



Non-Confidential

Update of the long-term forecasts of
Heathrow and Gatwick

BAA/CC2007/350

BAA Limited
July 2007

Introduction

1. Following the submission of the final reports of Constructive Engagement ('CE') by Heathrow and Gatwick, we have produced a revised (to those submitted as BAA/CC2007/100) set of financial forecasts that reflect those outputs of CE. [Excised]
2. This re-forecast has also updated a number of items where better information now exists. The re-forecast has necessarily been performed at a high level and only material items have been updated. A full re-forecast of all items has not been performed. Hence this is a high level refresh of the original forecast rather than a detailed line by line re-forecast to the same level of detail as the original forecast.
3. There are two main features of this resubmission.
4. First, the airlines have continued to put the case to BAA for enhanced and accelerated capital expenditure at Heathrow and Gatwick. At Heathrow, the airlines who will not be in Terminal 5 are pressing for competitive equivalence as fast as possible. The fact that the airlines are pressing for more expenditure and - by extension - higher prices, shows the demand for a superior Heathrow product. At Gatwick, despite the advent of 'Open Skies', the airlines have called for a significant increase in the proposed capital programme. We have some differences over the timing of the complete renovation of Gatwick, but the end goal of projects and costs has been agreed.
5. Second, security costs continue to rise. The new security directives in April and the EU review of security processes diverted, permanently, front line security staff. They have to be replaced by new recruits. Airlines are pressing for a return to "two bags" to be taken into the cabin. Passengers want shorter queues at security. Our latest estimate of security costs is included in this paper - although we have not included the full estimate of security costs (e.g. the return to "two bags") since it depends on agreement from the DfT as to new scanning technology.
6. Before we turn to the detailed commentary, we must reflect on the price rises at both airports. We are confident that our plans will transform Heathrow and Gatwick. Our capital expenditure efficiency has been verified by the airlines own consultants. These airports cannot remain comparatively cheap whilst delivering what will be world class facilities.

Summary of impacts

7. In summary, the amendments that have been made can be broken down into three categories:
 - Revised capital plans;
 - Security costs; and
 - Other airport specific items.

Revised capital plans

8. As described in greater detail in the respective final CE reports (BAA/CC2007/311 and BAA/CC2007/312), both Heathrow and Gatwick's capital plans have been increased since BAA/CC2007/100. At Heathrow there has been a £606m (2007/08 prices) and £128m (2007/08 prices) increase in the capital plans in Q5 and Q6 respectively. At Gatwick there has been a £408m

(2007/08 prices) increase and £86m (2007/08 prices) decrease in the capital plans in Q5 and Q6 respectively.

Table 1

£m 07/08 prices	Q5						Total	Q6					Total
	07/08	08/09	09/10	10/11	11/12	12/13		13/14	14/15	15/16	16/17	17/18	
Heathrow Revised*	786.4	839.7	932.8	884.1	591.3	311.6	3,559.5	789.3	730.1	544.2	308.4	303.5	2,675.5
Heathrow BAA/CC2007/100*	786.6	687.9	746.0	774.0	498.3	247.2	2,953.5	812.7	569.2	457.6	351.7	356.5	2,547.7
Variance	-0.2	151.8	186.7	110.0	93.0	64.4	606.0	-23.4	161.0	86.6	-43.3	-53.0	127.8
Gatwick Revised	91.2	137.1	216.8	238.3	147.8	104.8	844.8	55.5	67.5	92.0	61.0	52.0	328.0
Gatwick BAA/CC2007/100	87.7	99.1	92.6	71.8	67.7	105.6	436.8	109.8	72.1	64.9	78.8	88.8	414.5
Variance	3.6	38.0	124.2	166.5	80.1	-0.8	408.0	-54.3	-4.6	27.1	-17.8	-36.8	-86.5

*includes payments to Thames Water for land purchase

9. There were some minor changes to the Heathrow capital plan included within the final CE document that have not been reflected in the GSM forecast above. These adjustments are not considered to be material. The Gatwick capital plan included in the GSM forecast shows capital spend under 'allocated funds' evenly phased over Q5 and Q6. The phasing of the plan provided under BAA/CC2007/279 shows an alternative phasing.
10. This amendment to the capital plans has had consequential impacts on operating expenditure and non-aeronautical revenues. At Heathrow, in Q5 operating expenditure increases by £22m and non-aeronautical revenues decrease by £8m, and at Gatwick, operating expenditure increases by £19m. The operating expenditure impacts relate to rates, maintenance, utilities, ground transportation and cleaning costs. These impacts arise as a result of the incremental and re-phased capital expenditure.
11. At Heathrow, the reduction in non-aeronautical revenue relates to retail revenue and property revenue. There is a £5m retail revenue reduction in 2012/13 as a result of the phasing of the opening of the Heathrow East Multi-Storey Car Park and the closure of Multi-Storey Car Park 1. Additionally, the increased property revenue of £4m p.a. that was included in BAA/CC2007/100 as a result of Heathrow East has been removed from 2012/13 onwards following increased clarity on the scope of Heathrow East. An increase in property revenue of £2m has been included in 2010/11 following the re-phasing of T5C.
12. The impacts on operating expenditure and non-aeronautical revenue are summarised in the following table:

Table 2

£m 07/08 prices	07/08	08/09	09/10	10/11	11/12	12/13	13/14	14/15	15/16	16/17	17/18
Heathrow											
Property revenue	0.0	0.0	0.0	1.8	0.0	-4.4	-4.4	-4.4	-4.4	-4.4	-4.4
Retail revenue	0.0	0.0	0.0	0.0	0.0	-5.0	0.0	0.0	0.0	0.0	0.0
Rates	0.0	0.0	0.3	0.7	0.7	6.3	7.0	7.0	7.9	2.8	2.8
Utilities	0.0	0.0	0.2	0.5	0.5	0.7	1.0	1.0	1.5	1.5	1.5
Maintenance	0.0	0.0	0.3	0.7	0.7	1.2	1.8	1.8	2.6	2.6	2.6
Other costs	0.0	0.0	1.1	2.7	2.7	2.8	3.0	3.0	3.2	3.2	3.2
Net costs	0.0	0.0	1.9	2.8	4.6	20.4	17.2	17.2	19.6	14.5	14.5
Gatwick											
Rates	0.0	0.0	0.2	0.2	1.6	2.8	4.3	4.0	4.1	3.7	3.8
Utilities	0.0	0.0	0.2	0.5	0.9	1.1	1.1	1.1	1.1	1.2	1.2
Maintenance	0.0	0.0	0.1	2.3	3.5	3.8	3.8	3.2	3.2	3.4	3.2
Other costs	0.0	0.0	0.1	0.3	0.5	0.6	0.6	0.6	0.6	0.7	0.7
Net costs	0.0	0.0	0.6	3.3	6.5	8.3	9.8	8.9	9.0	9.0	8.9

13. In addition, following the delay in closing Terminal 1 to 2016/17 (which is the reason there is an increase in rates in 2012/13 which reduces in 2016/17), the accelerated depreciation associated with its closure has been amended. This only impacts statutory depreciation.

Security costs

14. Both airports have reassessed the security cost forecasts in light of better information in relation to the progress on recruitment of additional staff, the levels of staff required for a 10 minute and 5 minute standard, and the additional staff required as a result of the new security directives introduced in April 2007 (liquids testing) and the implications of a recent EU security audit. This has led to increased security costs at Heathrow in Q5 of £27m (£7m in 2007/08) and at Gatwick of £14m (2007/08 £4m).
15. At Heathrow, an additional 132 man years has been included from 2008/09 onwards at an additional cost of c.£5.5m p.a. This additional 132 man years increases the total number of incremental security man years post 10 August to 570 man years. These 570 man years are broken down as follows, 165 man years to return to a 10 minute standard (95% of the measured time), 163 man years to provide additional resilience and to target a 5 minute standard (95% of the measured time) and 242 man years in total as a result of the April 2007 Liquids directive (161 man years), EU security audit (33 man years) and additional service initiatives (48 man years).
16. In BAA/CC2007/100, 110 man years had been included as an early assessment of the impact of the new DfT and EU security audit impacts, and this incremental amount of 132 man years reflects a more informed estimate of the additional manpower requirements. Whilst this variance is driven by this revised assessment of the new DfT and EU security requirements, these additional security guards will be used to complete the 163 man years required to provide additional resilience and replace those security staff that have been diverted in order to comply with the new DfT directives, EU security and additional service requirements.
17. The impact in 2007/08 is similar but is also impacted by the timing of recruitment. The man year variance in 2007/08 compared to BAA/CC2007/100 is an additional 167 man years and a net staff cost increase of £7.3m. This comprises of 206 man years in total for the April 2007 Liquids directive (133 man years), EU security audit (31 man years) and additional service initiatives (42 man years) at a cost of £8.7m (including £1m recruitment costs) offset by a saving of 39 man years at a cost of £1.3m since the 163 man years anticipated to be in place by April 2007 will not be in place until

September 2007. The overall variance is larger since no impact of the new directives and EU security audit was included in 2007/08 in BAA/CC2007/100.

