

CAA Consultation paper – Price Control Review

Initial proposals for Heathrow, Gatwick and Stansted Airports

December 2006

Response by bmi - February 2007

bmi welcome the opportunity to comment on the CAA's initial proposals as part of the current Price Control Review for the London BAA Airports. Our comments are limited to Heathrow Airport, as bmi does not operate to Gatwick or Stansted Airports, and the comments build upon our response to the CAA's earlier consultation paper regarding policy issues for the Price Control Review.

1 Key General Points

- 1.1 bmi is the second largest carrier at Heathrow and operate primarily domestic and short-haul European services, with an expanding medium-long haul network. We are therefore in a unique position at Heathrow, operating in an intensely competitive market, and also against services from other London and regional airports, and other forms of transport, notably high-speed rail links.
- 1.2 To reiterate comments we have made previously, the viability of UK domestic and short-haul European services at Heathrow, and BAA's vision for 'a world class international hub airport', depend on a regulatory framework and price control that delivers competitive pricing as a very close proxy for an airport operating in a highly competitive market, ie) minimal prices consistent with cost effective services and facilities provision in line with airline requirements, and importantly this must be delivered on a level playing field.

These are the basic pre-requisites to enable the operation of viable services and choice for passengers, and are the key issues for the current price control review.

1.2.1 *Competitor Equivalence*

The opening of Terminal 5 (T5) for BA operations in March 2008 creates a new yardstick for the airport in terms of services and facilities provision, and will introduce a fundamental disparity in competitor equivalence for many years to come, at least until the Heathrow East Terminal (HET) and associated integral projects are completed, currently planned for 2012. This lack of a level playing field must be recognised and addressed within the price control framework established for Q5. As a major home-based carrier, it is essential to bmi that the HET project and other associated projects are delivered in line with MoUs to be agreed between BAA and Star, that a workable interim solution is agreed and implemented, and that broad competitor equivalence is achieved as quickly as possible.

1.2.2 *Competitive Pricing*

The CAA's initial proposals for Q5 pricing indicate a range of RPI+4% to +8% pa, representing an increase of up to almost 50% in real terms, and this follows on from increases of 37% during the last 5 years and 50% during the last 10 years, all in real terms.

Outturn prices using RPI @3.5% and assuming the top end of the pricing range indicated, are illustrated below;

£ per departing passenger

1997/8	9.64
2003/4	12.96
2007/8	18.55
2012/13 (estimate)	32.11

The proposal could therefore result in more than a 3-fold increase in airport charges in the 15 year period to 2012/13.

As we have stated many times previously, we do not accept that the Q4 pricing decision for Heathrow was balanced or justified, and in our view it is weighted heavily in favour of BAA. We believe that the findings of the various consultants' studies commissioned during Q4 by the airline community at Heathrow and also by the CAA provide evidence to substantiate our views, and therefore indicate that we are being overcharged in Q4. Further, BAA's early defence of the Ferrovial bid in 2006, through an offer to shareholders of a £750m incentive with a 40% dividend increase, reinforces the overly generous regulatory settlement providing excessive financial comfort to BAA, at the expense of its users.

We have not experienced price increases on the scale implemented to date and proposed for Q5 at Heathrow with any other controllable costs, and we have difficulty understanding how this level of increase can be substantiated or considered sustainable, especially for intensely competitive short-haul and domestic operations.

The position must be addressed and we appreciate the greater scrutiny applied by the CAA in its approach to the Q5 Price Control Review. However, there are various areas within the building blocks used to determine the Q5 price cap where we believe a more challenging approach is both necessary and justified, and these points are included within our detailed comments for the relevant elements, as set out below.

- 1.3 Although bmi has chosen not to participate in the Constructive Engagement workstreams with BAA, we did respond in detail to CAA's consultation paper on policy issues and also to BAA's draft Capital Investment Programme (CIP) 2006. We provided comment in response to the report issued by the Joint Steering Team in May 2006 on the output of Constructive Engagement. Further, we have been a member of the CAA-led Steering Group looking at benchmarking of airport efficiency. We have also been fully engaged with BAA in various consultations including the HET project, inter-terminal baggage connectivity, and baggage and check-in charges post 2008.

As a consequence, we believe that our views regarding key areas of the price control review have been well documented.

