

NON CONFIDENTIAL VERSION



**Airport Price Control Review Q5**

**Submission by British Airways to the Competition Commission**

**10 May 2007**

## CONTENTS

1.	Introduction	3
2.	Regulatory Approach	5
3.	Capital expenditure	17
4.	Cost of capital	25
5.	Non-regulated charges	29
6.	Commercial revenues	32
7.	Operating expenditure	36
8.	RAB	40
9.	Traffic forecasts	42
10.	Price control design	46
11.	SQR	49
12.	Public interest issues	55
13.	Conclusions	58
	Annex 1	64
	Annex 2	65
	Annex 3	66

## 1. **Introduction**

1.1 British Airways (BA) welcomes the opportunity to submit views to the Competition Commission (CC) investigation into the CAA's proposed price controls for Heathrow and Gatwick airports for the fifth quinquennium (Q5).

1.2 In summary, BA makes the case in this response for:

- (i) a price cap of RPI – 1.5% at Heathrow in Q5;
- (ii) a price cap of RPI – 4.4% at Gatwick in Q5;
- (iii) six capex triggers for major Heathrow projects and potentially five triggers for Gatwick;
- (iv) 6-7% of regulated revenues to be tied to an expanded service quality regime applied to BAA's services;
- (v) public interest remedies to address: (a) the risks associated with BAA's high gearing; (b) the risks associated with asset disposals by BAA; (c) BAA's failure to consult adequately over the costs and benefits of major capital projects and non-regulated charges at Gatwick; (d) BAA's failure to provide adequate fuel storage facilities at Heathrow; and (e) attempts to monopolise the supply of some IT services.

1.3 The Q5 review is important to BA. The charges levied by BAA are significant: "airport charges", at around (£) per year at Heathrow and (£) at Gatwick, account for a significant proportion of BA's cost base; in terms of "non regulated" charges, BA pays around (£) per year to Heathrow and (£) per year to Gatwick. Heathrow and Gatwick airports are BA's major bases and are therefore central to BA's operation. Heathrow in particular is of key strategic importance as it is BA's international hub.

1.4 BA's objectives are therefore to secure a regulatory settlement which :

- (i) sets a price which fairly balances the interests of BAA and airlines and is based on robust and fully tested evidence;
- (ii) delivers cost effective investment where it is necessary and secures or improves operational standards and quality as appropriate; and
- (iii) takes into account future developments.

- 1.5 BA believes that the CC must focus on the following issues:
- (i) implications of the acquisition of BAA by the Ferrovial consortium<sup>1</sup> in 2006;
  - (ii) the limitations of constructive engagement;
  - (iii) the need for objective scrutiny by the CC, especially in relation to forecasts of commercial revenues<sup>2</sup>, non-base capital costs and opex efficiencies;
  - (iv) the need to ensure that programmed capital expenditure is sufficient to meet the needs and expectations of airlines and that major projects not agreed through constructive engagement are examined;
  - (v) the need to ensure that the cost of capital for each airport is set at a level which passes the benefit of low required debt and equity returns to airlines without prejudicing investment;
  - (vi) developing an effective service quality regime; and
  - (vii) areas where BAA's conduct has operated, or might be expected to operate, against the public interest.
- 1.6 This submission is deliberately an overview, highlighting the key issues for BA at this point. BA is happy to supply further details on any of the issues raised and looks forward to engaging with the CC on all aspects of its review. In particular, BA hopes that further progress can be made by the end of June 2007 under the constructive engagement framework on the matters identified by the CAA and will comment further at that stage.
- 1.7 BA also looks forward to taking part in the CC's airport market investigation. The CAA's policy of separate airport regulation should ensure that the price cap determination does not prejudice the outcome of the market investigation. The CAA has stated that additional costs associated with a possible break-up of BAA are likely to be "relatively small".<sup>3</sup> It would be helpful if this point could be confirmed before making a recommendation on the price caps.

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<sup>1</sup> The consortium comprised Grupo Ferrovial SA, Caisse de Dépôt et Placement du Québec and GIC Special Investments Pte Ltd.

<sup>2</sup> The single till system implies closer scrutiny of commercial revenues than has been the case to date (see section 6 below).

<sup>3</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 3.28 and footnote 33.

## 2. **Regulatory Approach**

2.1 BA has previously made clear its support for separate airport regulation and the single till, and does not reiterate that here.<sup>4</sup>

2.2 This section concentrates on three areas which BA believes should be central to the CC's investigation, namely:

- (i) the implications of the acquisition of BAA by the Ferrovial consortium;
- (ii) the limitations of constructive engagement; and
- (iii) the need for independent scrutiny by the CC.

### **Implications of the acquisition of BAA by Ferrovial**

2.3 The implications for the price control of the acquisition of BAA by the Ferrovial consortium in 2006 is a key issue for BA (and other airlines). There are two concerns:

- (i) the need to protect airlines from the risks of high gearing; and
- (ii) the need to protect airlines from the risks of asset disposals.

2.4 They are considered below.

#### **The need to protect airlines from high gearing**

2.5 Ferrovial's firm intention to leverage BAA highly is well known.<sup>5</sup> This could have significant adverse consequences for airport charges, operations and investment, and thus airlines. It puts airport charges at risk of being called upon to satisfy debts other than those directly incurred in the course of carrying on the airport business, through their incorporation within the scope of the security provisions of financing arrangements covering an enlarged group. It also reduces BAA's financial capacity to deal with shocks. As a result, high gearing risks BAA's ability to continue to provide benefits to airlines and has as a possible consequence that airport operations will be run for cash and investment skimmed. In addition, it puts a financial strain on BAA to generate cash for distribution and to minimise investment in its airport business.

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<sup>4</sup> British Airways Response to the CAA's Initial Q5 Proposals for Heathrow, Gatwick and Stansted Airports (February 2007); paragraphs 4.1 and 6.9. See also British Airways Response to the CAA's Q5 Regulatory Consultation (20 March 2006); paragraph 6.7.

<sup>5</sup> See for example: Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 11.4.

2.6 It is therefore essential that sufficient measures are put in place to protect the integrity of BAA's airport operations, and thus airlines and passengers. BA believes the following measures are necessary:

- (i) the regulated business should be ring fenced (including restrictions on the ability to dispose of assets,<sup>6</sup> charge or grant security over assets, and restrictions on cross default provisions) in order to ameliorate the general impact on airlines of leveraging the airport business, and especially to avoid the undermining of the financial integrity of the airport business in consequence of the charge crystallising (or guarantee being called or cross-default operating); and
- (ii) there should be a cash lock up (restricting the payment of dividends or other means of stripping cash out of the business in defined circumstances, such as where the credit rating drops below investment grade or gearing exceeds a certain ratio) to avoid cash (otherwise available for use within the airport business) being stripped out to satisfy debt servicing and similar needs arising in consequence of leveraging and financial engineering across the wider group.

2.7 The CAA recognises the importance of protecting airlines from the effects of highly leveraged finance structures,<sup>7</sup> but considers that measures of the type proposed by BA might be “unnecessary” because the CAA:

*“...has a clear policy that the risks of high leverage should not be transmitted to users (whether through price, service or investment), and has proposed.....a comprehensive set of measures designed to give effect to this policy...”<sup>8</sup>*

2.8 The CAA also considers that they might “...send the wrong signal to investors” because:

*“...there is a possibility that introducing prescriptive measures to prevent particular financial arrangements, or associated credit ratings, might be interpreted (wrongly) by investors as a reflection of doubts about the credibility and/or adequacy of the CAA's underlying incentive-based approach, even though the regulator might be fully resolved to implement its incentive-based approach including in circumstances in which the regulated company became financially distressed”<sup>9</sup>*

2.9 The “incentive-based” alternative measures proposed by the CAA are:

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<sup>6</sup> See paragraphs 2.15 to 2.27 below.

<sup>7</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports; paragraph 3.14.

<sup>8</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); Annex C.11.

<sup>9</sup> Ibid.

- (i) competitive pressure on Heathrow and Gatwick;
- (ii) ex ante financial incentives (capital expenditure triggers) on investment; and
- (iii) ex post adjustments to allowed returns in certain, pre-specified circumstances.<sup>10</sup>

2.10 BA welcomes these measures as far as they go.<sup>11</sup> But they are not sufficient to protect the interests of airlines from the risks of high leveraging. This can only be achieved through measures which prevent Ferrovial from putting into place risky financial structures in relation to BAA in the first place. Such measures commonly form part of the framework for utility regulation applicable in other regulated industries, such as electricity, gas, water and air traffic control (as the CAA itself recognises<sup>12</sup>). Given these examples, which establish a clear regulatory precedent, BA is at a loss to understand why introduction of similar measures might be thought to “send the wrong signal to investors”. No such negative signal appears to have been identified in other regulated industries.

2.11 BA recognises that BAA is not subject to a licence regime. But this is not a barrier (as the CAA suggests it may be<sup>13</sup>), and BA respectfully suggests that the CC and thereafter the CAA should work to achieve the same ends using the tools at their disposal. For example, there is scope within the current regulatory framework to introduce proactive measures as conditions designed to remedy the adverse effects of conduct found to have operated, or which might be expected to operate, against the public interest.<sup>14</sup>

2.12 In order to fall within the public interest regime of the Airports Act, a particular course of conduct must:

- (i) relate to airport charges, operational activities or a right to carry on operational activities;<sup>15</sup> and
- (ii) have been pursued since the last quinquennial review.

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<sup>10</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 3.30. See also Annex B.54.

<sup>11</sup> See BA's comments at paragraph 10.3 below in relation to the CAA's proposal for ex post adjustments to allowed returns in certain circumstances.

<sup>12</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); Annex C.10.

<sup>13</sup> See Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 3.14.

<sup>14</sup> s.43(1)(b) and s.43(2) Airports Act 1986.

<sup>15</sup> s.36(1) Airports Act 1986.

2.13 BA considers that both these requirements are met. The relationship between leveraging and airport charges/operational activities is set out above (see paragraph 2.5), namely airport charge revenues are at risk of being called upon to satisfy debts incurred outside the airport business, and operational integrity and ongoing investment may be compromised. In terms of the second requirement, work to refinance BAA has already begun.<sup>16</sup> Therefore the courses of conduct which result from the financing arrangements have been pursued within the relevant period (i.e. they are not future or contingent courses of conduct).

2.14 The CC should therefore:

- (i) find that the courses of conduct resulting from the leveraging and financial engineering of BAA might be expected to operate against the public interest;<sup>17</sup> and
- (ii) recommend that conditions are imposed to ensure that the regulated business is ring-fenced and that a cash lock-up is put in place.

The need to protect airlines from asset disposals

2.15 Asset disposals (e.g. through sales or sale and leaseback mechanisms) are common following acquisitions involving private equity. But while they may be profitable for shareholders, experience at Heathrow and Gatwick has already shown (see paragraphs 2.19, 2.22 and 2.25 below) that they can have significant adverse consequences for airport charges and operations, and thus airlines.

2.16 BA is concerned that current regulatory policy:

- (i) allows BAA to continue to earn returns on assets after they have been transferred out of the Regulated Asset Base (RAB), leading to an unfair transfer of value between BAA and airlines;
- (ii) allows BAA to pass rental costs of assets disposed through sale and leasebacks on to airlines in the form of non regulated charges; and
- (iii) does not require BAA to apply for consent before disposals are effected, potentially jeopardising future airport expansion and operational performance.

2.17 These concerns are examined below.<sup>18</sup>

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<sup>16</sup> See for example "Ferrovial / BAA – A transforming acquisition"; 3 July 2006 ([http://www.ferrovial.com/recursos/doc/Sala\\_de\\_prensa/34033\\_3737200610032.pdf](http://www.ferrovial.com/recursos/doc/Sala_de_prensa/34033_3737200610032.pdf)).

<sup>17</sup> S.44(1)(a)(ii) and (iii) Airports Act 1986.

<sup>18</sup> See also section 8 below.

### *Returns*

- 2.18 Current regulatory policy allows BAA to remove assets from the RAB at full market value. Full market value exceeds the RAB value, therefore disposals generate an immediate windfall for BAA and its owners. However, as the impact of the disposal on the RAB is not considered until the next quinquennial review, BAA is able to continue to earn a return from airlines on assets which it no longer owns.
- 2.19 As noted by the CAA, during Q4 BAA made a number of disposals including transferring a number of BAA owned properties to the Airport Property Partnership (APP) – a joint venture between BAA and a third party investor (Morley Fund Management).<sup>19</sup> The assets which were disposed at Heathrow and Gatwick had an open market value of £275m.<sup>20</sup> BA has calculated that by continuing to price up to the Heathrow and Gatwick price caps BAA has earned £21.31m per year for the three years since the disposal to APP (i.e. £63.93m in total).<sup>21</sup> The redevelopment of the Central Area at Heathrow (Terminals 1, 2 and 3), scheduled to begin once Terminal 5 (“T5”) has become operational, will present a similar opportunity to BAA.
- 2.20 BA therefore believes that there should be a mechanism which allows the regulator to “clawback” at least some of any such unfairly earned revenues.<sup>22</sup> This could be written in to the price control formula or introduced under the public interest regime. For example, BA believes that BAA’s conduct in continuing to price up to the cap after the disposals to APP has operated, or might be expected to operate, against the public interest on the basis that (as per the criteria identified at paragraph 2.12 above):
- (i) airport charges have not been reduced to reflect disposals from the RAB; and
  - (ii) the disposals to APP were effected in 2005, therefore the conduct has been pursued since the last quinquennial review.

### *Non regulated charges*

- 2.21 Where assets are disposed of through sale and leasebacks BAA is able not only to release capital value but also to pass the rental costs back to airlines in the form of non regulated charges. Non regulated charges are subject to some degree of scrutiny during quinquennial reviews (though see paragraphs 5.2 to 5.5 below), but BAA is able to increase them during a regulatory period, thereby generating revenues that were not anticipated when the price control was set.

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<sup>19</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 10.3.

<sup>20</sup> Ibid.

<sup>21</sup> £275m multiplied by 7.75% (i.e. the return at Heathrow and Gatwick).

<sup>22</sup> BA notes that clawback of all of these revenues might have undesirable regulatory incentive effects.

- 2.22 For example, in the early 1990s BAA entered into a sale and leaseback arrangement with EDF (then LES) in relation to the Heathrow electricity infrastructure.<sup>23</sup> The terms of the disposal and thus the capital value benefit to BAA has never been made clear to airlines but the costs of leasing back the infrastructure was (and continues to be) passed on to airlines in the form of a non regulated utilities charge.
- 2.23 BA is therefore concerned to ensure that there is a mechanism in place which prevents BAA from using sale and leaseback mechanisms to increase non regulated charges thereby generating windfall revenues while at the same time benefiting from realising the capital value of the assets disposed. Again, BA believes that there is scope to do this under the public interest regime. For example, BA considers that BAA's conduct in recovering electricity infrastructure rental costs in the form of non regulated charges has operated, or might be expected to operate, against the public interest on the basis that (as per the criteria set out at paragraph 2.12 above):
- (i) non regulated charges in relation to an operational activity have been unfairly increased while at the same time BAA has benefited from the realisation of capital value of the assets; and
  - (ii) the disposal to EDF was effected in the 1990s, therefore the conduct has been pursued since the last quinquennial review.