18. Hence the revised additional security costs, post 10 August, can be summarised as follows for Heathrow:

Table 3

£m 07/08 prices	07/08	08/09	09/10	10/11	11/12	12/13	13/14	14/15	15/16	16/17	17/18
Costs to return to prior service level	10.4	10.5	10.7	10.8	10.9	11.1	11.2	11.4	11.5	11.6	11.8
Additional resilience	4.5	5.9	6.0	6.1	6.2	6.3	6.4	6.5	6.6	6.7	6.8
New DfT directives	5.3	6.0	6.1	6.2	6.3	6.4	6.5	6.7	6.8	6.9	7.0
EU audit & other service initiatives	3.2	3.1	3.1	3.2	3.2	3.3	3.3	3.4	3.4	3.5	3.5
Total	23.4	25.6	26.0	26.4	26.7	27.1	27.5	27.9	28.3	28.7	29.1

19. It should be noted that Table 13.3 in Chapter 13 Security costs in BAA/CC2007/100 had been incorrectly compiled for Heathrow and the costs associated with moving to a 5 minute target as presented had been overstated. This is an error in compilation of the table only, the figures in the financial forecasts contained in the files from the GSM had reflected the correct level of costs which, for Q5, would be as per “additional resilience” set out above (i.e. 163 man years).
20. At Gatwick as at Heathrow, the principal variance relates to the new DfT directives and EU security requirements. The impact of these requirements has been assessed as 133 man years, of which only 9 man years had been included in BAA/CC2007/100. The cost of these additional man years is c.£4.0m p.a. although this is then subject to the long-term productivity assumptions within the long-term forecast. [Excised].
21. In 2007/08, due to the timing of recruitment, the man year impact of these requirements is only 92 man years. The additional staff costs in 2007/08 in the re-forecast are £4.9m which are higher than in future years [Excised].
22. In addition to the staff cost impact of the additional security requirements, other cost reductions of £1.1m p.a. for the 10 minute standard costs have been reflected in the re-forecast principally due to the purchase rather than the leasing of equipment along with negotiated savings on agency and marketing costs. Additional other costs of £0.3m p.a. partially offset this in relation to the additional requirements of the new security directives and EU audit.
23. Hence the revised additional security costs, post 10 August, can be summarised as follows for Gatwick:

Table 4

£m 07/08 prices	07/08	08/09	09/10	10/11	11/12	12/13	13/14	14/15	15/16	16/17	17/18
Costs to return to prior service level	10.8	8.2	8.3	8.3	8.3	8.3	8.3	8.4	8.5	8.7	8.8
Additional resilience	0.4	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
New DfT directives & EU audit	4.0	4.7	4.7	4.7	4.7	4.7	4.7	4.8	4.9	4.9	5.0
Total	15.2	13.4	13.5	13.6	13.5	13.5	13.7	13.8	14.0	14.2	14.4

24. In summary the additional (compared to BAA/CC2007/100) security costs (staff and other) included in the re-forecasts are as follows:

Table 5

£m 07/08 prices	07/08	08/09	09/10	10/11	11/12	12/13	13/14	14/15	15/16	16/17	17/18
Heathrow											
Staff costs	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]
Gatwick											
Staff costs	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]
Other costs	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Net costs	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]

25. The forecasts are targeting a standard of 5 minutes or less queues 95% of the SQR measured time based on the “one bag” allowance continuing. At Gatwick however, due to the peak nature and passenger profile of its customers, the forecasts are delivering a consistent service standard of 10 minutes or less queues 95% of the SQR measured time, with an aspiration, at certain times of the year, to achieve 5 minutes or less queues 95% of the SQR measured time. At Heathrow this target does not include transfer passengers.

26. Work is currently underway to model and produce cost impacts (both operating and capital expenditure) of variants of the queuing standard, and these will be provided to the CC shortly. The standards being modelled are as follows:

- 10 mins or less 95% of the whole day;
- 5 mins or less 95% of the whole day; and
- 10 mins maximum queue 100% of the whole day.

27. These options will be modelled based on both a “one bag” and “two bag” scenario.

28. The operating expenditure (and other revenue impacts) and capital expenditure of these options are likely to be significant, particularly at Gatwick where operational and terminal capacity constraints, against a background of highly seasonal peak demand, result in disproportionate costs of meeting certain passenger queuing standards.

Other airport specific items

29. There are four such items at Heathrow:

- Noise and blight costs;
- Maintenance costs;
- Pay deal; and
- Other one-off 2007/08 cost reductions.