More detailed comments on the various elements that comprise the initial price proposals are set out below.

2 Framework

- 2.1 We are supportive of CAA's proposal to retain the current regulatory framework for the next quinquennium, including the single till and the separate regulation of the designated airports.
- 2.2 We believe that price should be based on service and facilities delivered as would be the case under normal commercial agreements. To that end we fully support the principles of the service quality scheme, delay term and capital triggers.

From the start of Q5 there will be a fundamental change in the environment at Heathrow with the extensive differential in facilities provision, quality of services and passenger experience that will occur post T5 opening, together with the substantial impact of major construction works for Terminal1 (T1) users throughout Q5 and beyond.

We shall therefore expect differential charging for airport fees to apply for as long as these disparities exist. This is a critical issue for our business and one that has not been addressed within the CAA's initial proposals. The issue is so fundamental to the principles of broad competitor equivalence and non-discriminatory charging that we believe the CAA should impose the condition of a differential tariff within the Q5 regulatory settlement.

The application of the service quality scheme only addresses a very limited number of issues surrounding metrics and is totally inadequate as a mechanism to reflect the fundamental change in the operating environment.

- 2.3 The review of security requirements and issues of resilience are currently being debated, but at this stage we continue to believe that given the ongoing uncertainty and potential changes in security requirements, the current policy of a 'de minimus' threshold and partial pass through broadly achieves the right balance, and should incentivise the most cost-effective solutions to developments.
- 2.4 The proposal to modify the correction factor so that the absolute amount of under or over recovery is collected is accepted as the most appropriate mechanism.
- 2.5 Revenue advancement has been applied to both Q3 and Q4, and we suggest this has provided an unjustified level of financial comfort to BAA rather than a strong incentive to minimise costs. As the regulatory framework provides for a return on the RAB, and with the application of price triggers to encourage investment delivery in the most cost effective and timely manner in line with user requirements and priorities, we strongly believe there is sufficient incentive for BAA to invest without revenue advancement.

Further, adding unnecessary cost to users directly inhibits the viability of services and the ability of airlines to compete, and is inconsistent with the CAA's duty of furthering the reasonable interests of users and the duty of promoting airport efficiency.

Should the CAA project price reductions over the medium-long term beyond Q5, we would welcome the benefit of revenue deferral being applied to Q5 pricing, to compensate in part for the revenue advancement applied over the last 10 years. On the other hand, should price increases be projected, then we maintain that Q5 pricing should be limited to the outcome of the regulatory building blocks defined by the CAA for Q5, ie) excluding revenue advancement.

3 Traffic Forecasts

- 3.1 The CAA has used the traffic forecasts presented by BAA in its September 2006 regulatory submission, which were the lowest forecasts available when preparing its consultation paper. Subsequently, BAA has prepared forecasts that are a further 2.83% lower for Q5, and which appear to be extremely pessimistic compared to recent Government data updated for the December White Paper Progress Report.

Traffic forecasts used by the CAA for its initial proposals are 3.25% below the traffic volumes assumed in BAA's CIP June 2006, and BAA's January 2007 forecasts are 6% below the CIP 2006 forecast.

These later forecasts represent a significant shift within the last 6 months, and as traffic volumes are a key component of the price control it is essential that the numbers incorporated have an agreed and robust basis. By adopting the lowest volumes, traffic risk is weighed heavily in favour of BAA, and these numbers have not been substantiated. Clearly, further analysis and rationale is required to be presented to users.

4 Service Quality

- 4.1 The current scheme should be enhanced in terms of scope and tightened in terms of financial value at risk to BAA to reflect both a wider scope and a much closer link with price than currently pertains, and thus provide a closer proxy to a competitive commercial environment.
- 4.11 Q4 was the first quinquennium whereby such mechanisms were introduced, and it was recognised at the time that a cautious approach was taken accordingly. Therefore, it seems reasonable to strengthen these mechanisms moving forward.

The rebate limit of 10% of airport charges income proposed by users and covering an enlarged scope is not unreasonable, especially when compared to commercial agreements which generally recognise payment for what is delivered.

However, the scheme is unlikely to ever fully compensate for fees paid by the airlines and whilst we would welcome increases in the rebate limit we would be concerned that the increased risks would be incorporated into an increased margin and ultimately cost users more overall. A balance needs to be struck accordingly.