*Consent*

- 2.24 BAA is able to take assets out of the RAB without requiring prior approval, which may very well constrain flexibility in relation to future airport development. BA believes that any disposals should be shown to be consistent with the long term master plan for the airport concerned. The Heathrow Master Plan (published by BAA in 2005) showed that BAA needed all the land within the existing airport boundary for planned developments and considerable additional land outside the airport boundary for future developments such as those associated with additional runway capacity.
- 2.25 Several projects have already been compromised by the disposal of land as part of the APP deal:
- (i) Heathrow Eastern Maintenance Area and Apron redevelopment. BA must move its motor transport maintenance base in order to accommodate the enlarged holding area for the southern runway. The development also involves the relocation of hangars (see paragraph 3.13 below). However, in both cases it has recently been discovered that the alternative sites earmarked by BAA were already disposed of to APP. It is not clear how this can be remedied.
  - (ii) Fuel supply. An increase in fuel supply capacity at Heathrow is urgently required (see paragraph 12.6 et seq. below). However, several potential

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<sup>23</sup> See paragraph 5.13 below.

storage sites (necessary to increase capacity) were sold off by BAA as part of the APP transaction. Again, it is not clear how this can be remedied.

- 2.26 It is widely reported that BAA is considering the disposal of its interest in APP and its subsidiary BAA Lynton (which provides asset management services to APP).<sup>24</sup>
- 2.27 BA therefore believes that there should be a mechanism which obliges BAA to seek the consent of the regulator before any disposals are effected so that a full analysis of all potential implications including consistency with the airport master plan can be undertaken (in conjunction with airlines). Again, this could be introduced under the public interest regime. For example, BA believes that BAA's conduct in failing to appreciate the impact of disposals on future airport development has operated, or might be expected to operate, against the public interest on the basis that (as per the criteria identified at paragraph 2.12 above):
- (i) operational activities have been compromised by the constraints placed on development; and
  - (ii) the disposals to APP were effected in 2005, therefore the conduct has been pursued since the last quinquennial review.

### **Constructive engagement**

- 2.28 The CAA's price control recommendations rely heavily on the outputs of "constructive engagement",<sup>25</sup> an initiative developed by the CAA to promote dialogue between Heathrow and Gatwick airports and their airlines in relation to the inputs to the price control review.
- 2.29 BA has consistently supported constructive engagement and recognises that it is a valuable part of the regulatory process.<sup>26</sup> However, there are limitations and it is important that these are recognised and dealt with by the CC:
- (i) constructive engagement is undermined where BAA fails to consult or share information with airlines; and

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<sup>24</sup> The Ferrovial presentation cited at footnote 16 above states that the BAA property management vehicles would be put under "strategic review" following a successful takeover bid. See also "Ferrovial calls off £1bn sale", (Financial Times, 12 January 2007) and "Take-off delayed for £300m BAA sale: Ferrovial halts Airport Property Partnership disposal after raising €2.2bn in Spain" (Property Week, 12 January 2007) which illustrate that Ferrovial has actively considered the disposals.

<sup>25</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 3.4.

<sup>26</sup> See, for example, paragraph 2.1 of BA's response to the CAA's Initial Q5 Proposals for Heathrow, Gatwick and Stansted Airports – February 2007.

- (ii) constructive engagement itself cannot procure implementation of agreed actions.

2.30 Each of these limitations is considered below.

Failure to consult or share information

2.31 Successful constructive engagement is dependent on adequate and timely disclosure of information by BAA to airlines. This has been lacking in relation to a number of important inputs to the current price control review, including:

- (i) project specific costs, on-costs and risk monies (see paragraph 3.15 et seq. below);
- (ii) capital expenditure at Heathrow including HET (see paragraph 2.33 et seq. below), pier service provision at Heathrow generally (see paragraph 2.36 et seq. below), pier service provision in T5 (see paragraph 3.8 et seq. below), stand provision (see paragraph 3.11 et seq. below) and the Eastern Apron development (see paragraph 3.13 et seq. below);
- (iii) capital expenditure at Gatwick (see paragraph 3.31); and
- (iv) non regulated charges at Gatwick (see paragraph 5.5).

2.32 This section concentrates on the undermining by BAA of constructive engagement on two major capex projects at Heathrow, namely:

- (i) plans for the Heathrow East Terminal development (HET) – one of the most significant projects in the Q5 capital plan; and
- (ii) provision of pier-served stands at Heathrow – a hugely important element of service offered by airlines to their passengers.

*HET*

2.33 HET is the planned replacement for T2 and T1. It is forecast by BAA to involve investment of £1.6bn. However, BAA did not involve airlines in the process of considering the case for HET, nor the options that led to its selection. It was conceived entirely by BAA and presented as a finished product to constructive engagement.

2.34 Furthermore, BAA has still not disclosed the business case for HET to airlines. There needs to be presented a fully costed “bottom-up” analysis of the costs of HET and of the timing of the investment, which can then be discussed and agreed with airlines. Only then will there be a significantly robust basis for taking this into account in the Q5 capex revenue requirement.

2.35 In addition, BAA radically reduced the size of HET (Phase 1) in February 2007 without cutting the capital cost. HET is due to be built in phases, starting from the south (over the site of T2), and then extending north over the current southern end of T1. The terminal design is based on a repeating grid, which can be added to as space is

released and/or the need arises. The depth of the terminal is fixed, but the width can be increased. One row of the grid is called a 'bay'. In February 2007 BAA cut the number of 'bays' in phase 1 from 5.5 to 4.5. BA estimates that this ought to have resulted in a capital cost reduction of some £100 to £150m. Despite requests by airlines, BAA has not offered an explanation.

*Pier-served stands*

- 2.36 Pier-served stands allow passengers to access aircraft directly from terminal buildings (and vice versa). Stands which are not pier served (i.e. "off pier" stands) must be accessed by bus.
- 2.37 Pier service is a major driver of airline customer satisfaction. Among the elements of customer satisfaction measured by BA are (a) ease of getting on plane; (b) overall departure process; and (c) ease of getting to gate. As shown in the chart at Annex 1, on all of these measures the availability of pier service as compared to non availability of pier service has a significant impact on customer satisfaction. For example, 15% to 35%<sup>27</sup> more BA passengers who were pier-served gave the top two marks for satisfaction with "ease of getting on plane" than those who were not pier served. Passengers tend to be dissatisfied with non-pier service because it often involves delayed departure and arrival times, cramped conditions on buses and long walks in terminal buildings.
- 2.38 In addition to the impact on customer service, off-pier service represents a significant operational cost to BA. For example, BA has calculated that it will incur costs of (£) per year in running the off-pier service operation at Terminals 3 and 5 prior to the opening of T5C (see paragraphs 3.8 et seq. and 3.22 below). This does not take account of any loss of revenues resulting from passengers switching from BA due to poor pier service provision.
- 2.39 Airlines want to see 95% pier service in each terminal at Heathrow, an objective which has been repeatedly communicated to BAA in constructive engagement. However, on the basis of information made available to date by BAA, BA does not believe that BAA's plans provide enough pier served stands to meet the airlines' requirement of at least 95% pier service. BAA has promised to provide analysis showing that its plans will meet this requirement or costed plans for doing so, but to date this has not been forthcoming. BA will be hit particularly hard by pier service levels below 95%. As Heathrow is the base of BA's hub operations, a larger proportion of its flights will be compromised as compared to airlines with hub bases elsewhere.
- 2.40 The lack of provision feared by airlines is particularly alarming in relation to the Eastern Apron development where BAA (without informing or involving airlines) submitted its plans in 2006 for planning approval.

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<sup>27</sup> Depending on class of travel (e.g. First, Club World, World Traveller Plus etc.) and whether long haul/short haul/domestic.

*Annex 4*

- 2.41 BAA's failure to engage with airlines in relation to these major capex projects is all the more surprising given its obligations under Annex 4.<sup>28</sup> Annex 4 sets out the agreement between the CAA and BAA on enhanced information disclosure and consultation around an annual business plan for each airport. It is designed to allow airlines to understand:
- (i) the principal business drivers behind the airports' central business plans;
  - (ii) the forecast demand for airport outputs for the duration of the plan;
  - (iii) the capacities that the airports intend to provide to meet this demand;
  - (iv) options for the development of the airport around the central plan;
  - (v) the resourcing implications behind the development plan;
  - (vi) cost estimates of individual projects within the capital expenditure programme;  
and
  - (vii) the outputs that are expected from individual projects.

*Implications for the price control review*

- 2.42 The experiences of airlines in relation to HET, provision for pier-served stands at Heathrow and the other issues highlighted at paragraph 2.31 above demonstrate that constructive engagement cannot be a substitute for due regulatory process involving scrutiny by (and thus informed input from) all parties (including the regulator), in circumstances where BAA has persistently failed to share information with airlines either in a timely fashion so as to allow airlines to input meaningfully or at all.
- 2.43 The CC must therefore ensure that airlines have the opportunity to analyse all aspects of the subject concerned. More generally, the CC should take steps to ensure that similar problems do not arise in future. In this regard, BA believes that there are grounds for a finding that BAA's failure to consult properly in relation to HET, the provision of pier served stands at Heathrow generally and the other issues listed at paragraph 2.31 above has operated against the public interest and thus for the CC to recommend conditions designed to ensure that consultation with airlines on major projects is more effective in future, particularly with regard to involvement of airlines in the early stages of project scoping.

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<sup>28</sup> Annex 4 to the CAA's decision on the Q4 price control (Economic Regulation of BAA London Airports (Heathrow, Gatwick and Stansted) 2003-2008; CAA decision (February 2003).

### Implementation

- 2.44 The decisive test of constructive engagement is whether BAA delivers on projects and commitments agreed. However, constructive engagement cannot procure delivery – there needs to be some other mechanism.
- 2.45 Capex triggers provide some guarantee of delivery of capital projects (see paragraph 3.25 et seq. below). However, there is no guarantee mechanism for non-capital projects agreed during constructive engagement (such as the airline occupancy agreement<sup>29</sup> or service quality projects). For example, at the last review the CC determined that BAA should offer BA and by extension other airlines a baggage service level agreement (SLA) at Gatwick. Although discussions began in September 2003, BA's SLA was only implemented in April 2007 and there is no fixed date for the implementation of the SLA for airlines in the South Terminal (ST).
- 2.46 BA believes that the CAA should review BAA's performance in relation to both capital and non capital projects on an annual basis (see also paragraph 3.29 et seq. below). There is regulatory precedent. For example, all licensees who operate electricity transmission or distribution systems are required by their licences to report annually to Ofgem on their performance in maintaining system security, availability and quality of service.<sup>30</sup> Similarly, gas distribution networks are required by their licences to collect information regarding their delivery of the outputs specified and report it to Ofgem.<sup>31</sup> Also, parties to the public/private partnership (PPP) agreements for maintenance and refurbishment of the London Underground can apply to the Office of the PPP Arbiter for an assessment of whether or not the private contractor has performed its activities in an overall efficient and economic manner and in accordance with good industry practice.<sup>32</sup>

### Independent scrutiny

- 2.47 There are several areas where independent scrutiny has been lacking in the current review to date, namely:
- (i) CAA has not followed regulatory best practice or taken account of market evidence in relation to:
    - (a) pre-tax cost of equity (see paragraphs 4.7 to 4.9);
    - (b) tax treatment in cost of capital (see paragraphs 4.13 to 4.19).

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<sup>29</sup> When T5 opens, a complex sequence of airline moves will begin. The moves are linked to a number of enablers, namely essential investments to make the new occupancy arrangements work and to provide "competitive equivalence" between airlines.

<sup>30</sup> 2005/06 Electricity Distribution Quality of Service Report; Ofgem (1 December 2006).

<sup>31</sup> 2005-06 Gas Distribution Quality of Service Report; Ofgem (12 December 2006).

<sup>32</sup> Procedural approach to the annual Metronet Report; Office of the PPP Arbiter.

- (ii) CAA has not accepted the recommendations of its independent consultants in relation to:
  - (a) commercial revenues (see paragraph 6.2);
  - (b) utility cost forecasts (see paragraph 5.10).
- (iii) CAA has taken BAA on trust in circumstances where it ought fully to probe BAA's submissions in relation to:
  - (a) project specific costs, on-costs and risk monies (see paragraph 3.15 et seq.);
  - (b) change to HET capex to reduce size but not cost (see paragraph 2.33 et seq.);
  - (c) pension allowance (see paragraph 7.9 et seq.).
- (iv) CAA has not scrutinised the Q4 baseline, one of the prime determinants of Q5 prices, in relation to opex numbers (see paragraph 7.16).

2.48 The CC must therefore apply appropriate independent scrutiny to these areas.

### **3. Capital expenditure**

- 3.1 As noted above, Heathrow and Gatwick are crucial to BA's operations. BA's global hub is based at Heathrow. Most of the remainder of its UK operation is based at Gatwick. It is therefore essential that the capex programme for Q5 delivers investment which is based on robust cost projections, and is sufficient and timely.
- 3.2 Expansion in capacity is essential to meet the needs of airlines. BA plans to place orders to expand and replace its existing long haul fleet during 2007. These orders are due to result in capital expenditure by BA of around £1bn per annum from 2009 for a decade or more. BA therefore needs to know that BAA's investment plans will provide the terminal, apron and runway capacity to meet the needs of this growing operation over Q5 and beyond. However, BAA must also deliver improved quality and operational robustness. Sufficient investment in pier service and transfer infrastructure for both passengers and baggage is therefore key.

#### **Heathrow**

##### Content of the capital plan

- 3.3 At Heathrow, during the course of constructive engagement, BAA and airlines have agreed a package of investment projects which will go some way to delivering the necessary capacity expansion and operational improvements (including the impact of possible future developments such as mixed mode operations and a third runway).
- 3.4 However, as noted above (see paragraph 2.31) there remain large areas where agreement is yet to be reached between airlines and BAA, namely:
- (i) HET
  - (ii) pier service provision across Heathrow;
  - (iii) pier service provision in T5;
  - (iv) stand provision; and
  - (v) Eastern Maintenance Area and Apron redevelopment.
- 3.5 Each of these areas is considered below.

##### *HET*

- 3.6 As noted above, BAA has failed to disclose the business case for HET (see paragraph 2.33 to 2.35). It is essential that airlines and the CC have the opportunity to scrutinise it.

##### *Pier service provision across Heathrow*

- 3.7 As noted above, BA believes that BAA's plans do not provide for sufficient numbers of pier-served stands that will be necessary to meet the airlines requirement of 95% pier service (see paragraphs 2.36 to 2.40 above).

*Pier service provision in T5*

- 3.8 Only 34 of the 61 gates in T5 will enjoy pier service when T5 opens. Pier service will be well below 90%. This is the lowest share of pier served stands of any terminal at Heathrow (and will continue to be the case even after Terminal 5 Satellite C (T5C) opens in 2010). BAA itself has estimated that following opening of T5C 92% of passengers will be pier served in T5. This means that 2 to 2.5 million BA passengers per annum will not enjoy pier service. That will require, at Heathrow's newest terminal, a coaching operation for BA that will transport more than the entire passenger load of all but a handful of the other airlines at Heathrow. As noted above (see paragraphs 2.37 and 2.38), this will result in significant costs to BA both in terms of customer service and operational costs of running the off-pier operation (not to mention lost revenues).
- 3.9 In addition, even achieving the 92% pier service levels estimated by BAA will still require BA to operate a huge aircraft towing operation in order to move aircraft on and off stand within the T5 site. In addition, BAA forecasts that on a typical day BA will have to tow 13 aircraft several miles from one end of Heathrow to the other, then back again, at significant cost to BA. BA is also having to build the parking stands for these aircraft, at its own expense (£30m to £35m). No other airline will have to move any aircraft away from the terminal from which it operates.
- 3.10 BA therefore believes that BAA must bring forward capital expenditure to add 4 pier served stands to T5C. Only in that way will T5 achieve 95% pier service. BA estimates that it will mean that 1 to 1.5 million extra passengers per year would be able to walk on or off flights rather than having to be coached. Planning permission exists for this development. In December 2006 BAA specifically agreed to cost increasing the number of pier served stands in T5C from 10 to 14. That information has not been supplied to airlines.