30. Additional Night Noise costs have been included within the forecast from 2008/09 totalling £33m in Q5 (resulting in a Q5 total of £60m). Further costs of £11m have been included in Q6, although these are more than offset by £6m p.a. savings from 2012/13 onwards in relation to the Community Building Noise Insulation Scheme where the costs assumed in the previous forecast in that period have been removed. Costs of the vortex programme have also been reassessed resulting in a reduction of £1m p.a. from 2008/09 onwards.

31. Additional maintenance costs of £9m in 2007/08 and £5m p.a. from 2008/09 onwards have been included as part of the 'Fix the Basics' regime covering items such as new carpet tiles, painting, replacing ceiling tiles, increased maintenance on poor-performing assets, etc.
32. [Excised].
33. In 2007/08, two items have been amended following updated information. [Excised]
34. At Gatwick, there are also four items:
- 'Open Skies' impact;
 - Maintenance costs;
 - Noise and blight costs; and
 - One-off 2007/08 cost.
35. The impact of 'Open Skies' on non-aeronautical revenue has been reassessed. The 'Open Skies' impact included in BAA/CC2007/100 was highlighted as a simplistic overlay, with the impact on retail revenue simply being calculated as the decrease in passengers at the previous retail yield. Gatwick has taken the opportunity to review the impact of 'Open Skies' on retail yields and on other revenue streams and have consequently reduced retail revenue by £4m and property revenue by £3m in Q5.
36. Similar to Heathrow, additional maintenance costs have been included in the re-forecast as part of the 'Fix the Basics' programme, amounting to £2.5m p.a. (2007/08 £1.5m). The financial implications of night noise, noise insulation and other environmental schemes have been reassessed and additional costs of £0.8m p.a. have been included in the forecast from 2008/09 onwards, increasing to £1m p.a. from 2013/14.
37. [Excised]
38. These other variances are summarised as follows:

Table 6

£m 07/08 prices	07/08	08/09	09/10	10/11	11/12	12/13	13/14	14/15	15/16	16/17	17/18
Heathrow											
Staff costs	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]
Maintenance	9.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Other costs	0.0	0.5	5.7	5.8	5.8	3.3	-5.0	-5.2	-4.9	-5.0	-4.9
Net costs	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]	[Excised]
Gatwick											
Retail revenue	0.0	-1.3	-1.3	-0.7	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Property revenue	0.0	-0.7	-0.9	-1.1	-0.6	0.0	0.0	0.0	0.0	0.0	0.0
Staff costs	[Excised]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Maintenance	1.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Other costs	0.0	0.8	0.8	0.8	0.8	0.8	1.0	1.0	1.0	1.0	1.0
Net costs	[Excised]	5.3	5.4	5.0	4.1	3.3	3.5	3.5	3.5	3.5	3.5

39. In addition to the operating expenditure, non-aeronautical revenue and capital expenditure impacts described above, the opening RAB position at 1 April 2007 has been amended. In BAA/CC2007/100 this had been based on a forecast position calculated based on actual capital expenditure, disposals

and indexation as at 31 December 2006, with forecast information for the remaining three months to March 2007 used.

40. The opening RAB position has been amended in line with the current position in the draft regulatory accounts of the two airports at 31 March 2007. The revised opening RAB positions have been amended to £8,834.2m and £1,515.7m at Heathrow and Gatwick respectively, compared to £8,817.3m and £1,522.9m.
41. In addition, the regulatory depreciation for 2007/08 has been amended slightly to reflect the final indexation for 2006/07. The new capital plans will have had consequential impacts on the regulatory depreciation forecasts for the two airports. No further update of the regulatory depreciation on existing assets or in relation to assets in the course of construction for projects contained within the rump capital expenditure has been made and hence the estimates made for these items in BAA/CC2007/100 have been carried forward.

Price path

42. As a consequence of the adjustments to operating expenditure, non-aeronautical revenues and capital expenditure described above, the aeronautical revenues have also been adjusted. The rate of return that has been assumed is, as per BAA/CC2007/100, 7.75%.
43. The opening yield adjustments explained in Chapter 20 of BAA/CC2007/100 have been amended for two items. Firstly at Gatwick, following the reassessment of the impact of 'Open Skies' explained above, fuel revenue has been reduced, specifically by £1.4m in 2008/09. In BAA/CC2007/100, it had been assumed that a cessation of fuel rent charging occurred and an opening yield adjustment was to be made. The reduction in Gatwick's forecast of the revenue stream that is to cease, results in a reduction in this element of the opening yield adjustment from 27p to 23p (based on 2008/09 passengers).
44. Secondly, at both Heathrow and Gatwick, due to the increase in security costs as explained above, the security cost element of the opening yield adjustment has increased at Heathrow from 34p to 36p and at Gatwick from 31p to 37p (based on 2008/09 passengers). The increase at Heathrow is not as marked as Gatwick since the opening yield adjustment contained within BAA/CC2007/100 reflected the incorrect costs contained within Table 13.3 (see paragraph 19) the correction of which in the re-forecast partially offsets this increase. The security opening yield adjustment has been based on all the incremental security costs post 10 August (ignoring one off items) and hence also includes the costs of the EU security audit requirements.
45. As a result of the above, the following price path occurs at each airport:

Table 7

	Q5	Q6
Heathrow	+12.14	-3.93
assuming an opening yield adjustment of £2.10		
Gatwick	+9.60	-2.92
assuming an opening yield adjustment of £0.60		

46. The prices that result from this price path, in 2007/08 prices are:

Table 8

	2008/09	2012/13
Heathrow	£12.91	£20.22
Gatwick	£6.04	£8.64

Items not adjusted

47. It is also worth considering the items that have not been adjusted in this re-forecast.

Traffic forecasts

48. Revised traffic forecasts have been produced for Heathrow and Gatwick. BAA/CC2007/100 contained traffic forecasts that had been updated for the impact of 'Open Skies', however this reflected only a high level assessment of the impact of the EU-US 'Open Skies' agreement. The revised traffic forecasts have considered the impacts of 'Open Skies' in more detail. These forecasts have been submitted to the CC as BAA/CC2007/315.

49. Since the revised traffic forecasts are not significantly different to those contained within BAA/CC2007/100, the re-forecast has not been amended for the changes to the traffic forecasts.

Table 9

mppa	Heathrow			Gatwick		
	Revised	Original	Variance	Revised	Original	Variance
2008/09	70.6	70.6	0.0	35.8	36.2	-0.4
2009/10	72.5	72.8	-0.3	36.4	36.6	-0.2
2010/11	74.0	74.2	-0.2	36.8	36.8	0.0
2011/12	75.3	75.3	0.0	37.2	37.3	-0.1
2012/13	77.2	77.2	0.0	37.8	37.7	0.1
2013/14	78.6	78.6	0.0	38.4	38.2	0.2
2014/15	79.9	79.9	0.0	38.9	38.8	0.1
2015/16	81.5	81.5	0.0	38.8	39.5	-0.7
2016/17	82.9	82.9	0.0	39.3	40.0	-0.7
2017/18	84.4	84.4	0.0	39.8	40.5	-0.7

50. It should be noted that BAA's current view is that if there were to be a new traffic forecast the current softness in traffic could be reflected in lower long-term forecasts.

Simplification programme

51. The re-forecast has not been updated for any further impacts of the recently announced simplification programme. As noted in BAA/CC2007/100, the impacts of this programme had not been specifically included within the Heathrow and Gatwick financial forecasts, though those forecasts included efficiency savings some of which the airports did not have any specific plans for. Hence certain of these efficiency savings may be met in part or in full by the simplification programme and this continues to be the case.

52. Initial costs of the simplification programme have not been included in the forecast. Initial indications are that these could amount to [Excised] spread over the first three years of the programme.

53. Over the last few months, work has continued to assess the practicality of developing the recommendations from the McKinsey report. This has been undertaken by managers within the business who work directly in each of the areas being considered.
54. This further analysis has taken a risk based approach, in order to explain the potential impact to the business if selected recommendations are progressed. The work has yet to be completed.
55. The work has been put on hold for at least the duration of the peak summer period, to ensure that BAA staff remain focused on the challenges of providing good customer service during this busy period and to increase the resources being applied to the 'Fix the Basics' programme.

Further security cost impacts

56. The security cost impacts described above have been prepared before the recent security incidents in Glasgow and London. Hence they do not reflect any additional costs that may arise as a consequence of these events and the heightened security environment.

Re-financing

57. As the re-financing progresses and the structure and contractual arrangements of the re-financed group become more certain, a number of changes to the way in which items are charged to the businesses within the group may occur. No impact of these changes has been included within the re-forecast. [Excised]

Mixed Mode and Runway 3

58. The submission continues to be prepared on a within existing limits basis with no costs for Mixed Mode or Runway 3 being reflected, prior to the Government consultation due later this year and the expected planning inquiry process and determination.

Other initiatives

59. The company continues to seek to improve efficiency. However, no other specific initiatives have been included at this stage [Excised]

Annex 1 Summary of Impact on Heathrow

[Excised]

Annex 2 Summary of Impact on Gatwick

[Excised]