- 4.1.2 We support the additional items proposed for inclusion. Also, as noted in our previous responses to quality of service and policy consultation papers, we propose further measures covering cleanliness and tidiness, building maintenance and temperature control, which continue to be of unacceptable quality in T1.
- 4.2 We maintain that a rebate only scheme should be retained, as this most closely replicates commercial agreements, and users are unlikely to be able to take advantage of above-par performance for any event as flight programmes are generally established many months in advance based upon agreed standards. Any proposed change in those standards would have to be considered in light of the whole network operated.
- 4.3 As the review of security requirements and issues of resilience are currently being debated, we are unable to propose any changes to the security element of the scheme at this stage and await the outcome of these discussions.
- 4.4 We note the issues of pier service and are supportive of a two-pronged approach through capital triggers and a pier service standard, both aligned to the capital programme.
- 4.5 As we stated during the last review, BAA have sufficient incentive through the price cap formula to increase movements and therefore passengers, as this will deliver higher income to BAA without the need for a further incentive. We also concur with the CAA's views with regard to the aerodrome congestion term which does not compensate users for delays, and therefore it is inappropriate to implement an ATM incentive.

5 Operating Costs

- 5.1 Evidence presented within the consultation paper suggests that there has been insufficient cost pressure on BAA, and we very much welcome the CAA scrutiny across various aspects of BAA's operating costs.
- 5.2 It is alarming to note that operating costs are expected to increase by 40% in total and by 7.7% per passenger during Q4, coupled with negative productivity after adjusting for volume growth.
- 5.3 Almost half of the increase during Q4 (£90m) is due to other operating costs, including ground transport operations, general expenses, insurance and £26m for one-off exceptional costs relating to change programmes.

We concur with the CAA in excluding the latter item from the baseline for Q5, but the scale of increase in value of the other elements is not explained and is a worrying trend that is expected to continue into Q5.

- 5.4 The summary findings of the various consultants' studies commissioned by the CAA as part of the Price Control Review suggest that there is room for substantial improvement in operating costs.
 - 5.4.1 Staff costs form approximately 30% of operating costs and several of the studies cover staff costs, including security staff which represent the most populous job type at BAA. The Airport Process Efficiency Assessment and the Employment Costs Study in particular provide evidence of potential significant areas for cost savings regarding employment cost packages and productivity.
 - 5.4.2 The Airport Process Efficiency Assessment analysis of passenger screening at central search reported substantial scope for process improvements through increasing flexibility in rostering and reducing absenteeism. Other areas reviewed indicated similar potential.
 - 5.4.3 The Employment Costs Study findings show that security staff are paid at the upper quartile and engineering technicians and senior managers are paid between the median and upper quartile.

Further, BAA's pension scheme is noted to be a very generous scheme in all respects, especially when compared to many companies operating in a competitive market which have been forced to reduce pension benefits considerably and to close final salary schemes for new entrants, in order to reduce operating costs.

In addition, BAA's sickness absence is reported to be 86% higher than the CBI average.

- 5.5 The LECG study reports various issues regarding cost allocation drivers and methodology, and suggests that a more robust approach should be used. For example, the use of operating profit as a driver for cost allocation between businesses, the capping of adjustments and the use of outdated values for drivers together indicate the need to move to a more equitable basis.

We note that LECG have suggested an alternate approach which would result in a reduction in cost allocated to Heathrow of £9.5m, which is equivalent to approximately 1.5% of Heathrow's total operating expenditure.

- 5.6 Given the weight of evidence presented for the areas analysed, the baseline operating cost efficiency target proposed of 1% pa appears to be a weak incentive.

As BAA have been aware of the findings of the studies during the course of 2006 and have up to 2 years to address these issues prior the start of Q5, it is only reasonable to expect a strong focus on cost efficiency together with adjustments to bring cost allocations onto a more appropriate basis in the period leading up to Q5, and to maintain focus ongoing.

In the absence of full details behind the various findings presented and BAA operating cost data, we are unable to calculate what the efficiency target should be, but suggest that there should be a stepped reduction of say 5% from the start of Q5 to reflect the opportunity for changes in the interim period, with a 1-2% pa reduction each year thereafter.