*Stand provision*

- 3.11 In the traffic forecasts that were submitted to BAA in June 2006 (see section 9), airlines assumed that the EU-US "open skies" agreement would come into force in Q5, boosting demand in the early part of Q5 and skewing Heathrow's mix of services towards long-haul. BA believes that "open skies" will have a net impact on stand demand at peak times of about 15 long haul stands over and above BAA's current plans. This arises from the concentration of US services in peak times (compared to other long haul). About one-third of the extra stands required will be taken up in T4 where there is spare capacity. However, the remainder will be needed between the runways.
- 3.12 BAA will need to bring forward capital expenditure to meet this demand in the early years of Q5 and new investment on the Western and Eastern apron stands to meet the net increase in demand in the latter years of Q5.

*Eastern Maintenance Area and Apron redevelopment*

- 3.13 The Eastern Maintenance Area and Apron is a large site (about the same size as the T5 site or the Central Terminal area). It needs large scale redevelopment, requiring significant capital expenditure (by BAA and airlines alike), which must take place around

continuing airfield and maintenance operations. However, BAA has failed to make provision in the capital plan for the following:

- (i) BAA must undertake major road and airfield realignments and relocation of services, in particular to accommodate the eastward expansion of the Terminal 1/HET apron as well as airport taxiway and holding area realignment and expansion. This is necessary to provide for:
- (ii) relocation, wholesale modernisation and replacement of many of the existing buildings (mainly hangars and workshops) in order that they are suitable for new long haul aircraft (see paragraph 3.2). Some of this will be funded by airlines (or third parties), some by BAA.

- 3.14 BAA has also failed to take the holistic approach to planning that is essential for a major redevelopment in a complicated operational environment. BA therefore believes that the Eastern Area Master Plan should be developed in the wider airport context so that it takes adequate account of all elements.

### Costs

#### *Scrutiny and risk sharing*

- 3.15 Capital expenditure at Heathrow is currently forecast at £2.928bn over Q5. The top 10 capex projects (by value) for Q5 are set out in Annex 2. BA is concerned that half of the projects in the top 10 (with a combined total cost in Q5 of over £400m) have not been properly costed. Further, even in relation to the half where there has been an attempt by BAA to break down total Q5 costs, airlines have only been able to scrutinise the base costs. There has been no opportunity to test BAA's forecasts for project specific costs, pass through of projected on-costs not subject to BAA control or risk allowance (effectively transferring capex risk from BAA to airlines in circumstances where BAA gets an allowance for this in the RAB). These non base cost elements amount to between 30% and 60% of overall costs (see Annex 2).

- 3.16 BA believes that the following measures are necessary:

- (i) full and detailed disclosure by BAA of costings for all capex projects;
- (ii) airlines to have closer involvement in scrutinising non base cost element of capital projects;
- (iii) risk sharing to be equitable (as opposed to BAA automatically passing the risk on to airlines through the risk allowance); and
- (iv) central handling of risk allowance monies so that they are only paid out on establishing the eventuation of risk on a BAA fault-free basis.

#### *Efficiencies*

- 3.17 As BA has previously stated, it believes that BAA should achieve a 5% improvement on the total capex budget in relation to project specific costs in Q5 as well as a 2%

improvement in benchmark costs. On BAA's full capex proposals, these improvements would reduce investment costs by £200m.<sup>33</sup> The CAA notes that BAA intends to incorporate further opportunities for capital efficiency into its next capital investment plan for each airport later in Spring 2007.<sup>34</sup> However, a draft seen by BA does not appear to incorporate any such opportunities.

#### *Construction price inflation*

- 3.18 The CAA has concluded that it is appropriate to include some degree of positive adjustment to capex projections for Q5 to reflect forecast positive differentials between construction and retail price inflation, but as it has not yet formed a view on the appropriate level it currently proposes to include BAA's construction price inflation (CPI) factors in capex projections.<sup>35</sup>
- 3.19 BA has reviewed BAA's projections from September 2006 against more recent figures obtained from the building construction information service (BCIS). The BCIS forecasts for the Q5 period clearly show an average CPI/RPI differential of approximately 1.3%, considerably lower than the 2% put forward by BAA. Even adjusting for labour, materials, market conditions for the South East and the impact of major new developments such as the Olympics and Crossrail the differential increases only to 1.5% over the next 3 years (providing accurate projections beyond this period is difficult due to future supply and demand characteristics). The sums involved are not negligible: on a capex budget of £2.928bn at Heathrow over 5 years, an additional 0.5% on CPI represents £38.2m.

#### Inter-terminal baggage system at Heathrow

- 3.20 As the CAA notes,<sup>36</sup> the inter-terminal baggage system project is supported by BAA and most airlines except those in the Star Alliance.<sup>37</sup> BA believes this is a spoiling tactic by the Star Alliance, designed to harm the competitive capability of the OneWorld Alliance.<sup>38</sup>

<sup>33</sup> BA's response to the CAA's Initial Q5 Proposals for Heathrow, Gatwick and Stansted Airports (February 2007); paragraphs 14.2 and 14.8 to 14.14.

<sup>34</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 9.57.

<sup>35</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 9.62.

<sup>36</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 9.20.

<sup>37</sup> Members include Air Canada, Air New Zealand, ANA, Asiana Airlines, Austrian, bmi, Lot Polish Airlines, Lufthansa, SAS Scandinavian Airlines, Singapore Airlines, South African Airways, Spanair, Swiss, TAP Portugal, Thai, United, and US Airways.

<sup>38</sup> Members include American Airlines, BA, Cathay Pacific, Finnair, Iberia, JAL Japan Airlines, LAN, Malev, Qantas and Royal Jordanian.

- 3.21 Automated systems are standard at other hub airports with which Heathrow competes, including at Frankfurt (the main hub of the Star Alliance) where the two existing terminals have automated links for baggage transfers and there are plans to connect the new third terminal to the system. It is therefore important that investment in equivalent systems is made at Heathrow in Q5.
- 3.22 Although most of BA's services (catering for some 27 to 30 million passengers per annum in Q5) will move to T5 when it opens, there will not be room for them all: services catering for some 2 million passengers per annum in Q5 will be in T3, as will services operated by BA's oneworld alliance partners (catering to some 7 to 8 million passengers per annum in Q5). Absent an inter-terminal baggage system, baggage will continue to be transferred by road which is less efficient and less operationally robust than an automated system. In addition, baggage transfer will be "within-terminal" for competitors of BA (and oneworld) at Heathrow. The Star Alliance will be accommodated entirely within T1-HET and Sky Team within T4.
- 3.23 The CC should therefore endorse the position of the CAA and the majority of airlines at Heathrow by supporting the inclusion of the inter-terminal baggage system in the Heathrow capital plan.

Incentives for delivery of capital projects

- 3.24 As noted above, BA is concerned that there should be sufficient mechanisms in place to ensure delivery of capital (and non capital) projects. There are two elements:
- (i) capital triggers; and
  - (ii) ex-post review and adjustments.

*Triggers*

- 3.25 BA welcomes the CAA's acceptance of the need for a broader range of triggers covering a larger sub-set of the proposal capital programme at each airport.<sup>39</sup> Triggers are an essential element in providing airlines with appropriate guarantees that the investment they require will materialise. They need to be set for all key elements of the capex programme, because failure to set a trigger on a project scheduled for completion early in the programme will have knock-on effects for subsequent capex projects and undermine the whole programme.
- 3.26 The potential for such knock-on effects is particularly marked at Heathrow. T5 has entered its final year of construction. In BA's experience, the final year of construction is one of the most critical to delivery of major capital projects on time, on budget and to

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<sup>39</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 9.74.

agreed specification. Even a small delay to the T5 opening date could have major knock-on effects – many of which will be suffered by airlines. For example:

- (i) airline schedules, which are co-ordinated months in advance, will have to be revised leading to cancellations, a massive re-ticketing exercise (tickets are already on sale) and disruption;
- (ii) the timescales for airline moves post-T5 opening are very tight, and the building and renovation work is already dependent on 24 hour working in some cases; and
- (iii) BAA has told airlines that T2 will close on schedule even if the terminals they are due to move to are not ready to accept them, thus transferring risk to airlines.

3.27 It is therefore imperative that there is a trigger on the scheduled opening of T5 on 27 March 2008 (following a full six months of live operational readiness<sup>40</sup>). BA cannot understand why the CAA “...is sceptical of the benefit of adopting the opening of the first phase of T5 as an appropriate trigger...”<sup>41</sup>, especially where the need for such a trigger has been agreed between BAA and airlines in constructive engagement (as the CAA notes<sup>42</sup>).

3.28 Other triggers which BA believes are necessary at Heathrow include:<sup>43</sup>

- (i) T5C to open for passenger service no later than 10 May 2010 and to include 10 pier served stands. BA also believes the following should be included: provision of aircraft stands, vehicle parking facilities, provision of staff accommodation and lounge facilities, fully integrated baggage system with other T5 satellites (A and B), automated baggage link to T3 and completion to allow for operational readiness period of 3 months from 10 February 2010;
- (ii) 4 more T5C stands to be pier served by summer 2011;
- (iii) automated baggage transfer system linking at least T5 and T3 to be opened at the same time as T5C (and in any event no later than 10 May 2010);

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<sup>40</sup> BA and BAA have agreed timing and specification for handover of T5 phase 1 to BA for operational trials.

<sup>41</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 12.35.

<sup>42</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 12.30.

<sup>43</sup> BA response to the CAA's Initial Q5 Proposals for Heathrow, Gatwick and Stansted Airports (February 2007); paragraphs 14.34 to 14.38.

- (iv) package of measures in T3 enabling BA to offer a good level of service to its operations there; and
- (v) investment in T4 to enable the relocation of airlines from T3 and T2.

*Ex-post review and adjustments*

- 3.29 The CAA proposes (to prevent the risks of high leveraging being transmitted to airlines through channels other than price, e.g. investment) to identify at the Q6 review:

*“...whether (and the extent to which) the level of investment during Q5 had fallen short of that which might reasonably have been expected to have taken place had the airports adopted financial arrangements consistent with those assumed in setting the price control. If the CAA had reasonable grounds to suspect a significant divergence attributable to financial causes as opposed to operational or related business reasons, it would expect to scrutinise in more detail the execution of the investment programmes at Heathrow and Gatwick, with a view to making retrospective (or ex post) adjustments for divergences between overall outturn capital expenditure, and that projected as part of the Q5 price controls, that could not be fully justified.”<sup>44</sup>*

- 3.30 As noted above (see paragraph 2.46), BA believes that the CAA should review the performance of BAA in delivering capital (and non capital) projects on an annual basis.

**Gatwick**

- 3.31 In April 2007 BAA tabled a significantly expanded capital programme for Gatwick. It represents a significant increase in proposed capital spending in Q5 (up by one third, or £178m, compared with June 2006). It has not yet been fully costed, and airlines have not yet had the opportunity to subject it to scrutiny.
- 3.32 Crucially, it appears that what was presented to airlines in April 2007 is not the BAA capital programme that was evaluated by the CAA as part of its reference to the CC. This makes it difficult for the airlines to assess the price settlement implications of the new capital programme. Airlines will need that information to take a balanced view.
- 3.33 It is important to note that one of the major factors behind BAA's proposed increase in capex at Gatwick is the need to accommodate more passengers in each year of Q5 in an airport that is already congested. The increase results from some Q6 capex being brought forward into Q5 and some provisional (or “overlay”) projects being included in Q5 expenditure. Currently, airlines are reviewing with BAA which of several potential growth scenarios is likely to work best, and how best to deal with uncertainties, such as the effects of the EU/US open skies agreement. BA hopes to be able to reach broad conclusions through the constructive engagement process by the end of June 2007 so

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<sup>44</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); Annex B.54.

that a joint position with BAA can be reached. However, it is likely to take longer than that to reach final conclusions on all points. In principle, BA believes that there is a case for increasing capex in Q5 and reducing capex in Q6 in order to accommodate more passengers and to improve service quality. BA also thinks that this would tend to reduce prices because the additional passenger revenues would more than offset the additional costs. In section 13 below, BA comments on the price cap implications both for the current scenario (as adopted by the CAA) and, in broad terms, on a possible higher capex/higher passenger scenario.

3.34 The capital investment triggers for Gatwick will need to be refined in light of the capital plan. However, at this stage BA has identified the following potential triggers:

- (i) pier service programme for the North Terminal (NT).<sup>45</sup> If all built in Q5, to be completed by February 2011. A service quality trigger may be needed if building phased flexibly;
- (ii) NT expansion to allow total airport growth to 39m ppa. Sub trigger baggage expansion and new sorters by November 2009. Check-in and arrivals by March 2010;
- (iii) ST re-ordering and refurbishment to be complete by December 2010;
- (iv) ST new baggage system. To be complete by December 2010; and
- (v) ST new forecourt and rail interchange. To be complete by December 2009.

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<sup>45</sup> The demand for pier served stands, and stand size, depends on fleet composition and growth rates. Airlines are tending to buy aircraft with wider wing span, e.g. 787 and A340-600 – for which some orders have been announced, and short haul aircraft fleet replacement.

#### 4. **Cost of capital**

- 4.1 This section sets out BA's view on the cost of capital. It should be read in conjunction with the technical submission that has been prepared by BA's economic advisors, Cambridge Economic Policy Associates (CEPA).
- 4.2 Cost of capital is a particularly important component of the price control determination due to the increase in the size of the regulatory asset base (RAB): for example a change of 25 basis points on the cost of capital is worth around 1 on the X and will cost airlines at Heathrow an additional £120m over Q5.<sup>46</sup>
- 4.3 As BA has previously made clear, it welcomes the CAA's recommendations for a lower cost of capital than that allowed in Q4 (which was excessive).<sup>47</sup> This is consistent with the current economic environment. Returns on cash and bonds have been at historically low levels for a sustained period - due to current global liquidity and other UK specific factors. In this context it is important to note that low returns on cash and bonds have a direct impact on expected/required returns on property and equities.
- 4.4 A significantly lower cost of capital compared with Q4 is also consistent with the circumstances of the acquisition of BAA by Ferrovial. The acquisition price was at a very substantial premium to RAB (at least 30%), implying that the actual cost of capital is significantly below that allowed by the CAA in Q4. The result has been a very significant transfer of value from airlines to BAA's shareholders in Q4.
- 4.5 However, BA remains of the view that the allowed revenues for cost of capital recommended by the CAA are still too high. BA disagrees with two particular aspects of the CAA's cost of capital approach:
- (i) the estimate of the cost of equity; and
  - (ii) the treatment of tax
- 4.6 BA notes that a key challenge in this review (and for other economic regulators) is how to set the cost of capital at a level that passes the benefit of low returns currently required on both debt and equity to airlines without prejudicing investment by BAA in the airport business. BA believes that the CAA has not got the right balance in relation to cost of equity. In relation to debt, BA believes that the CAA's proposals take account of the risk of mean reversion but notes that there is more scope to pass on the benefits of current market conditions if the CC endorses the suggested use of 'triggers' (see below).

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<sup>46</sup> Based on the CAA's projected RAB over Q5.

<sup>47</sup> See paragraph 17.1 of BA's response to the CAA's Initial Q5 Proposals for Heathrow, Gatwick and Stansted Airports – February 2007.

