

Heathrow and Gatwick Quinquennial Review

Response by the British Air Transport Association (BATA)

1. BATA welcomes this opportunity to submit its views to the Competition Commission investigation into CAA's price control proposals for Heathrow and Gatwick airports during the 5th Quinquennial period (Q5).
2. BATA is the trade association for UK-registered airlines. Our members cover all sectors of airline operations and represent over 85% of UK-airline output. It is very important to BATA members that the current review of prices at Heathrow and Gatwick results in an objective settlement based on a thorough analysis of the inputs. Most BATA members have their main bases or a significant proportion of their UK operations at one or both of these BAA-owned airports. Hence the cost of operations at these airports is crucial to our members who are operating in highly competitive air-travel markets. BATA members need a fair settlement which recognises the need for capacity, appropriate levels of service for airlines and their customers, efficient operations and good value investment.
3. We believe that the price settlement for the current Q4 period was unfair to airline users and very generous to the airport owner BAA. In our view, these concerns have been vindicated by Ferrovial's acquisition of BAA in 2006 at a price which clearly exceeded any value recognised by the regulatory process. The new owners and their advisors must have seen a combination of asset value and price-regulation regime which was highly attractive.
4. The CAA have maintained two principals in their approach, both of which are very important to BATA members. Firstly, stand alone regulation is very important in an attempt to simulate some form of competition between the airports and also the "single till" principle is very much supported by the airlines as the most realistic description of real life behaviour of airports outside the regulatory regime.
5. The initial proposals from CAA for prices at Heathrow and Gatwick in Q5 are based on a complex series of inputs and assumptions and we expect the Competition Commission to review the issues very carefully and in some detail. We would ask the Commission to consider, in particular:
 - a. The current financial structure of BAA and risks to airport users
 - b. The outputs of constructive engagement
 - c. Capital investment including efficiency and cost of capital
 - d. Operating costs and efficiency

- e. Traffic forecasts
- f. Commercial revenues
- g. Service quality

6. Financial structure of BAA

The purchase of BAA in 2006 has resulted in a significant change to the company's financial structure. BAA is now a highly leveraged company and the first priority for CAA and the Commission should be to ensure that revenues from airport users is not used to pay-off debt generated by the acquisition and the resulting new financial structure for the company.

- 7. This risk has significantly increased since the last Quinquennial Review, and it deserves robust measures to ensure that the integrity of the airport's operation is protected. We are not able to suggest specific measures but would expect the regulated businesses to be, in effect, ring fenced such that the risks associated with a highly leveraged business can be minimised and should not be transferred onto airport users. These measures should protect regulated income and also control the disposal of assets as the new financial structure may encourage premature disposal of assets which have a strategic value to the airport business.

8. Constructive Engagement

CAA initiated a process of Constructive Engagement (CE) between the airport and airlines and has made it a key feature of this round of price regulation. CE has been supported by the airlines at Heathrow and Gatwick and the process has resulted in joint agreement on several issues. However, this process has also exposed a number of disagreements between the airport and its customers and has also highlighted examples of poor consultation by the airport. The most recent examples include the following :

- a. Pier service at Heathrow. This critical element of customer service remains an issue of disagreement with airlines not happy with the level of service being provided.
- b. The Eastern Apron masterplan at Heathrow, where airlines are still seeking further information and the development has been reduced in size without a reduction in the capital cost.
- c. The content and assumptions behind the recent Gatwick Capital Investment plan are unclear as is the plan's status in relation to CAA's price review.

8. Capital Investment

The treatment of capital investment and, in particular the cost of capital, has an important effect on the price proposals. We welcome the CAA's proposal of a lower cost of capital than that allowed in Q4 which was very generous to the airport. However, we feel that this remains too high and would support the analysis of British Airways on this subject.

We also believe that BAA should be able to deliver significantly improved value from its capital projects – the rate of improvement offered by BAA so far is inadequate.

CAA is planning to make an allowance for construction price inflation in excess of RPI and is currently assuming BAA's own forecast. We feel strongly that this assumption should be the subject of an independent, professional view from the construction industry.

9. Operating Efficiency

The CAA's reduction of BAA's operating costs assumption is welcome but we do not think that this fully recognises the potential for improvement. Competition is driving airlines to seek improvement in their own operating costs in the interests of being able to offer competitive fares to passengers. The search for operating efficiencies in airlines is a relentless ongoing task that absorbs much management time. We believe Heathrow and Gatwick should be tasked with achieving significant levels of opex saving in order to incentivise further efficiencies in the deliveries of airport services. We would expect BAA to be able to do better in key areas such as rostering and absence management.

Airlines recognise the need for the airport to invest in additional security staff and technology to meet the latest security requirements and deliver an appropriate queuing standard for passengers. However, it is also increasingly important that this very large part of the airport's operating costs is subject to transparent efficiency targets that demonstrate the airport's desire to deliver value for money. BAA's plans in this area are unclear.

10. Traffic Forecasts

The nature of the pricing structure means that the forecast of passenger numbers must be as up-to-date and objective as possible if the process is to avoid an unfair settlement.

The CE process reached agreement on forecasts in June 2006 but subsequent downward adjustments by BAA have not been agreed with the airlines and, if incorporated in the final proposals, will contribute to an unfair price settlement. We believe that BAA's latest forecast underestimates passenger numbers for Q5. It does not even account for the likely implementation of EU/US "open skies" agreement on flights to and from the USA.

This is an important element of the price control mechanism which deserves close attention by the Commission.

11. Commercial Revenues

As indicated by the CAA, commercial revenues are a significant element of Heathrow's and Gatwick's overall revenue (26% and 39% respectively) during Q4. The CAA commissioned a report by Donaldsons which indicated that BAA's forecasts of commercial revenue for Q5 were conservative. The CAA has also confirmed that BAA has outperformed its forecasts for commercial revenue in Q4. This combination of: the size of the contribution to BAA's revenues; BAA's conservative forecasts for Q5; and capacity to outperform such forecast points to the need for an objective and agreed forecast of commercial revenues in Q5.

12. Service Quality

The service quality regime put in place by the CAA in response to the public interest finding made by the Competition Commission has generated improvements in the level of service of the areas covered by the scheme. We believe these improvements should be built upon in Q5 and we support the positions of the airlines as articulated in the output of constructive engagement so far.

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