6 Capital Expenditure

6.1 *Q5 spend*

6.1.1 *HET*

It is essential that capital investment is undertaken both currently and ongoing to address the main issue of competitive equivalence post T5, and the HET project and associated integral projects are key to achieving this objective, together with a workable interim solution.

We are alarmed by the CAA's suggestion that if there is airport-airline disagreement of principle for the HET project, the CAA may seek to gather evidence on passenger preferences between the value of HET and a refurbished T1/2. We trust that the broad agreement reached between BAA and Star for the development of HET means that the CAA are no longer considering adopting this approach, and we would welcome the CAA's early confirmation of this point.

We therefore expect the CAA to include the HET project and associated integral projects in the capital investment projections used for the price control review.

6.1.2 *Inter-Terminal Baggage Connectivity*

With regard to an automated inter-terminal baggage transfer system, there is no business case to support this proposal at this time, either operationally or financially and we therefore reiterate our opposition to its inclusion in the capital investment projections used for the price control review for Q5.

BAA's consultation process for baggage connectivity is flawed as only automated solutions were presented through the Constructive Engagement process for consideration, and with limited data regarding the overall financial impact on users.

BAA's formal consultation directly with users in Spring 2005, and prior to Constructive Engagement, concluded that;

'Given the weight of airlines now opposing a community remunerated systems-based solution, HAL can no longer advocate proceeding with such an option at this time. However, with the continued majority interest in a systems-based solution, albeit focused on BA/Oneworld, the option for a directly licensed partial system T5-T3 remains open'.

We believe the position of users has not changed in the interim period, and we do not know how the scoring mechanism adopted to assess user support and priority ranking for various Q5 capital projects was determined under the Constructive Engagement process, as this has not been explained or made transparent.

Using BAA data we have estimated that the annual charge for an automated system will be around £27m pa higher than for a road-based system (2004/5 prices), and this excludes the cost of a contingency operation as no viable options have been proposed. Any potential benefits in MCT's from an automated system are estimated to be limited to just 6% of passengers and are subject to handler performance. Further, given the impending relocation of airlines within alliances, the level of inter-terminal transfers are expected to reduce going forward.

An automated system brings a number of risks including cost, delivery and performance, with no viable contingency in the event of system failure and no scalability. Extensive construction works are also required for this option, which has environmental impacts. The T1-T4 tunnel built for BA is a prime example of a facility that will not be financially viable to operate when BA move to T5. We have suggested the facility should be mothballed until it becomes economically viable to operate at some point in the future, or a decision is taken to close the facility. It is important that this investment solution is not repeated across the airport.

Conversely, road-based connectivity provides a low tech, low cost, high performance solution that is readily scalable to meet demand. It may also be possible to introduce electric vehicles to reduce any environmental concerns and possibly cost– it is a solution sufficient to meet the requirements of the whole community at this time, and one which we fully endorse.

6.1.3 *Link of Investments to Price*

As the level of capital expenditure has a significant bearing on the price cap, and as users expect the capital programme to be delivered to provide agreed investments, we are fully supportive of a robust link between price and actual capital delivered, measured in terms of outputs rather than cost. The capital triggers approach adopted for Q4

avoids the issue of a cost pass through but rewards delivery, and we believe it should be possible to define projects in this manner and build them into a price related scheme for Q5.

bmi and Star are currently reviewing details of the HET and related projects with BAA and should be in a position within the next few months to suggest milestones for these projects to be used as capital triggers for Q5.

6.2 Q4 Spend

6.2.1 Capital costs and process efficiency were questioned at the last review, particularly with respect to T5. Evidence from three independent consultants commissioned by airlines at Heathrow during the last 3 years (ref WTP report dated September 2003, Avia Solutions report dated January 2004, and Currie & Brown report dated February 2006) each suggest there is work to be done to minimise costs.