### Cost of equity

- 4.7 The CAA has used a post-tax cost of equity of 7.7% (which is the top of its range). This is excessive. It:
- (i) ignores market evidence which clearly show investor appetite for low risk infrastructure, such as airports;<sup>48</sup>
  - (ii) is inconsistent with regulatory practice elsewhere, including Ofgem's recent determination of the post-tax cost of equity for energy transmission services at 7.0%;<sup>49</sup> and
  - (iii) is significantly higher than the cost of equity allowed by CAA in Q4 despite the observed reductions in returns required by equity investors.
- 4.8 BA believes that the evidence points strongly to the fact that required returns on equity for comparable regulated companies are in the range 5.5% to 7.0%, and if anything may be at the lower end of that range. Even a rate of 7.0% (at the top end of what BA thinks to be justifiable) would allow for a significant tightening of financial markets over Q5 compared with current actual required returns of equity investors. Setting the cost of equity above 7% is not justified, and will again result in a very significant transfer from airlines to BAA's shareholders.
- 4.9 The main reason for the CAA's high cost of equity is the approach it has used to estimate the equity beta combined with a relatively high estimate of the equity risk premium. This approach, which assumes that the equity beta must rise with gearing (to maintain a constant asset beta) is at major variance with regulatory precedent and empirical evidence. In particular:
- (i) the approach is not consistent with market evidence (recently presented by Smithers & Co) on the impact of gearing on equity betas in other regulated companies in the UK (i.e. that the expected positive relationship has not been observed). In the reference the CAA seeks to explain away this evidence by arguing that one of Smithers & Co's attempted explanations of the evidence is not applicable to CAA. But the CAA does not question the underlying evidence or provide reasons why it should not be taken into account in setting BAA's cost of equity;
  - (ii) the implication that regulated airports are more risky than the equity market as a whole is not plausible, especially at Heathrow where output volume and price risks are muted.

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<sup>48</sup> As shown by Ferrovial's acquisition of BAA and infrastructure asset disposals / sales in other sectors, including other regulated utilities. See "The Allowed Cost of Capital: Ofgem GDPCR 2008-2013"; CEPA (April 2007).

<sup>49</sup> BA notes that there are differences in risk between airports and energy transmission businesses. But this should be set against further evidence since 2006 of sustained and low returns on equity.

### **Cost of debt**

- 4.10 Although the CAA has conducted only high-level analysis on the cost of debt, it has proposed a cost of debt of 3% (comprising a 2% risk free rate and a 1% debt premium).
- 4.11 Further work carried out recently by CEPA<sup>50</sup> (which takes account of the mix of index-linked and nominal debt that might be used by an efficiently financed utility) suggests that if greater weight is given to the likelihood that an efficiently financed company would make use of long-dated index-linked debt<sup>51</sup>, the appropriate rate might in fact be below 3%.
- 4.12 There is a strong rationale for consideration of triggers on either the risk-free rate or the all-in cost of debt. Risk-free rates and debt premia for investment grade bonds have remained low and stable in recent years. However, regulators (including the CAA) have typically been slow to reflect these rates – in order to protect the regulated company from the risk that rates increase over the course of the price review period. This ‘aiming high’ means that airlines and consumers have not benefited from the current benign market conditions. An automatic, pre-determined trigger mechanism that links allowed revenues to movements in a transparent benchmark for the cost of debt could ensure that airlines benefit from low rates whilst protecting the ability of BAA to finance its investment. BA believes that including such trigger mechanisms as part of the regulatory settlement would allow the CAA to set the cost of debt at levels below 3%. CEPA’s technical submission to the CC provides some initial thoughts on the nature of such triggers.

### **Tax treatment**

- 4.13 BA notes that CAA has decided to put on hold its analysis of the appropriate treatment of tax given the changes announced by the Budget. In addition, it indicates that there are strong arguments to continue with the current approach to setting allowed revenues using a pre-tax WACC calculated with a tax-wedge adjustment based on “optimal” gearing and the statutory rate of taxation (that is, an “optimal-notional approach”)<sup>52</sup>.

### **Effective versus statutory tax rate**

- 4.14 BA believes strongly that this represents a failure to protect the reasonable interests of airlines. The CAA should set BAA’s allowed revenues to cover *actual* tax payments – so that airlines pay only the amounts that are required to remunerate the providers of capital and fund BAA’s tax bill. This is now established regulatory practice in the UK. Indeed, both Ofgem and Ofwat recognise that it is inappropriate to allow revenue which is significantly in excess of that actually required for tax purposes.

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<sup>50</sup> CEPA (April 2007).

<sup>51</sup> Market evidence suggests that the all-in cost of long-date debt is significantly below 2%.

<sup>52</sup> See CEPA’s discussion of these options in CEPA’s technical submission to the CC (CEPA, May 2007).

- 4.15 Illustrative calculations provided by CEPA suggest that the CAA's current approach to funding tax might result in a net present value cost for Heathrow airlines of £30 million per annum or more.
- 4.16 The CAA has expressed a number of practical concerns about moving to an actual tax approach. These include:
- (i) The complexity and degree of intrusiveness implied by an actual tax approach.
  - (ii) The need to avoid asking airlines to pay twice.
- 4.17 BA believes that these concerns are significantly overstated – especially given the sums at stake for airlines and the regulatory precedent in this area. In relation to the concern around complexity and intrusiveness, BA notes that the approach taken by other regulators has been to ask the company concerned to provide an estimate of the tax which is then reviewed by the regulator's specialist tax advisers. This is no different from other parts of the review process; and the onus would be on BAA (not the CAA), which would produce these estimates in the normal course of its business; and BAA have to produce these estimates in any event. In any event, the information that the CAA would need to project "actual tax" is already largely contained in the regulatory building block projections.
- 4.18 In relation to the double counting concern, the CC should note that, in relation to Heathrow, the major tax benefits associated with T5 will accrue from Q5 onwards, when the assets come onto the balance sheet of Heathrow Airport Limited. In addition, there is an easy adjustment to make to the tax calculations to treat assets put onto the balance sheet in Q5 differently from those added in Q4 and earlier. This will avoid the possible double payment by airlines. This issue is discussed in more detail in CEPA's technical submission (see paragraph 4.1 above).

#### Tax impact of higher gearing

- 4.19 In the absence of formal (licence) requirements for BAA to retain an investment grade rating, BA believes that there is a strong case for the regulator to move to an actual tax basis to limit the incentives that BAA has to increase its leverage unduly – which could put at risk the capital programme and service quality.

## 5. Non-regulated charges

- 5.1 Non-regulated charges are an important element of the single till: BAA estimates that airlines will pay in excess of £800m at Heathrow and £150m at Gatwick over Q5.<sup>53</sup> Effective scrutiny by airlines and the regulator is essential.<sup>54</sup> Without it BAA is in a position to impose charges for individual activities that are not systematically related to costs, and increases in charges unrelated to and in excess of increases in costs.

### Forecasts

- 5.2 The lack of protection afforded to airlines in relation to non-regulated charges was recognised by the Monopolies and Mergers Commission (MMC) in 1991.<sup>55</sup> It found that BAA's failure to supply adequate details of the costs, or other principles, on which non-regulated charges are based might be expected to operate against the public interest because (as noted at paragraph 5.1 above) it allowed BAA to impose charges or increases in charges that were not related to costs or were excessive. As a remedy the MMC recommended that BAA should (inter alia):
- (i) make annual disclosures to the CAA of the system for allocating costs to non-regulated charges, detailed assumptions on which prices were set and statements of actual costs and revenues; and
  - (ii) provide annually, or at the time of each price increase, to airlines a statement of pricing principles, and the assumptions and relevant cost information adequate to verify that charges were derived from the application of the cost principles.<sup>56</sup>
- 5.3 In practice however the measures envisaged by the MMC have provided only limited protection to airlines: BAA has consistently refused to disclose on grounds of confidentiality much of the information required by airlines to verify the basis of non-regulated charges. This was so even after the CAA had told BAA and airlines that they ought to agree forecasts of non-regulated charges in constructive engagement.
- 5.4 Although reaffirmation by the CAA of its objective that airlines and BAA should agree forecasts in constructive engagement prompted BAA to share initial forecasts with airlines at Heathrow, it is not (yet) appropriate to use these forecasts in the price control

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<sup>53</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); tables 7-1 and 7-2 (which include the CAA's downward adjustment of utility cost projections).

<sup>54</sup> BA response to the CAA's Initial Q5 Proposals for Heathrow, Gatwick and Stansted Airports (February 2007); paragraph 12.1.

<sup>55</sup> BAA plc: A report on the economic regulation of the South-East airports companies (Heathrow Airport Limited, Gatwick Airport Limited and Stansted Airport Limited) (1991); paragraph 13.126.

<sup>56</sup> Ibid; paragraph 13.129.

as proposed by the CAA.<sup>57</sup> Agreement has not been reached. Airlines are continuing to scrutinise various aspects of the forecasts (as noted by the CAA<sup>58</sup>) and have requested further meetings with BAA (though it remains for BAA to identify the individual(s) responsible for taking this workstream forward, the previous BAA contact – the Finance Director – having informed airlines that he is no longer involved).

- 5.5 At Gatwick, BAA has failed to share detailed forecasts with airlines. It provided airlines with a high level summary in October 2006 but this did not contain any meaningful information on assumptions or cost/demand drivers. Therefore a significant amount of work remains before it is appropriate to include BAA's forecasts in the price control. In addition, BA continues to believe that BAA's conduct in relation to non regulated charges at Gatwick has operated against the public interest (see paragraph 2.43 above).

### **Increases in charges**

- 5.6 In addition to agreeing forecasts, BA believes that BAA should agree with airlines the basis of any increase in charges during a quinquennial period. This would ensure that BAA cannot unilaterally increase non regulated charges. BA also believes that any future increases at rates above an appropriate inflation index should at future quinquennial reviews be taken to constitute conduct which is adverse to the public interest, especially now that BAA is owned by private equity (see paragraph 2.21 et seq. above).

### **BAA's proposed adjustments**

- 5.7 BA supports the proposal for recovery of baggage infrastructure costs through airport charges and the recovery of the operating costs of the baggage system through a per bag non regulated charge. BA believes that this is the solution best placed to ensure a parity of baggage systems across the whole Heathrow campus capable of operating in an integrated manner. BA also welcomes BAA's withdrawal of its proposals to implement a separate charge for the removal of aircraft cabin waste (since this is already recovered through airport charges).
- 5.8 However, BA is surprised by the CAA proposal to allow BAA to remove the fuel turnover levy from the scope of non-regulated charges. This is not an issue that has been discussed between airlines and BAA in constructive engagement, and BA has not been consulted by either BAA or the CAA.
- 5.9 As previously noted by BA, BAA has also proposed that differences in rents charged for the hydrant refuelling system in Q4 and Q5 should be recovered through Q5 airport

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<sup>57</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraphs 7.31 and 7.36.

<sup>58</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraphs 7.9 to 7.10.

charges.<sup>59</sup> BA does not accept that revenues earned in one regulatory period should automatically be carried over to successive periods and therefore does not consider that the CAA should accept an automatic pass through to airport charges of the difference between the Q4 and Q5 revenues to Heathrow from hydrant system rents.

### **Utility costs**

- 5.10 BA welcomes the CAA's revised analysis of BAA's utility costs, in particular the recognition that the costs for each airport should be lower than BAA's own projections. However, BA believes that the CAA was wrong to adopt the high point suggested by the consultants (IPA) and considers that the CAA should adopt (at least) the mid-point. This is particularly the case since airlines had already indicated an understanding that non-regulated utility charges could vary in a regulatory period subject to market conditions and that such changes would be accepted subject to being transparently demonstrated by BAA.
- 5.11 The IPA base case (mid point) forecast for total utilities costs at Heathrow and Gatwick for Q5 is £301.14m (i.e. on average a little over £60m per year). The percentage increase to give the high case adopted by the CAA is 9.91%. BA could be expected to incur an additional (≈) per year if the high case (not the base case) was adopted.
- 5.12 BA notes that the CAA expects to update its forecasts in Autumn 2007. BA looks forward to contribution to the assessment of utility costs as part of that process.

### **Other costs**

- 5.13 As noted by the CAA, BA considers that airlines at Heathrow should have greater visibility of the terms on which BAA has sold part of the airport electricity infrastructure to its supplier and then rented back use of these facilities, passing the rental costs through to airlines in the form of non regulated utilities charges (see paragraph 2.22 above).<sup>60</sup> Although the disposal occurred in the early 1990s, it is only since the advent of constructive engagement that the potential implications of the disposal have been brought to the attention of airlines. Airlines have asked BAA repeatedly for details of the disposal and impact on the RAB but this has not been forthcoming.
- 5.14 BA also considers that airlines should have greater visibility of policing costs faced by BAA. This is especially so given the call from police forces for increased charges. As policing services are provided to all aspects of BAA's airport operations, it is not appropriate for all policing costs to be passed on to airlines.

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<sup>59</sup> BA response to the CAA's Initial Q5 Proposals for Heathrow, Gatwick and Stansted Airports (February 2007); paragraph 12.6.

<sup>60</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 7.18.

## 6. Commercial revenues

- 6.1 In any system of single till regulation, commercial revenues are crucially important: in Q4 they accounted for 26% of the revenues earned by BAA at Heathrow and 39% at Gatwick.<sup>61</sup> Following the Q4 review, the CAA consulted stakeholders about the lessons to be learned. The result was constructive engagement. But a small number of issues (where it was thought that constructive engagement could not be expected to produce the inputs needed for calculating the price cap) were reserved to the CAA. Commercial revenues was one of these issues.<sup>62</sup> Airlines are relying on the CAA to test fully BAA's projections. BA does not believe the CAA has done so adequately, if at all.
- 6.2 In the past the outturns of commercial revenues have been significantly above the forecasts used to establish the regulatory settlement, leading to an unjust transfer of value from airlines to BAA. With regard to the forecasts for Q4 commercial revenues, the CAA reported in December 2006 that actual commercial revenues in Q4 were some way above the levels forecast at the last price control review with outturn levels some £0.60 per passenger higher than forecast at both Heathrow and Gatwick.<sup>63</sup> Using the passenger numbers in 05/06 at Heathrow (67.4m) and Gatwick (32.8m) this represents a windfall benefit to BAA of some £60m across both airports for 05/06. The total windfall is likely to be substantially higher for the whole Q4 period and an equitable share of this figure should be taken into account in setting the price control for Q5. The CAA is also correct in considering that the evidence that BAA has been able to offset longer term downward trends in retail revenues per passenger, contrary to the projections at the last price control review, is the relevant context in which to consider BAA's projections for Q5.<sup>64</sup>
- 6.3 The CAA commissioned consultants (Donaldsons) to review BAA's forecasts.<sup>65</sup> They concluded that BAA's forecasts were unduly pessimistic. However the CAA did not accept the alternatives proposed, preferring instead to adopt a forecast set between that of BAA and the higher end of the forecasts proposed by its consultants.
- 6.4 Limited information has been made available to airlines on the assumptions underlying the forecasts put forward by BAA and the report produced by Donaldsons. However, BA continues to believe that projected Q5 commercial revenues have been underestimated,

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<sup>61</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 8.1.

<sup>62</sup> Airport Regulation: the process for constructive engagement (May 2005); paragraph 3.3.

<sup>63</sup> Price control review – initial proposals for Heathrow, Gatwick and Stansted Airports (December 2006); paragraph 14.11.

<sup>64</sup> Price control review – initial proposals for Heathrow, Gatwick and Stansted Airports (December 2006); paragraph 14.12.

