, which had been agreed in principle but would not be ready before the CAA deadline;

(b) the amount of *rebate* at risk should be increased and some of the target performance levels should be made more challenging;

(c) the inter-terminal track transit system (*ITTS*) had not been well maintained, though this had now improved. There was agreement on replacing it with a new system. However, BAA was reluctant to follow standard industry practice and lease the new trains and preferred instead to buy them;

(d) there was disagreement on *service bonus payment schemes*. The airlines felt that there was benefit to them in BAA performing to a higher standard than agreed but did not want to pay twice for BAA to do better BAA were keen on bonus payments; and as it intended to use them to offset service quality rebates in other areas, it was clear that the only beneficiary of a bonus scheme would be BAA;

(e) *security queue measurement*. Measurement was currently a manual process and the aim was to automate it and remove human error—for instance measurement often began when passengers were already in the queue and approaching the security X-ray area rather than when they actually entered the queue. BAA were very slow to adopt new technology; and

(f) one area where the airlines were keen for improvements was in the weighting given to *passenger-sensitive equipment*. The most critical pieces of equipment

were lifts and escalators. Equipment like this needed a higher weighting than those not used by passengers to the same degree.

Charges

14. The AOC and ACC had not done any analysis of charging issues as they did not have the necessary resources. However they had been able to rely on the expertise supplied by airlines such as BA and Virgin; and in any case had a strong feel for what the airline market could bear by way of charges at Gatwick. Some of BAA's forecast requirements, for example for RPI plus 5 or 6, would have acted as a severe brake on some carriers. BA in its submission had suggested a cost of capital around 5.6 per cent on the RAB which seemed not unreasonable. BAA always charged up to the cap. As it was, the airport's charges were roughly comparable with those at Barcelona and Munich, which operated at the same sort of level as Gatwick from the point of view of size and passenger volumes. If people asked whether the airlines at Gatwick had a consensus view on what the Q5 charges should be, the answer would depend on which charges were being referred to—utility prices, check-in prices, etc. there were many debates and they still had some way to go to achieve consensus, but there was a much better communication system now and the airlines' charging group either came to an agreement with BAA or disagreement.

15. That said, the airlines thought that a level of investment in Q5 around the £630 to £650 million mark was affordable, though they were looking to the CAA and the CC to ensure a reasonable cost of capital regime; and considered that an increased capital investment programme was feasible without raising charges because there was a lot of scope for efficiencies. BAA had not disclosed the off-setting effect of retail revenue in projects like the proposed rail interchange. In addition there had been a major investment (£26 million) in Q4 to extend the international departure lounge in the south terminal, but the airport had so far refused to provide information on the net income gained from that development.

16. The ACC-AOC view on the merits of differential charging between the north and south terminals at Gatwick was reserved. Once the south terminal had been modernized it would be as good as the north terminal. The two were, however, rather different with the south terminal having the benefit of the adjacent rail and road network and the north terminal better provided for spatially. How differential charging might work in these circumstances was anyone's guess.

Traffic forecasts

17. The difference between the airlines and BAA on traffic forecasts was relatively narrow and there was no impact on investment. The issue for the airlines lay in the charges and the fact that they felt that BAA had underestimated the rapidity of the likely backfill to vacated slots—emphasized all the more as airlines' Open Skies plans began to filter into the public domain. In any case, the ACC and AOC knew that there was a queue of companies for any vacant slots. The constructive engagement process would have been a straightforward forum for reaching agreement with BAA on forecasts, but for the intervention of Open Skies which the airlines had not expected to be settled so quickly and the consequent degree of commercial sensitivity surrounding individual airlines' plans. There had, however, been a useful degree of productive mutual effort between BAA and the airlines which had started off quite a way apart at the beginning of 2007.

Opex issues

18. The airlines had not been happy with BAA's handling of the IT for check-in desks. The ACC and AOC had done their own research and had come up with a markedly cheaper solution. While BAA had been proposing a deal costing 21p per passenger plus a sum to offset previous under-recovery of £3 million (over the five years of Q5), the airlines had managed after a good two years of discussion to reduce the charge to 14p all-in (ie including under-recovery charges). The airlines believed they could do better than this if they had the opportunity to outsource the IT provision. In addition, they also believed that there were economies of scale to be had by integrating the 'common user self-service' system unilaterally imposed by BAA with the bespoke automatic check-in facilities already in place. The airlines believed they were in a better position to provide these services than BAA which had simply, and without consultation, decided that it was going to be the sole supplier of them—as it had also done at Heathrow. BAA clearly saw it as a revenue stream.

19. As to efficiency savings, BAA were a backward organization. While the airlines had been reducing their costs by 25 per cent or so over the past four years and struggling to make a profit, BAA simply sat on its permitted revenue stream making a healthy profit. It had pushed a little on efficiency but kept coming back saying that it was all too difficult. Underlying this were industrial relations issues. There are multiple roster patterns which do not always match the fight schedules.

20. The airlines would not have been able to survive if their crews had been working with a like number of union agreements. BAA's behaviour was to be contrasted with that of Manchester airport which had faced up to major industrial issues and reorganized its whole security operation. It now had a much more flexible workforce and better working practices.

Market inquiry issues

21. The ACC-AOC view of whether competition was to be preferred to regulation in the London area was conditioned by the fact that there was such limited spare capacity. Splitting the airports between different companies could well be beneficial in terms of better management and a more focused operation. The management of the airports might also be more responsive to airlines' needs. The airlines view was that some form of regulation would still be needed and this should be subject to full consultation. At present, for example, there was not even any point in an airline wanting to move from the south to the north terminal at Gatwick as both were full. One got a similar situation abroad, for example between Cologne and Düsseldorf; although the latter had been part privatized, there had been little movement from Cologne, or any drop in prices at Düsseldorf, because the airport was approaching capacity at peak.