6.2.2 Consultants commissioned by the airlines as part of the current constructive engagement process at Heathrow (ref Currie & Brown report dated February 2006) concluded that;

'BAA has acknowledged many of the conclusions of the C&B/Avia Report of January 2004 and has accepted that a real step change in its approach to commercial delivery of projects is required to ensure that the airlines, the regulator and other stakeholders are convinced that Capex delivery represents real value for money'

The report suggests that substantial cost reductions against CIP should result from the changes highlighted by the review. As a result, cost decreases of 5% were built into BAA's CIP 2006, but further potential savings from on-costs estimated at 1-2% minimum, and potential substantial risk management and project specific costs were identified but not quantified or incorporated into BAA's CIP 2006. It is our understanding that these further areas have not been finalised by BAA, and clearly this presents an ongoing issue to be taken into account in the assessment of investment costs for Q5.

6.2.3 Given the consistency of message from these three independent pieces of work over the last 3 years, we believe this provides sufficient evidence that BAA costs of project delivery are, and have been, higher than necessary, and that we are paying more than we should be for those investments. This position is compounded by the highest levels of capital spend seen at Heathrow.

None of the consultants' reviews covered T5, and so we do not know whether T5 costs have been efficiently and effectively incurred, but we have to assume that the consultants' findings can be generally applied to all BAA investments. Therefore, if we apply a minimum 5% efficiency

to the Q4 capital programme for years 1-3 only with a total cost of £3.5bn, this suggests a value of around £175m 'excess' cost. If capital for the whole of Q4 is subject to adjustment, then the value of 'excess' cost rises to a minimum of £260m.

In light of the evidence presented, we believe the CAA should disallow an appropriate value of Q4 capital expenditure to reflect inefficient spend paid for by users.

- 6.2.4 There has been no consultation with users on the increased spend on T5 and future spend has been excluded from the scope of Constructive Engagement.

Further, a contingency of some £600m was noted at the last review as included in the cost of T5. In the absence of any further information, and given the additional capital spend planned for Q4, we assume that the T5 contingency is expected to be fully utilised in Q4.

Costs are approximately double the levels presented to the MMC inquiry in 1996, and there has been no consultation or information made available to users subsequently. bmi requested benchmark data for T5, but this has not been provided. Against this background, we do not know the basis of measure of the T5 budget, and whether the project has run to budget as claimed, or whether any efficiency adjustments should be taken into account for Q5 pricing specifically relating to T5.

- 6.2.5 It is important that an interim workable solution is agreed and implemented until the HET and other associated projects are delivered. The interim solution requires investments to be undertaken in Q4 as well as Q5, and these should be included in the costs used by the CAA for the Price Control review.

7 Treatment of Pension Costs

- 7.1 We note that cash payments have been the basis of allowance for pension costs in previous price control reviews, and having reviewed the arguments for alternative bases, including a measure of service costs or a charge per the accounts, on balance it seems reasonable to retain the cash payments approach for Q5.
- 7.2 We concur with CAA's view that it would be inappropriate for the increase in annual cash contributions paid by BAA, agreed as part of the ADI acquisition, to be passed on to users. We therefore suggest that the increase in value is excluded from the pension costs allowance for Q5. Looking ahead to Q6 and beyond, this adjustment should be

reconsidered as part of the Q6 review along with any other issues arising in relation to the treatment of pension costs

- 7.3 With regard to the pensions holiday that BAA took in Q3, and for which a part adjustment was made and returned to users in Q4, we note that the balance of over payment by users in Q3 is estimated at £175m. We suggest that the outstanding amount by which users overpaid BAA in Q3 should be fully adjusted and returned to users in Q5, and that it would be unreasonable to extend the period of repayment further, ie) beyond the 10 years.

8 Other Revenues

- 8.1 We welcome the CAA's proposals for commercial revenues. Although we note BAA's claim that the inclusion of revenues within the single till dulls incentives to develop commercial opportunities, passenger growth would be stimulated by lower airport fees. Airports generally look to maximise commercial revenue opportunities to be competitive on airport charges.

- 8.2 With regard to non-regulated charges, we have a major issue with the proposal to move departure baggage infrastructure costs to airport charges.

We are also concerned that the CAA has incorrectly stated that the users are calling for this change, when bmi, and our Star partners' opposition to this proposal has been clearly documented. Rather than create parity, it moves away from cost-related charges and financially discriminates against T1 carriers.

- 8.2.1 The transfer of departure baggage infrastructure to airport charges will mean that all passengers will pay equally for this infrastructure, regardless of whether they have hold baggage. It would be more rational and cost-related to transfer all baggage infrastructure out of airport charges, combine it with operating costs and charge to users as a fee per bag.