<sup>65</sup> Scrutinising trends in commercial revenue at BAA's designated airports (Heathrow, Gatwick and Stansted); Donaldsons (December 2006) (Support paper VIII to CAA's initial price control proposals for Heathrow, Gatwick and Stansted Airports (December 2006).

particularly those flowing from BAA's retail activities. BA commissioned Pragma Consulting (a leading strategy consultant, with specialist experience in airport retail both in the UK and overseas)<sup>66</sup> to review the retail related elements of both BAA's forecasts and the work undertaken for the CAA by Donaldsons (albeit that limited details are publicly available). Pragma's report is attached at Annex 3. It questions several of the assumptions made by BAA, including:

- (i) the overall effect of recent security issues on retail spend per passenger. Pragma's work at other UK airports shows this spend to have been switched from landside to airside, not to have declined;
- (ii) future improvements planned to cut security queues generally across the airport, and specific quicker processes in T5 will lengthen the time passengers spend in the airside retail area. At an airport like Heathrow Pragma would expect there to be an increase in income of £0.30 to £0.50 per passenger (on average) for a 10 minute increase in passenger dwell in the retail area (up to a dwell of about 60 to 75 minutes, when the effect fades);
- (iii) T5 (net of T2 closure) will add significantly to the retail floor space at Heathrow both in total and per passenger, with all terminals benefiting. More passengers buy (a higher conversion rate) as the space per passenger rises. Pragma have estimated that this effect for Q5 could be £0.16 per passenger;
- (iv) the retail offer (mix, layout etc) in T5 has been specially designed to increase retail spend per passenger;<sup>67</sup> and
- (v) there will be a progressive increase in the share of non-EU passengers at Heathrow. BAA forecast 80 to 90% of additional passengers in Q5 will be long haul (non-EU). This will overwhelm any small increase in short and medium haul passengers. In Pragma's experience, passengers to non-EU destinations spend more than passengers travelling to EU destinations. BAA will thus benefit increasingly from this mix effect at Heathrow.

6.5 BA does not claim to have definitive information on these effects (as noted in paragraph 6.4 above, a limited amount is publicly available). Indeed, BA has put several questions to BAA on this issue (see the list at section 7 of the Pragma report) but BAA has declined to comment, noting that "*..it is for [the CC] to ask these questions at this time...*".<sup>68</sup> Nevertheless BA has assessed the impact on BAA's retail revenues at

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<sup>66</sup> [www.pragmauk.com](http://www.pragmauk.com)

<sup>67</sup> In a speech to the Airport Operators' Association, London (15 November 2006) Stephen Nelson (BAA CEO) said: "*...Terminal 5, where we intend to take the airport shopping experience to a new level...its retail offer really will be something special...*".

<sup>68</sup> Letter dated 3 May 2007 from Kyran P Hanks, BAA Economics and Regulation Director to Andrew Cunningham, BA Manager Economic Regulation.

Heathrow in Q5 using information available Pragma (see Figure 1 below). BA's assessment takes a Q4 baseline of £3.30 per passenger. This is an average of data from 2001/02 to 2005/06 (inclusive) and includes duty free and tax free shops, food and beverages, other retailing (including book shops, advertising etc.). It does not include bureau de change, car parking or property revenues.<sup>69</sup>

**Figure 1**  
**Impact on BAA's retail revenues at Heathrow in Q5 (real terms)**

<b>Impact</b>	<b>Revenue Increase</b> (average per passenger)
<b>Q4 baseline</b>	£3.30 <sup>70</sup>
<b>Due to cuts in security/process times<sup>71</sup></b> (increases time in retail area) (5 min. cut in non-T5 terminals) (10 min. cut in T5, with new processes)	£0.17
<b>Due to increased retail space per passenger</b> (Higher 'conversion' rate)	£0.16
<b>Due to T5 targeted retail offer</b> (BAA stresses this in its literature) (Estimated at minimum 10% uplift in T5) (Would also apply to HET from Q5, 2012/13)	£0.13
<b>Due to increasing longhaul/non-EU share</b> (Effect would increase to £0.10 by 2012/13)	£0.02 per year
<b>TOTAL</b>	<b>£3.78 rising to £3.86</b>

6.6 Figure 1 shows that the factors set out at paragraph 6.4 above indicate an increase of 16.9% on the Q4 baseline. In BA's view this 16.9% increase in retail revenues per

<sup>69</sup> Source: Scrutinising trends in commercial revenue at BAA' designated airports (Heathrow, Gatwick and Stansted); Donaldsons (December 2006); page 43.

<sup>70</sup> This does not take account of the £0.11 decrease forecast by BAA as a result of security issues. As noted at paragraph 6.4(i) above, BA does not believe that recent security changes will result in a decline in retail spend per passenger.

<sup>71</sup> As noted in paragraph 6.4(ii) above, Pragma expect a 10 minute increase in passenger dwell airside to generate up to £0.50 increase in airside spend per passenger. Therefore, T5 passenger spending an extra 10 minutes airside is worth £0.50 in extra spend and a non-T5 passenger spending an extra 5 minutes airside is worth £0.25 in extra spend. Assuming BAA gets 50% of extra spend as increased revenue, security and processing improvements will generate £12.375m in extra revenue (£7m in T5, i.e. 50% of (28m passengers x £0.50 each) and £5.375m outside T5, i.e. 50% of (43m passengers x £0.25 each). This gives an average revenue increase per passenger of £0.174, i.e. £12.375m / 71m passengers).

passenger is very likely to be achieved by the end of Q5. If it were to be achieved, it would represent an average real increase of about 3% p.a. That would not be out of line with general retail trends. And for every 1m passengers above forecast passing through Heathrow (see section 9 below) it would generate a windfall gain for BAA of £3.78m.

- 6.7 Given the particularly favourable factors for retail that BAA will enjoy at Heathrow once T5 opens, BA would expect BAA to anticipate significant headroom to perform above the 3% level.
- 6.8 BA would expect a jump in revenues at the start of the period with T5 opening, EU-US open skies, improved security, reduced crowding. Two years of above trend growth (say 4-5% per annum) in years 1 and 2, followed by 2% per annum in years 3 and 4, then a pick up again in year 5, to 3% p.a. if HET opens on time early in FY 2012/13.
- 6.9 BA also expects car parking revenues to grow in real terms, as BAA will be able to progressively increase the unit rate due to the limit on car parking spaces at Heathrow set by the T5 planning permission. In effect, BAA will be able to set a rationing price. This may be a reasonable course of conduct provided car parking revenues remain in the single till and are linked to funding being transparent and contributing to the modal shift that is needed to public transport and that the monies raised are invested in such projects as AirTrack or other public transport improvements.
- 6.10 BA has included its estimates of increases in retail revenues in its modelling of the Q5 settlement (see section 13 below). BA is looking for the CC to commission a full and open review of commercial revenues, especially the retail opportunities that will arise in Q5, so that this area can at last be properly addressed in the regulatory settlement.

## 7. Operating expenditure

7.1 BA has two main concerns in relation to operating expenditure, namely that:

- (i) all efficiency opportunities are identified; and
- (ii) the baseline is appropriate.

7.2 Each is considered below.

### Efficiency opportunities

7.3 BA welcomes the reduction by the CAA of BAA's over-inflated operating cost forecasts by £330m (£216m identified for Heathrow and £69m for Gatwick). However, BA believes that there are further opportunities to save at least another £272m (6%) (£216m at Heathrow and £55m at Gatwick).

7.4 The potential savings can be broken down as follows:

#### *Heathrow*

Frontier shift operating efficiency/full impact of benchmark studies	£95m
Pensions	£91m
T5/T2 adjustment	£30m
<b>Total</b>	<b>£216m</b>

#### *Gatwick*

Frontier shift operating efficiency/full impact of benchmark studies	£38m
Pensions	£17m
<b>Total</b>	<b>£55m</b>

#### Frontier shift operating efficient/full impact of benchmark studies (Heathrow and Gatwick)

7.5 The level of operating efficiency assumed by the CAA at 1% per annum is below the range employed by other UK regulators. While the form of measure and impact of volume growth needs to be considered, evidence reported at other price reviews, such as PostComm's 2005 determination, suggest regulators have employed a range of 1.3% to 7% per annum – with a simple average of 2.8%.<sup>72</sup> An adjustment for volume

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<sup>72</sup> See Table 251, page 413 of the LECG August 2005 report to PostComm: Future Efficient Costs of Royal Mail's Regulated Mail Activities.

growth then reduces this average to about 2.5%. PostComm also presented evidence to show that on average regulated companies have outperformed these targets by between 0.7% and 2.3% per annum. There has also been a trend among regulators to reduce the target over time – later price determinations establish lower targets than earlier ones, reflecting the idea that the majority of catch-up has taken place and shifting the focus to expected frontier shift. However, a simple average of the most recent determinations still yields an unadjusted average of almost 2.7%.

- 7.6 BAA should be set efficiency targets that address both ‘catch-up’ and ‘frontier shift’ opportunities.
- 7.7 In terms of benchmark studies, BA believes that there are further cost efficiency opportunities in increased security requirements. Whilst BA supports the investment required to improve queuing times, it notes that this is a factor not only of increased manpower but also more efficient use of manpower and increased numbers of more powerful x-ray machines. It is not clear to BA what assumptions have been made in respect of potential efficiency opportunities, such as maximising transaction times through central search from optimised processes coupled with more advanced screening machines.
- 7.8 BA also believes that there are opportunities to save utility costs, as highlighted by the review of utility costs undertaken by IPA. As noted above (see paragraph 5.10), BA considers that the CAA ought at least to have adopted the mid point suggested by the consultants. As noted by the CAA,<sup>73</sup> this would better serve the airline community because:
- (i) a significant proportion of utility costs are recovered from airlines through non regulated charges; and
  - (ii) BAA would have incentives to manage its exposure to wholesale price volatility through contractual arrangements with power suppliers and other counter parties.

#### Pensions (Heathrow and Gatwick)

- 7.9 BA welcomes the proposed cash basis for recognising pension costs but is very concerned that the CAA has ignored the market fundamentals of defined benefits pension schemes. The CAA’s proposed allowance of a more conservative investment policy without expecting a more conservative employee benefits proposal does not match open market realities. This puts an additional annual cost of £25m (per Trustee cost of £45m to post investment policy change of £70m) on to airlines. Setting such a precedent might encourage the trustees to further de-risk the investment policy as the airline community is underwriting the cost of such a strategy. This is not equitable. BA

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<sup>73</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 6.27.

has no desire to dictate how BAA should operate its pension scheme, but it is essential that the impact of the scheme in the regulatory settlement reflects market reality. Where this is not the case an appropriate correction should be made so that airlines do not subsidise this employee cost/benefit. BA has only been able to make broad estimates of the impact due to lack of information. The impact of £25m over 5 years should be £125m, though from the data available BA has only been able to estimate an impact of £108m (£91m for Heathrow and £17m for Gatwick).

- 7.10 BA is surprised that the removal of the service cost for both Heathrow and Gatwick is £8m for both airports whereas the cash contribution is between £25m to £27m for Heathrow and £11m for Gatwick. This further highlights the inequity of the impact of the investment policy on the cash contribution. To be clear, BA's preference for the cash basis is predicated on reflecting true market forces on the trustees' pension scheme policy setting. This also highlights the continued lack of transparency for airlines to understand key cost drivers of the BAA business.
- 7.11 BA is also surprised that the CAA has not so far been able to determine unequivocally whether the assumptions underlying the CC's Q4 recommendations (subsequently endorsed fully by the CAA) were based on accounting or cash projections.
- 7.12 BA welcomes the proposed adjustment to the RAB to correct the Q3 pension holiday but still needs to see the impact and transparency of this.
- 7.13 BA notes that in relation to Q6 pensions policy the CAA considers that "*...there could be advantage in moving progressively away from the separate assessment of salary and pension costs towards a regulatory approach in which labour costs are evaluated holistically, and discretion afforded to the regulated companies – in this case Heathrow and Gatwick airports – to decide how best to remunerate staff.*".<sup>74</sup> BA considers that there could be advantage in adopting that approach for Q5.

#### T5/T2 Adjustment (Heathrow)

- 7.14 Whilst BA accepts that T5 will create additional costs for BAA (e.g. terms of staff, rates and other property charges, maintenance, police and other costs such as cleaning and inter-terminal operations), savings will be made in other terminals at Heathrow, most notably with the closure of T2 and the reduction in volumes through T4. Therefore, there is potential for double counting and artificial inflation of operating cost forecasts.
- 7.15 BA welcomes the removal of the potential £10m double count staff cost with respect to the increase in costs due to T5, but seeks increased transparency in this area because it remains unclear what these increased costs (of between £50 and £60m) net of the T2 closure, comprise.

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<sup>74</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 6.50 and Annex B.68.

**Baseline adjustment**

- 7.16 BA also believes that as part of the Q5 price cap review the CC should consider revising all the operating expenditure opening baseline to Q5, once Q4 has closed. At present these are only assessed on a forecast basis and significant changes can occur between now and the final outturn of Q4.

## 8. **RAB**

8.1 BA has concerns in relation to the treatment of:

- (i) disposals;
- (ii) write offs;
- (iii) depreciation; and
- (iv) profiling.

8.2 Each is considered below.

### **Disposals**

8.3 As noted above (see paragraph 2.15 et seq), BA is concerned that current regulatory policy allows BAA to:

- (i) earn an immediate profit by disposing of regulated assets at full market value (which notably exceeds RAB value) but at the same time benefit from a “holiday” until the next review, i.e. BAA continues to earn a return on assets which are no longer in the RAB. As noted above (see paragraph 2.19) BA has calculated that BAA has thereby earned £21.31m per year for the three years since the disposal to APP (i.e. £63.93m in total); and
- (ii) take assets out of the RAB without requiring prior approval, which may very well constrain flexibility in relation to future airport development.

8.4 These concerns are especially relevant now as Ferrovial is widely expected to start to sweat BAA's assets (see paragraph 2.15 et seq. above). BA therefore believes that there should be mechanisms in place so that:

- (i) BAA must apply for consent prior to effecting any disposals; and
- (ii) the regulator can “clawback” revenues additionally earned by BAA during a RAB “holiday”.

8.5 BA notes the CAA's request for clarification from the CC on the appropriate treatment of the transfer of the Heathrow T5 hotel site, BAA having suggested that it should be transferred out of the RAB according to the cost of preparing that portion of the T5 site (rather than full market value).<sup>75</sup> BA looks forward to considering this issue further during the course of the CC's investigation but notes at this stage that adopting a

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<sup>75</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 10.4.

transfer value which is less than full market value must be dependent on effective scrutiny by the regulator of commercial revenue forecasts (see section 6).

### **Write offs**

- 8.6 The CAA proposes to continue its current policy of not reducing the RAB where assets are written off.<sup>76</sup> However, BA continues to believe that this can lead to overstating the RAB and lead to excessive pricing by BAA.<sup>77</sup> This issue will be particularly relevant at Heathrow in Q5 if HET goes ahead.

### **Depreciation**

- 8.7 As noted by the CAA, this issue needs further investigation.<sup>78</sup> Like the CAA, BA awaits further clarification of BAA's depreciation calculation. However, BA notes at this point a particular concern around the accelerated depreciation of T2.

### **Profiling**

- 8.8 In the past two reviews, the CAA applied price profiling in a way that smoothed prices across the next two review periods. When outlining the approach to the current review, the CAA discussed the factors that could result in the need for price profiling and concluded:

*"...Accordingly, it is to be expected that these factors will lead to some price profiling in the forthcoming airports reviews, just as they did in the CAA's last reviews of Heathrow (where there was significant revenue advancement) and at Stansted (where there was some revenue deferral)...".<sup>79</sup>*

- 8.9 Clearly, decisions on profiling cannot be taken until late in the review, when the range of prices is known. BA continues to believe that prices at Heathrow can be maintained at RPI - 1.5. If this is the case, there may not be a need for price profiling. However, if prices are to rise significantly beyond that, profiling should be used to reduce revenues in Q5 and increase them in Q6. This would avoid a further 5 years of sharp price rises coming on top of the 5 years of rises in Q4. At this stage BA expects any mixed mode overlay effect to be approximately neutral in terms of price impact. At Gatwick, BA believes that prices should reduce in Q5 (see paragraph 13.5) so do not at present see the need for price profiling.

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<sup>76</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 10.17.

<sup>77</sup> BA response to the CAA's Initial Q5 Proposals for Heathrow, Gatwick and Stansted Airports (February 2007); paragraph 16.6.

<sup>78</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 10.15.

<sup>79</sup> Airport Regulation: the process for constructive engagement (May 2005); paragraph 2.33.

## 9. Traffic forecasts

- 9.1 BA is concerned to ensure that that traffic forecasts are set at realistic levels.
- 9.2 The adoption of a price cap based on revenue yield per passenger means that traffic forecasts are a key input into the regulatory settlement. In order to fairly balance the interests of airlines and BAA, they must be set at realistic levels. Incorporating unrealistically low forecasts into the price control will result in an unacceptable transfer of cost and risk to airlines from BAA. For example, every 1 million additional passengers at Heathrow represents a windfall gain in revenue yield per passenger of £56m over Q5<sup>80</sup>, quite apart from any additional benefits obtained via commercial activities (see section 6).

### Heathrow

- 9.3 At Heathrow good progress was made in constructive engagement and traffic forecasts (in the form of an appropriate range) were agreed in June 2006. However, BAA subsequently unilaterally adjusted the agreed forecasts downwards on two occasions.
- 9.4 BAA claimed that its first downward adjustment (in December 2006) was necessitated by:
- (i) Economic factors:
    - an increase in the assumed long term oil prices by \$5-10 per barrel;
    - the impact of recent changes to Air Passenger Duty (APD);
    - the prospect of aviation being included in the EU Emissions Trading Scheme (ETS); and
    - adjustment to the assumed passenger price elasticities.
  - (ii) Airport factors:
    - a reduction to the assumed maximum number of passengers per ATM, reflecting changes to the assumed fleet mix at Heathrow; and
    - modifications to reflect changes in passenger sentiment towards individual airports.

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<sup>80</sup> This assumes (i) that passenger numbers increase by 1m in each year of Q5 compared to the forecasts in the reference; (ii) at revenue yields in the reference.

- 9.5 As BA has previously noted, these factors do not justify the adjustments to forecasts made by BAA.<sup>81</sup> At an airport like Heathrow where capacity is below underlying demand, airline responses to APD mean that there is no impact on traffic (airlines adjust mix – the proportion of seats sold at a particular fare type/price – rather than price in order to keep loads constant and consistent with forecasts). Discounts for increased environment costs (through inclusion of aviation in ETS or some other mechanism) were already included in the forecasts agreed in constructive engagement. And there were no changes to fleet mix between the reaching of agreement in June 2006 and BAA's revision in December 2006. So the purported justifications put forward by BAA simply do not withstand scrutiny.
- 9.6 In relation to the second downward adjustment of traffic forecasts undertaken by BAA (January 2007), BAA has (as requested by the CAA<sup>82</sup>) supplied additional forecast breakdowns. BA has analysed these, but remains of the view that they are not justified. BA believes that:
- (i) BAA's January 2007 forecasts understate long-haul growth at Heathrow. Over the last 6 years long-haul movements at Heathrow have grown roughly by 4.2% p.a. whilst total movements have only grown by 0.5% p.a. The last 2 years had flat total growth but long-haul growth still was around 4 - 5%. BAA's January 2007 forecast has only 1.7% growth in long haul movements from the 2006 base to 2010. This is low, even without accounting for the impact of "Open Skies". BA anticipates a long-haul movement growth rate of around 3.5% - 4% p.a in 2006–2010;
  - (ii) BAA's fleet mix assumptions are inaccurate. For example, few carriers are buying 777-200s (BA being an exception). Most future orders are for the 777-300. However BAA shows a strong bias in favour of the 777-200 (22, 900 new movements in 2010 c.f. 2006 compared to 8,800 on 777-300s). If these proportions were reversed, this alone would account for around 1 mppa difference in the forecasts (because of the very different seat capacities: a 777-300 is assumed in BAA's forecasts as having 346 seats compared to a 777-200's 252 seats);
  - (iii) BAA's load factors – particularly on long-haul - are unduly conservative, even without accounting for the impact of "Open skies";

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<sup>81</sup> BA response to the CAA's Initial Q5 Proposals for Heathrow, Gatwick and Stansted Airports (February 2007); paragraphs 8.12 to 8.16.

<sup>82</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 4.20.

- (iv) BAA does not assume implementation of “Open Skies”. This is a major flaw. Traffic forecasts for Q5 must take into account the impact of “Open Skies”.<sup>83</sup>
- 9.7 In addition, a study by IATA (commissioned by airlines to review BAA’s January 2007 forecasts) found that:
- (i) the rise in oil prices anticipated by BAA was not warranted by recent developments in oil markets and in consensus forecasts (from organisations such as Oxford Economics, International Energy Agency and the Department for Transport);
  - (ii) key (underlying) drivers of air passenger numbers strengthened in the second half of 2006 and that there was no reason to assume that any of the factors responsible for dampening 2006 figures (new security measures, bad weather and threatened cabin crew strike) would have an ongoing impact in Q5; and
  - (iii) traffic at Heathrow would increase with the implementation of the “Open Skies” agreement.
- 9.8 The IATA study also remarked that it was unusual to revise forecasts so quickly.

#### Implications for Heathrow price control

- 9.9 Therefore, BA remains of the view that BAA’s forecasts are too low. BA’s internal forecasts would tend to support this position. They predict growth of approximately 5% in commercial passengers between 2006/07 and 2007/08.
- 9.10 If agreement cannot be reached between BAA and airlines the CC must ensure that this important aspect of the price control is properly scrutinised.

#### Gatwick

- 9.11 The CAA has adopted very low passenger forecasts for Gatwick, based on the low test scenario agreed through constructive engagement in June 2006. BA agrees that this set of passenger numbers is broadly consistent with the capex plan agreed at the same time, even though it represents a very conservative view. Since then, as explained in paragraph 3.31 et seq. above, BAA has tabled higher passenger forecasts and a larger capital programme at Gatwick. It would therefore be helpful to consider two possible scenarios when reviewing the price cap settlement for Gatwick (see section 13 below). While BA hopes to be able to come to agreement with BAA in relation to Gatwick by the end of June on the passenger forecasts, this is an area that is likely to change, especially as the implications of the EU/US open skies agreement become clearer. It is

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<sup>83</sup> The original forecasts did assume “Open Skies” would be implemented (albeit no firm date was known so the impact would have been more smoothed than the likely actual impact, which is likely to show the greatest impact in the early years).

clear, however, that the current Gatwick forecasts are far too low and will have to be increased.

## 10. Price control design

10.1 BA agrees with most of the CAA's conclusions on price control design, namely:

- (i) volume risk, where the CAA's position is not to develop proposals for risk sharing between the airports and airlines (subject to a more realistic appraisal of likely passenger volumes, see section 9 above);<sup>84</sup>
- (ii) continued use of the revenue yield per passenger approach to price control;<sup>85</sup>
- (iii) continued use of the RPI +/- X formula to govern the movement of the revenue yield;<sup>86</sup>
- (iv) no change to the nature of the current cap on charges for non passenger aircraft;<sup>87</sup>
- (v) over/under recovery within a control period, where the CAA has proposed that the correction factor within a control period should be based on the absolute level of under or over recovery rather than on a per passenger basis;<sup>88</sup>
- (vi) use of triggers as a mechanism for incentivising delivery of investment projects (see paragraph 3.25 et seq. above)<sup>89</sup>, especially the CAA's proposal that the scale of each trigger should reflect the value of the project to airlines (normally based on the capital expenditure to deliver the project);<sup>90</sup>
- (vii) air transport movement incentive, where the CAA has concluded that a yield adjustment (that would be triggered as and when certain mixed mode

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<sup>84</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 12.16.

<sup>85</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 12.17.

<sup>86</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 12.18.

<sup>87</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraphs 12.20 to 12.22.

<sup>88</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 12.27.

<sup>89</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 12.28 et seq.

<sup>90</sup> Ibid; paragraph 12.39.

permission and development triggers were met) has better incentive properties than the air transport movement incentive;<sup>91</sup>

(viii) published tariff of net yield after discounts;<sup>92</sup>

(ix) the single till (though forecasts of commercial revenues and non regulated charges must be checked rigorously).

10.2 In relation to flexible revenue profiling see BA's comments at paragraphs 8.8 and 8.9 above.

10.3 BA notes the CAA's proposals for ex post adjustments to allowed returns at the Q6 review in circumstances where BAA's financial arrangements had resulted in a lower level of investment than might have been expected if financial arrangements consistent with those assumed in the price control had been adopted.<sup>93</sup> The CAA would have to specify in detail how this mechanism would work. BA considers assessing whether investment was as expected on a 5 yearly basis is too irregular. But in any event BA does not consider that ex post measures are sufficient to protect airlines from the adverse consequences flowing from highly leveraged financial arrangements (see paragraph 2.10 above). An attempt to recover post under-investment at the same time as encouraging future investment is intrinsically difficult: only ex ante restrictions that prevent risky financial structures from being put in place in the first place can protect airlines sufficiently.

10.4 In relation to operating expenditure roll-over mechanism,<sup>94</sup> BA believes that the practical complexities and the prospects of regulatory gaming associated with an opex roll-over mechanism are significant and therefore does not support it. Furthermore the best method of incentivising ongoing opex efficiencies is not to rely on an unproven mechanism such as the roll-over mechanism but rather for the CAA to ensure that the airports are provided with a real opex challenge for the entirety of the Q5 period through the regulatory settlement.

10.5 In relation to S – Factor pass through costs,<sup>95</sup> the CAA has proposed raising the level of security pass through costs for security directives from the Secretary of State above

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<sup>91</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraphs 12.44 to 12.46.

<sup>92</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 12.48.

<sup>93</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); Annex B.54

<sup>94</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraphs 12.24 to 12.26.

<sup>95</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 12.49 to 12.52.

normal security levels from 75% to 90% whilst retaining the de minimis thresholds at each airport. The Q4 period was one in which the airports had to implement significant extra security arrangements. These arrangements are likely to remain in place. The retention of the annual de minimis level will continue to incentivise the airports to procure any further requirements efficiently. Therefore BA is prepared to accept a move of the S – Factor from 75% to 90%. However, BA believes that the annual de minimis amounts at each airport should be uplifted by RPI for each year of the Q4 period in order to retain the same level of incentive property at the commencement of Q5.

## 11. SQR

11.1 BA recognises that the Service Quality Regime (SQR), introduced by the CAA as a remedy for the public interest finding made by the CC at the Q4 review, has secured service improvements in certain areas (e.g. within the terminals). The challenge now is to build on these improvements in Q5 especially in relation to airfield operations, where significant disruption could result from the range of planned infrastructure developments.

### Scope

11.2 BA is content with the elements currently included in the SQR, in particular the retention of pier service due to its importance to customer satisfaction (see paragraph 2.37). In common with other airlines, BA believes that the people moving equipment metric (which is usually met by BAA) ought to be disaggregated so that specific service quality measures attach to items of people moving equipment that are critical to passenger flows within the terminals. There are often significant break downs in critical pieces of equipment, causing considerable inconvenience to passengers, but which are not captured in the monthly aggregated scores. Discussions between BAA and airlines in relation to this proposal are ongoing with a view to reaching an agreed position on the elements in the critical flow for the June 2007 constructive engagement report.

11.3 As previously stated BA supports the CAA's criteria for determining whether a particular service should be included in the SQR.<sup>96</sup> BA notes that the CAA is minded to accept the criteria put forward by BAA as "guiding" rather than "binding" principles.<sup>97</sup> BA agrees with the CAA that in principle the SQR should be capable of being different at different airports (though this is unlikely to occur in practice as the quality needs of airlines are broadly similar across airports).

11.4 However, BA disagrees with the idea that the SQR should only apply to areas covered by airport charges. Airlines pay for BAA's services not only through airport charges: they pay non-regulated charges and rents too. The public interest finding at Q4 was not limited to airport charges. BA therefore disagrees with the CAA's view that as a "guiding principle" it should not look to include areas that are not "closely related" to facilities and services remunerated through airport charges.

11.5 BA also disagrees with the idea that the CAA might take into account the proportion of passengers affected by a particular measure so that it would be less inclined to include a service factor in the SQR if only a relatively small number of passengers were affected. A service can affect only a small number of passengers but have a large

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<sup>96</sup> BA response to the CAA's Initial Q5 Proposals for Heathrow, Gatwick and Stansted Airports (February 2007); paragraph 9.2.

<sup>97</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 5.9.

impact on airline revenues. Therefore, the importance to airlines and passengers should be the relevant criterion (as per the CAA's existing criteria).

- 11.6 BA does not consider that achievability of a measure should be a relevant consideration to whether a particular metric is included in the SQR (as suggested by BAA). Airlines are interested in securing real improvements in service quality. Therefore, by definition any suggestions made by airlines for additions to the SQR ought to be reasonable and achievable.

### **Exclusions**

- 11.7 BA supports the CAA's recognition that there are likely to be circumstances where BAA and airlines may agree lower standards or even a suspension of elements of the SQR, and that any such changes should take place using the expedited procedures for making agreed changes and without any diminution of the overall monies at risk.<sup>98</sup> The key for BA is that BAA should not be allowed unilaterally (without consulting airlines) to lower standards, suspend any SQR elements or monies at risk.

### **Raising standards**

- 11.8 The data at Annex D to the CAA's reference document demonstrates that:
- (i) service quality has improved over the course of Q4 since the SQR scheme was implemented; and
  - (ii) in most areas BAA has consistently performed above standard.
- 11.9 This means that on the occasions of service failure which do not take overall performance below standard, airlines incur the costs of absorbing service failures but do not receive rebates. BA believes this should be addressed through either establishing higher performance metrics or a secondary compensation mechanism for airlines when services are not provided (or both). These proposals are being considered in constructive engagement and will be included in the June 2007 report.
- 11.10 BA welcomes the recognition by the CAA that standards should be raised in the central security search and passengers' experience of key terminal facilities.<sup>99</sup>

### **Central security search**

- 11.11 The central security search is critically important to both airlines and passengers. In practice the current metric has the effect of averaging the performance of the central

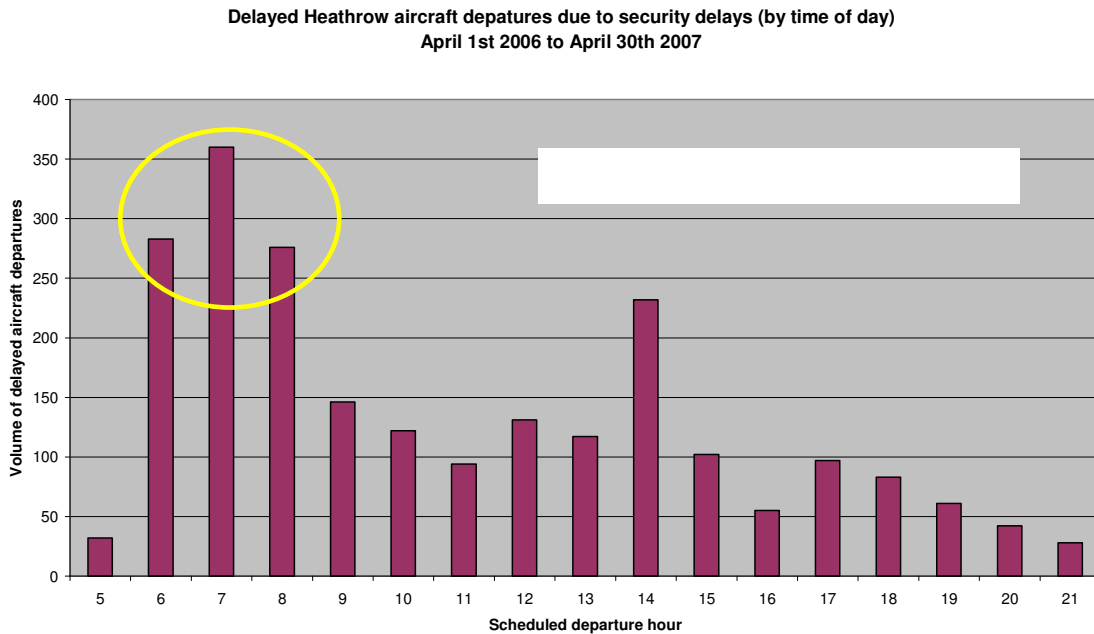
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<sup>98</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 5.68.