BAA's charging proposal will therefore have a major negative impact on short-haul and domestic users and their passengers.

- 8.2.2 The proposal also includes bringing all departing baggage systems to a common standard based on the T1 system, funded through airport charges.

Whether or not T1 is the appropriate mean, clearly such a process will require measurement against an ever-moving datum, especially given the scale of works over Q5 and beyond.

More fundamentally, this presents financial discrimination against T1 carriers, notably bmi who will remain in T1 post T5 opening, who have paid for the current system and upgrades to its current state through a direct licence fee over the last 10 years. It is therefore totally unreasonable to suggest that bmi should now contribute to the cost of upgrade of competitors' systems without financial compensation.

8.2.3 Similarly, we do not accept that the cost of early write-offs of previous investments or legacy assets should be charged to the community.

8.3 BAA have significantly increased essential non-regulated charges that are within their control during Q4.

BAA's approach to increase incomes from non-regulated services without a corresponding reduction in airport charges clearly has an adverse impact on users. We would therefore welcome a commitment from BAA not to increase any of the identified unregulated charges above RPI during Q5, nor introduce any new charges for activities not currently charged for separately without an offsetting reduction in airport charges.

9 Cost of Capital

9.1 We welcome the reduction in cost of capital proposed for Q5, and support the approach taken of using an assumed financial structure.

9.2 Despite this, we believe there is room for a further reduction in rate as the CAA has erred towards the upper end of ranges for the equity beta and risk premium assumptions, and has assumed an overall cost of capital at the top of the range indicated.

We suggest that median rates should be adopted where ranges are derived, to reflect an average rather than high-end cost of capital. An average result would provide a more equitable settlement rather than one weighted in favour of BAA.

9.3 The use of the standard taxation rate at 30% is likely to unreasonably favour BAA, given expected high capital allowances for the medium-long term. We suggest that an effective rate of taxation could be broadly estimated for Q5, and used in the cost of capital calculation. The same approach can be adopted for future reviews for consistency.

We understand that this approach is also consistent with evolving UK regulatory practice.

- 9.4 The adjustments proposed above would deliver a cost of capital that represents a more equitable and balanced result. As the derived rate has a huge bearing on price levels it is very important that the rate is calculated as accurately and equitably as possible.

The use of mid-point rates and an estimated rate of taxation of say 26%, would deliver a cost of capital of 5.6%, compared to the rate of 6.2% assumed by the CAA. This in turn would reduce the proposed value of X by 2.4 points.

10 Regulatory Asset Base

- 10.1 As the RAB is inflated annually and as BAA investment properties are revalued annually, it seems more appropriate for disposals of assets to be transferred out of the RAB at current market value.
- 10.2 As noted above under our comments on Q4 capital spend, ref point 6.2.3, we suggest that the CAA should disallow an appropriate value of Q4 capital expenditure to reflect inefficient spend.

Summary

The most fundamental issues for this review are competitor equivalence and competitive pricing.

Competitor Equivalence

It is essential that the HET project and integral projects are delivered in line with plans agreed between BAA and Star, and capital triggers should be built into the price control to incentivise timely delivery.

It is also essential that a workable interim solution is agreed and implemented.

Differential charging should apply for as long as the disparities in facilities and services exist.

Competitive Pricing

We have outlined above various areas where we believe a more challenging approach should be adopted, including;

- Traffic forecasts where the lowest available numbers have been used.
- Operating costs where the efficiency factor of 1% appears low, based on the evidence of the various studies undertaken, including areas of cost allocation.
- Q4 capital spend should be reviewed in light of the various consultants' reports regarding efficiency of spend and any excess costs should be excluded from the RAB.
- Cost of capital should be adjusted to mean rates and an effective rate of tax, which could deliver a rate close to 5.6%.
- Pension holiday 'overpayment' by users in Q3 should be fully returned in Q5.
- Automated inter-terminal baggage connectivity should not be included in Q5 investment plans, as this is not the optimal solution.

In addition, the proposal to transfer departure baggage infrastructure costs to airport charges, along with funding of the upgrade of all departure baggage systems is unreasonable. It moves away from cost-related charging and financially discriminates against T1 carriers.