<sup>99</sup> Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 5.70.

search function over the course of a month. This average does not take account of operational impact on airlines of queues in peak periods – particularly the daily morning peak. Figure 2 shows that passengers departing Heathrow between 0600 and 0900 are most likely to be affected by security delays. If the service standard is not achieved in the morning peaks it can cause delays to aircraft operations which have a knock-on effect throughout the day, affecting both operational efficiency and quality of service given to passengers since punctuality is a key driver of customer satisfaction.

**Figure 2**



11.12 Under the current averaging effect of the quality measure it is possible for the airport to pass the metric measurement for a day whilst the airlines and passengers continue to experience the cost and inconvenience of the operational disruption resulting from morning service failures.

11.13 Therefore, BA welcomes the CAA's recognition of the importance of a peak measure and a second measure designed to ensure that average queues in the remainder of the operational day provide a satisfactory level of service. However, in contrast to the CAA BA believes the appropriate measures for these two metrics are:

- (i) a peak queue length of 10 minutes where any occasions of queues above this length trigger a rebate payment, and
- (ii) an average queue length of 5 minutes for passengers generally.

11.14 Discussions between airlines and BAA in relation to the appropriate metrics, cost impacts and the monitoring regime are ongoing with a view to reaching agreement as part of the June 2007 constructive engagement report. However, BA believes that BAA should be able to provide an improved level of service without simply resorting to higher costs to airlines. Indeed, BA believes that there are number of efficiency opportunities

that BAA must consider before simply passing costs onto airlines and passengers (see paragraph 7.7 above).

- 11.15 But it is not just the central security search where peak (and secondary) measures are needed: security processing of transfer passengers, staff and at vehicle control posts is also critical to airlines and passengers and there is peak loading similar to that experienced in the central security search. BA is therefore seeking equivalent measures to those set out at paragraph 11.13 above in relation to security processing of transfer passengers, staff and at vehicle control posts.<sup>100</sup>

#### Key terminal facilities

- 11.16 In terms of passengers' experience of key terminal facilities, BA believes that standards of cleanliness, wayfinding and flight information should be increased. These areas are critical to the comfort and ease of passengers' airport experience. This will particularly be the case when the majority of airlines have moved terminals in Q5. BAA has supplied a cost for improving these service levels which the airlines at Heathrow are considering and will comment on in the constructive engagement report due to be issued in June 2007.

#### Aerodrome congestion

- 11.17 However, BA does not agree with the suggestion that the 1% of airport charges attached to the Aerodrome Congestion Term (ACT) should be halved with a view to moving the other 0.5% onto the less accurately measurable QSM elements. This is something on which the CAA did not consult airlines in any way before including it in the reference. Although the ACT has only been in place since April 2006, it is a key part of the overall package of quality incentive measures placed on the airport. Indeed, it will be vital to keep the service quality incentives for efficient airfield activities as high as possible in the Q5 period given the amount of airside investment that will be taking place. BA therefore believes the level of airport charges associated with the ACT should not be reduced below 1%. In addition, BA believes that the level of flat rate payments (which cannot exceed the 1% ceiling) should be increased in line with airport charges.

#### Incentives

- 11.18 The current airport charges at risk do not in every case operate to provide BAA with a clear incentive to meet the SQR targets - it is often easier (and less financially disadvantageous) to fail than to make the investments necessary to meet the standards. BA considers that the levels of airport charges at risk ought to provide some incentive to meet or improve service standards.

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<sup>100</sup> See BA Response to the CAA's Initial Q5 Proposals for Heathrow, Gatwick and Stansted Airports (February 2007); paragraph 9.19.

11.19 BA therefore continues to believe that there is a case for increasing the proportion of airport charges put at risk under the SQR from the current 3% to something in the order of 6 – 7%:

- (i) the incentive to improve quality should be generally increased now that the low hanging fruit of quality improvements have been harvested, requiring the airports to face greater incentives to continue improvements;
- (ii) as the scope of SQR increases, the weighting for each element decreases unless more revenues are put at risk;
- (iii) the scheme is based on making payments on the first 6 months of failures in a 12 month period. This was part of the original framework and designed to put at risk a greater amount of charges in each month with the expectation that the higher monthly payment would incentivise improvements as a years worth of rebates could be paid in 6 months if services continued to fail. BA accepted this logic at the time but would prefer to see the airports facing a meaningful monthly incentive for each of 12 months.

11.20 In general, BA supports the idea of increasing weightings in passenger facing areas, but does not believe that the QSM (which is used to measure service quality in passenger facing areas) provides an accurate measure of quality because it is based on the subjective opinions of passengers some time after the experience of the element of quality it sets out to measure. For example, when a passenger is asked to rate the performance of the central search facility once they are in the departure lounge (where QSM surveys take place) they are liable to provide a less accurate measure of their impressions than if they were to be asked the same question on immediately exiting the central search queue.

### **Bonuses**

11.21 The SQR should remain a rebate only scheme. Airlines pay for the services supplied by the airports. In a competitive world, it would be reasonable to expect this service to be provided to the highest level possible. Since airlines have no choice but to use BAA airports, it is even more reasonable to assume that services should be provided to the highest levels possible.

11.22 In addition, BA notes that the rebate payments made by BAA are not punitive, therefore it would not be appropriate to introduce bonuses. BA notes the CAA's sudden switch to the nomenclature of penalties and bonuses in its reference to the CC when discussing bonuses. It may be that if the payments made by BAA for failure to meet SQR standards were punitive, there would be a case for bonuses. But since the sums at stake are rebates, BA does not believe it would be appropriate to introduce bonuses.

11.23 Also, as acknowledged by the CAA the introduction of the bonuses would add a significant amount of complexity to the SQR in the areas of administration, fairness and the time link between the achievement of the above standard performance and the expected bonus payments. The willingness of the CAA to propose the addition of this complexity is surprising as it runs contrary to the often stated intentions of the CAA to minimise restrictions and intervention when establishing regulatory settlements. BA is

also disappointed that the CAA would include such a significant addition to its proposals in the reference to the CC without raising it in previous consultation opportunities with airlines.

### **Shared airline airport processes**

- 11.24 BA considers the CAA's suggestion that the airlines should enter into service performance commitments to the airports or performance reporting arrangements to be beyond the scope of airport regulation.
- 11.25 The SQR was established as a remedy for the CC's finding that BAA had acted against the public interest in "...*failing to conduct themselves so as to make prices paid sufficiently reflect the level of service provided...*". It is not part of the wider portfolio of regulation applied to the air transport sector generally (i.e. not just BAA).
- 11.26 BA recognises the CAA's motivation in improving the quality experienced by passengers. However, BA, like other airlines, already has challenging internal quality measures to produce high levels of customer service for passengers and through this compete for their business. BA believes that airlines' own measures and the ambition of providing competitive customer service already ensure that airlines are seeking to deliver the best service quality for passengers at the airports. Passengers understand the differences in service performances provided by various airlines and do not require published data (which in any event might be commercially sensitive as between airlines) to come to a view about the service they are experiencing. In addition, airlines seek to enhance passenger experience through their suggestions for improvements to the SQR, e.g. the proposal to disaggregate the service quality metric attached to people moving equipment (see paragraph 11.2 above).
- 11.27 It is not appropriate for the CAA to attempt to regulate airlines through the airport regulation framework. Nor is it appropriate for the customers of a monopoly to be expected to make service commitments to such a supplier.

## **12. Public interest issues**

12.1 As noted above (see paragraph 2.12), in order to fall within the public interest regime a particular course of conduct must:

- (i) relate to airport charges, operational activities or a right to carry on operational activities; and
- (ii) have been pursued since the last quinquennial review.

### **Previously identified public interest detriments**

12.2 BA has already set out its belief that BAA's conduct has operated or might be expected to operate against the public interest in several areas, namely:

- (i) leveraging and financial engineering of BAA (see paragraphs 2.11 to 2.14);
- (ii) asset disposals (see paragraphs 2.20, 2.23 and 2.27); and
- (iii) failure to consult airlines (see paragraph 2.43).

12.3 Each of those merits an adverse public interest finding and the introduction of appropriate remedies or controls for the future in so far as they are not adequately addressed in the price control.

### **Other public interest detriments**

12.4 To date BA has identified two other courses of conduct pursued by BAA which BA believes have operated, or might be expected to operate, against the public interest. These are set out below.

12.5 If during the course of the investigation BA identifies any further courses of conduct pursued by BAA which have operated, or might be expected to operate, against the public interest it will inform the CC.

### **Fuel storage at Heathrow**

12.6 Fuel storage provision at Heathrow has not kept pace with airport growth. Increasing storage provision does not require capital investment by BAA as the necessary infrastructure is provided by third party fuel suppliers. But it does require forward planning by BAA in relation to identifying the need to increase capacity and making available the necessary land. BAA has failed to do this. Furthermore, much of the land needed to increase storage capacity was sold off as part of the APP property deal (see paragraph 2.15 et seq. above).

12.7 BA warned BAA that fuel storage provision was becoming increasingly inadequate and that demand was likely to outstrip supply by the time T5 opened. The Buncefield explosion in December 2005 made the problem acute. The lack of attention to strategic fuel supply capacity has meant that BAA is now trying to play catch up. But this type of infrastructure takes many years to implement. Meanwhile airlines carry both the risk of

supply disruption and the cost: BAA continues to receive fixed rental income from fuel suppliers which it passes on to airlines.

12.8 With the advent of “Open Skies” and the increase in long haul flights (overall and at the expense of some short haul flights) the problem is only likely to worsen. Long haul aircraft typically need 10 times as much fuel as short haul aircraft.

12.9 BA believes that BAA's conduct in failing to plan adequately to increase fuel storage provision at Heathrow and to make available the necessary land has operated, or might be expected to operate against the public interest because (as per the criteria identified at paragraph 12.1 above):

- (i) it relates to an operational activity; and
- (ii) has been pursued since the last quinquennial review.

12.10 To remedy the adverse effects on the public interest, BAA should be required to improve its strategic planning capability and to involve airlines in that process in order that the lack of fuel storage provision at Heathrow is rectified.

#### IT services

12.11 Airlines have become increasingly reliant on the operational use of IT systems for activities like check-in and baggage reconciliation over the last 20 years. They are now mission critical systems as manual fall back is either impossible or disruptive.

12.12 Historically, BAA has allowed major airlines to install their own networks subject to BAA technical control and property ‘way leaves’ being granted for the fibre. The airlines selected their suppliers through a competitive tender process.

12.13 However, over the past three years BAA has attempted to restrict the supply of IT networks to itself. BA is concerned that BAA:

- (i) charges in excess of market rates;
- (ii) does not allow airlines to input into specification decisions or negotiate service commitments.

12.14 For example, at Gatwick BAA is seeking to charge airlines in excess of market rates for the fixed IT network service for the common use check in system. In T5 at Heathrow it is seeking to restrict the supply of CCTV and WIFI networks to itself and is refusing to allow BA to install its own.

12.15 BA believes that BAA's conduct in relation to IT services has operated, or might be expected to operate against the public interest because (as per the criteria set out at paragraph 12.1 above):

- (i) it relates to an operational activity; and
- (ii) has been pursued since the last quinquennial review.

- 12.16 In order to remedy the effects adverse to the public interest, BA believes that BAA should allow airlines a free choice of supplier. Alternatively, if airlines are forced to continue to use BAA it must be on a commercially competitive cost basis with full cost transparency and on commercial terms and service levels that are comparable with the external market place.

**13. Conclusions**

13.1 This section sets out BA's conclusions on the price control, SQR and public interest issues.

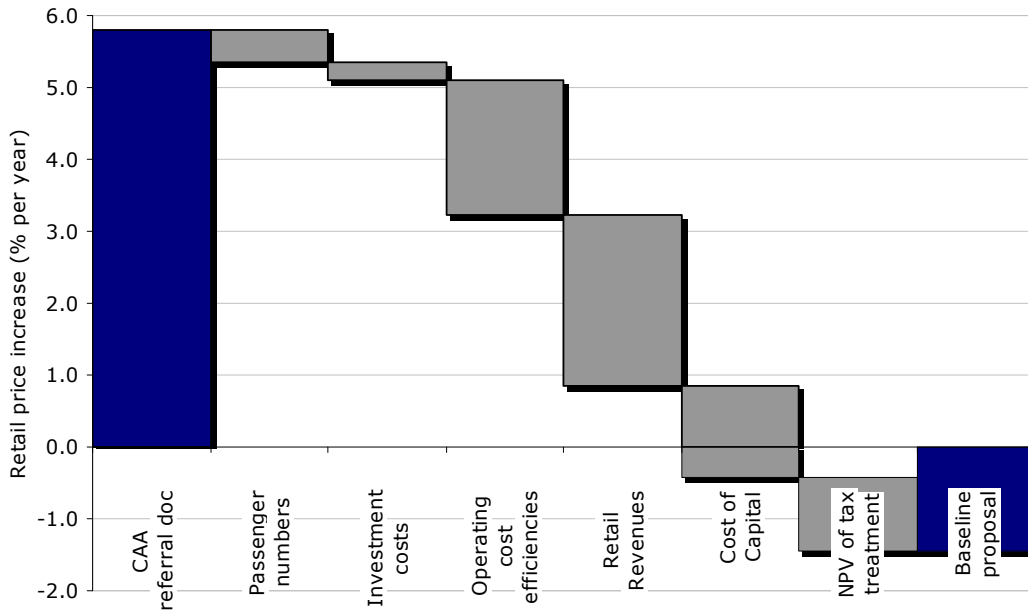
**Price control**

13.2 BA has modelled the impact on the Q5 price determination (i.e. the X) of illustrative changes suggested by BA. The financial modelling for this analysis is consistent with the 'ready reckoners' provided by CAA.<sup>101</sup> It shows that even relatively conservative changes to the CAA's building block assumptions mean that X should be below zero for Heathrow, and significantly below zero for Gatwick.

Heathrow

13.3 BA considers that price proposal for Heathrow should be RPI – 1.5. Figure 3 disaggregates the changes suggested by BA (as explained at paragraph 13.4 below) starting from the indicative CAA estimate of a 5.8% value for X.

**Figure 3  
Indicative Q5 real price increases (%) for Heathrow**



13.4 The reductions to X shown Figure 3 are as follows:

<sup>101</sup> See In Focus – a briefing from the CAA (20 December 2005).

- (i) Passenger numbers. Using the constructive engagement 'low case' for passengers (which BA believes is conservative)<sup>102</sup> contributes a reduction of around 0.5 to X.
- (ii) Capex. More efficient capital expenditure, evenly spread across Q5 and totalling £200m (2006/07 prices) results in a reduction of 0.25 in X (see paragraph 3.17 above).
- (iii) Opex. More demanding assumptions on the potential for operating savings through Q5, which save a further 6% on total Q5 operating costs compared with the CAA reference document (see paragraph 7.3 above). This results in a reduction in X of around 2.1
- (iv) Retail revenue. A significant increase in retail revenue reflecting the work done by Pragma about the potential impact of T5, HET and shorter waiting times in security (see paragraph 6.6 above). This reduces X by around 2.4.
- (v) Cost of capital. Using the CAA's low estimate of the cost of equity reduces the WACC to 5.9% and the X by around 1.25 (see paragraph 4.7 above). An illustrative adjustment of £20m per year to allowed revenues to reflect the present value of the tax benefits that accrue to BAA from CAA's approach reduces X by around 1.

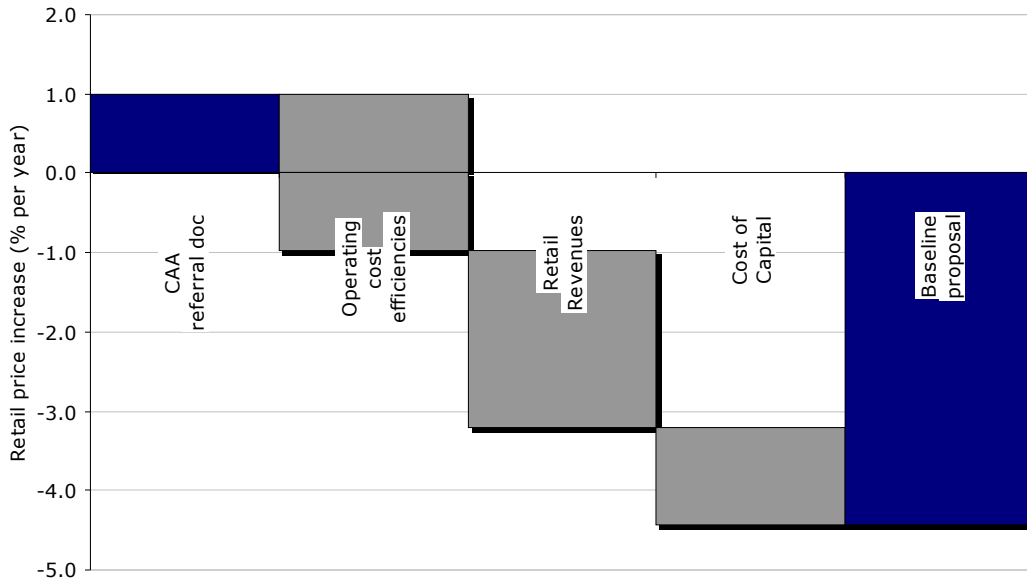
#### Gatwick

- 13.5 BA has also carried out this analysis for Gatwick. The results suggest that the price proposal for Gatwick should be RPI - 4.4, rather than RPI + 1 as suggested by the CAA in its reference document. Figure 4 disaggregates the changes suggested by BA (as explained in paragraph 13.6 below). BA's analysis uses the passenger and capital expenditure numbers in CAA's reference document. However, BA discusses below (see paragraph 13.7 to 13.9) the possible impact of additional investment, higher passenger numbers and commensurate increases in retail revenue and operating costs.

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<sup>102</sup> See Price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports (March 2007); paragraph 4.25 and table 4-1. See also Airports price control review – Initial proposals for Heathrow, Gatwick and Stansted (December 2006); paragraph 8.10.

**Figure 4**  
**Indicative Q5 real price increases (RPI+X) for Gatwick**

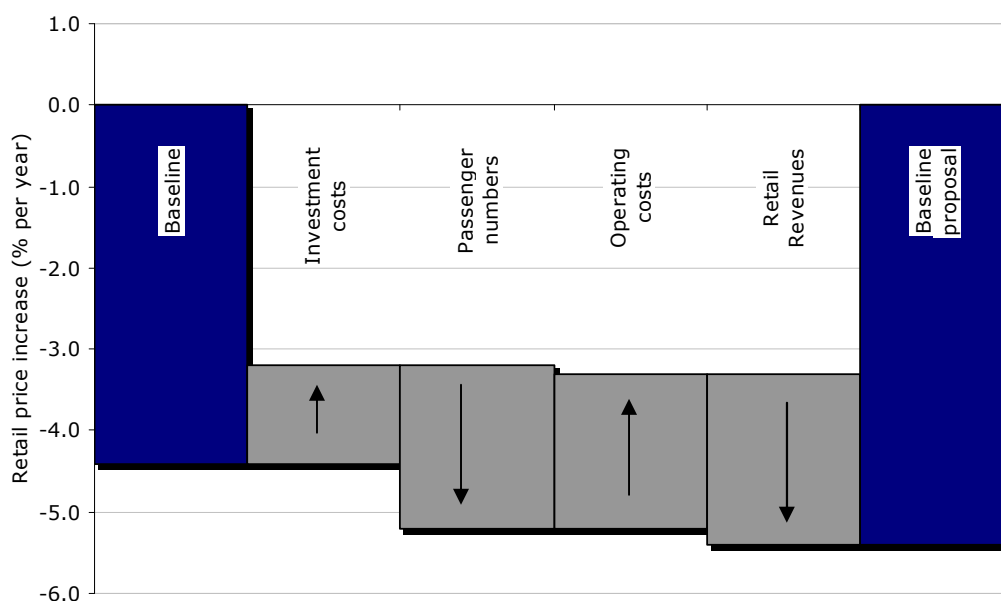


13.6 The reductions to X shown in Figure 4 are as follows:

- (i) Opex. More demanding assumptions on the potential for operating savings through Q5, which relate to the potential for efficiency saving and the treatment of pensions, result in a reduction to the X of close to 2 (see paragraph 7.3 above).
- (ii) Retail revenue. Higher retail revenues, based on a conservative assumption that actual revenue per passenger is 5% higher than currently assumed by CAA. This results in a reduction in X of around 2.2
- (iii) Cost of capital. Using the CAA's low estimate of the WACC of 6.3% (on the basis of BA's arguments about the cost of equity (see paragraphs 4.7 to 4.9 above) reduces the X by 1.2.

13.7 Figure 5 below uses the baseline X of just below -4 (as set out in Figure 4 above) as the starting point for an analysis of the impact of an additional capital expenditure programme designed to achieve significant increases in passengers. These figures are consistent with the latest figures proposed by BAA to airlines. However, until constructive engagement discussions have concluded, this analysis can only be illustrative. Based on reasonable assumptions, it suggests that the net impact on the X is unlikely to be significant and may even be negative.

**Figure 5**  
**Q5 X Impact of illustrative increased capital expenditure programme at Gatwick**



13.8 Key points to note about Figure 5 are as follows:

- (i) It assumes additional capital expenditure of £176m, comprising around £112m brought forward from Q6, and £64m additional capital expenditure. The impact on the X of this capital expenditure is an increase of 1.2.
- (ii) The capital expenditure is assumed to support increases in passenger numbers of around 6% per annum compared to the CAA case (throughout Q5), which reduces the X by 2.0.
- (iii) BA has also made assumptions about the impact of higher passengers on operating expenditure and retail revenues. In particular, BA assumes that 75% of operating costs are variable – and therefore rise in line with passenger numbers. This has the effect of increasing the X by around 1.9.
- (iv) Retail revenue from the additional passengers is calculated at the CAA's assumed retail revenue per passenger, and leads to a reduction in X of 2.1.

13.9 The combined effect of these changes is an X of -5.4 compared with the starting 'baseline X' of -4.4.

### **SQR**

13.10 The SQR has secured service improvements in Q4, particularly within the terminals. The challenge for Q5 is to build on these improvements, especially in relation to service metrics relating to airfield operations such as pier service which is such an important driver of customer satisfaction (see paragraph 2.37 above).

- 13.11 With that in mind, BA believes that there is a case for increasing the proportion of airport charges put at risk for failure to meet SQR standards from 3% to 6-7% and welcomes the proposal to raise standards in the central security search and passengers' experience of key terminal facilities. Similarly, that is why BA does not agree with the proposal (on which it was not consulted) to reduce by 50% the amount of airport charges attached to the aerodrome congestion term.
- 13.12 The SQR should remain a rebate only scheme. In a competitive world airlines would have a reasonable expectation that services would be provided to the highest level possible. This is even more so in a world where airlines have no choice but to use BAA airports. And since the SQR is not punitive to BAA, a bonus element cannot be justified.
- 13.13 BA does not believe that the CAA's suggestion that airlines should enter into service performance commitments is appropriate or necessary. The SQR (and the quinquennial review process generally) is about regulating BAA's behaviour, not that of airlines. And BA, like other airlines, already has challenging internal quality measures to produce high levels of customer service.

#### **Public interest issues**

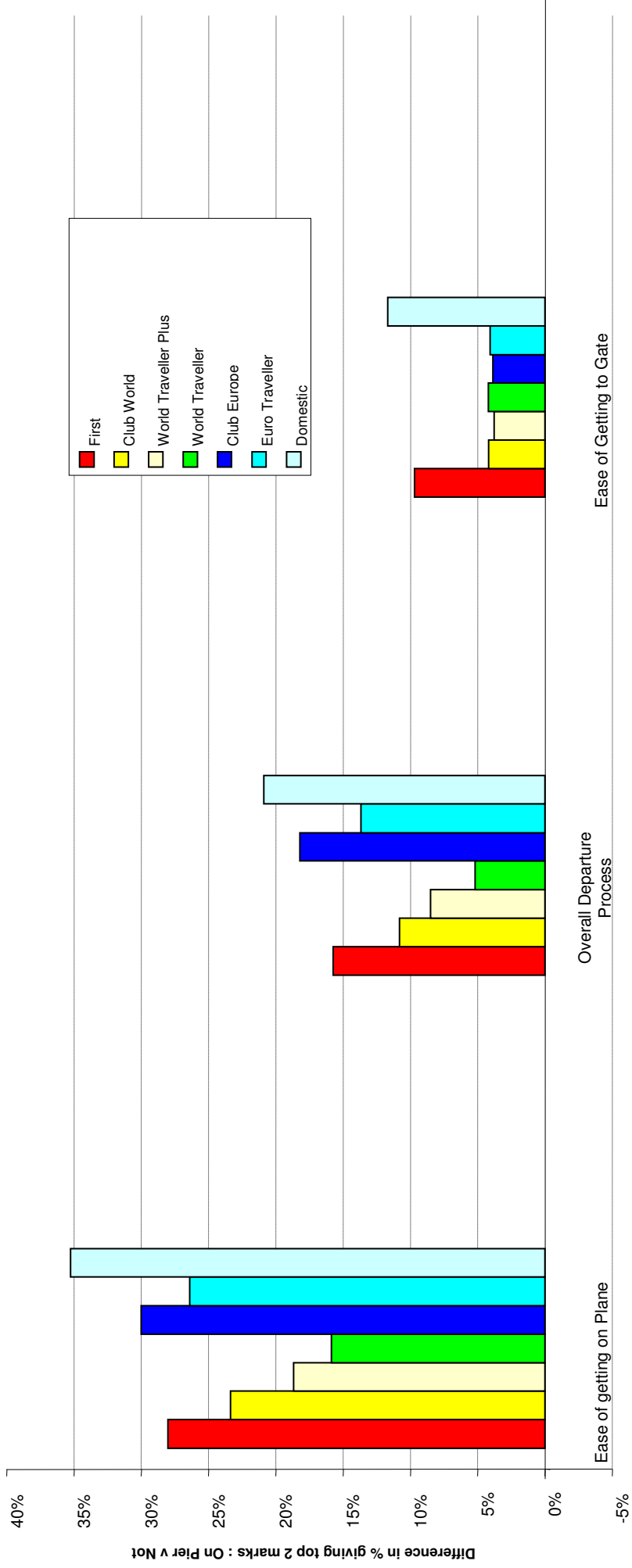
- 13.14 There are three key areas where BA believes BAA's conduct has operated, or might be expected to operate against the public interest, namely:
- (i) leveraging and financial engineering of BAA;
  - (ii) asset disposals; and
  - (iii) failure to consult airlines.
- 13.15 The acquisition of BAA by the Ferrovial consortium has highlighted that airlines are not protected from the risks flowing from the leveraging and financial engineering of BAA or the risks flowing from asset disposals. Gearing up BAA risks compromising airport operations and investment, to the detriment of airlines. And as experience at Heathrow has shown, asset disposals jeopardise future airport development and result in value transfers from airlines to BAA through BAA's ability to continue to price up to the cap post disposal and to recoup leaseback rents through non regulated charges.
- 13.16 A key challenge for the CC in this review is to ensure that airlines do not remain exposed to these risks. BA believes that there is scope to do this through the public interest regime in relation to both financial leveraging of BAA and asset disposals.
- 13.17 Failure by BAA to consult airlines or provide them with sufficient information has undermined several aspects of the current price control review, namely capital expenditure costs, capital expenditure at Heathrow and Gatwick and non regulated charges at Gatwick. In order that the eventual price control settlement fairly balances the interests of airlines and BAA it is imperative that all inputs are exposed to full and informed scrutiny by airlines (and the regulator). The CC must ensure that the lack of consultation and provision of insufficient information that has persisted to date is rectified in the current investigation. Further, the CC must take steps to ensure that

similar problems do not arise in relation to future price control reviews. Again BA believes that there is scope to do this through the public interest regime.

- 13.18 BA also believes that BAA has acted against the public interest in relation to fuel storage provision at Heathrow and provision of IT services.

**Annex 1**

**Impact of On Pier Departures at Heathrow by Brand May 03 to Apr 04**  
**(Difference in % Giving Top 2 Marks for Satisfaction v Score for Off Pier Departure)**



**Annex 2****Top 10 Heathrow CAPEX Products**

Item	CIP ID	Project Name	Q5 TOTA	Base Cost	Project Specific	Project On-Costs	Risks	Non-Base Cost	Total	Prev. Q4 spend	07/08 spend	Q6 spend	Base Cost %	Non-Base Cost %	Notes	
1)	H.ET.01	HET Programme - Heathrow East Terminal Build	1,084	716.	422.0	227.7	245.9	895.	1,612	15	43	471	44	56		
2)	H.CX.0	CONNECTIVITY - Post T5 Transfer Baggage Syst	243		<i>No costs available at present</i>											No costs breakdown available - begins 08/09
3)	H.T1.36	Eastern Apron - Star Mfield Pier Sth & Snds P1	143	82.	16.9	17.9	26.0	60.	143	-	-	-	58	42		
4)	H.T1.07a	Eastern Apron - T1 Star Mfield Pier Nth & Stn	129	93.	0.0	16.8	27.6	44.	138	-	8	-	68	32		
5)	H.T1.39	Airfield - EA A/side Rd & Taxilane U/pass	60		<i>No costs available at present</i>											No costs breakdown available - begins 09/10
6)	H.ASS.35	Airfield - Eastern Apron Development P3	57		<i>No costs available at present</i>											No costs breakdown available - begins 07/08
7)	H.CX.0	CONNECTIVITY - HBS VIVID replacement prog	48		<i>No costs available at present</i>											No costs breakdown available - begins 07/08
8)	H.T4.0	T4 Refurbishment - Terminal 4 Refurbishment	42	23.	4.6	5.8	8.4	18.	42	-	-	-	55	45		
9)	H.CX.18	CONNECTIVITY - Manual Handling Aids	36	21.	3.5	4.4	7.3	15.	36	-	-	-	58	42		
10)	H.T4.0	T4 Refurbishment - T4 Check-in Capacity	31		<i>No costs available at present</i>											No costs breakdown available - begins 07/08
	<b>TOTA</b>		<b>1,873</b>	<b>936.</b>	<b>447.0</b>	<b>272.6</b>	<b>315.1</b>	<b>1034.8</b>	<b>1,971</b>	<b>15</b>	<b>51</b>	<b>471</b>	<b>48</b>	<b>52</b>		

**Source:** Heathrow Airport Limited Capital Investment Programme 2007 (Draft for Consultation)

**Cost definitions:** The Heathrow Airport Limited Capital Investment Programme 2007 does not give detailed definitions of base costs or non-base costs (project specific costs, project on costs and risks). BA defines them as follows

<b>1) Base Construction Costs</b>	These costs would appear to be simply the actual construction costs of items in the capital plan
<b>Non-Base Costs</b>	These are the other costs excluding the Base Construction Costs for each project. They include Project Specific costs, Project On-costs and Risks and are individually listed below.
<b>2a) Project Specific</b>	These costs would appear to be for ancillary items required to facilitate the building of the development specified in the project.
<b>2b) Project On-Costs</b>	These costs are made up of Design, Project, Commercial & Production.
<b>2c) Risks</b>	These costs are made up of Design Development, Contingency and Risk.

**Annex 3**

**Pragma Study**