

IATA response to the UK Competition Commission Heathrow and Gatwick Airports Quinquennial Review consultation letter of 5 April 2007.

Summary

- We welcome and fully support continuation of the single till and separate regulation of the airports.
- The proposed headline RPI+5.8% at Heathrow in particular is unacceptable and unjustified in our view.
- Constructive Engagement at LHR and LGW to agree the capacity and service required has resulted in significant achievements including a better working relationship between the airlines and BAA.
- Traffic forecasts - we believe a more challenging and robust approach is required on traffic forecasts - the BAA revised figures are over-pessimistic and unjustified.
- Service quality - we support consideration for broadening the scope of the service quality regime and strengthening the incentives under the current scheme of rebates above the 3% of airport charges currently at risk.
- Operating costs – the proposed 1% efficiency target is insufficiently challenging and should be closer to 2%.
- Commercial revenues – while we welcome the CAA's 4% increase on the BAAs projections we believe these are too conservative.
- Investment is the biggest cost driver in the initial price cap recommendations and must be delivered more cost effectively – we fully support incentive triggers.
- While we welcome the reduction in the cost of capital of 6.2% for LHR and 6.7% for LGW we believe this should be lower.

GENERAL

a) The International Air Transport Association (IATA) is the trade association representing 250 worldwide members who together provide some 94% of international scheduled traffic. With 140 of our worldwide members using the major UK airports, we have a significant interest and concern with their economic regulation. We therefore very much welcome the opportunity to respond to this Competition Commission (CC) review.

b) Airlines are operating in an increasingly competitive and deregulated business that is driving cost reduction and improved efficiency. We have reduced non-fuel unit costs some 14% over the last five years, with a 33% improvement in labour productivity. While the drop in fuel price is welcome it is still more than twice as much as we were paying in 2001 and some 26% of our total operating costs.

c) Competition has driven down our real yields some 30% over the last 10 years. Airlines are continuously reducing costs in line with consumers' demands. Unfortunately we are seeing nowhere near this improvement in efficiency from our key airport partners within the industry supply chain who enjoy a relatively stable and growing revenue.

d) As major airports Heathrow (LHR) and Gatwick (LGW) are natural monopolies that provide essential services and facilities for the airlines. More than ever we need regulatory support and incentives to ensure the lowest possible costs and charges consistent with the provision of the agreed necessary capacity and service.

For easy reference the chapter headings in this response are consistent with the CAA recommendations and reference document of March 2007 to the CC.

1. INTRODUCTION

CAA statutory duties

1.1 In our view the CAA primary duty is to further the reasonable interests of the users, the major of which are the airlines. The outcome of the current price controls however, with increased costs of some 50% over the period, together with the proposed 50% increase over the next control period, gives us the impression the process has become unbalanced in favour of the airports, their shareholders and lenders.

1.2 We note the CAA interprets its duty as including the interest of future users. We believe at least equal weighting should be given to the current users who will be paying for the costs through their charges during this control period. We would be particularly concerned if this duty was used to justify pre-financing through our charges that we cannot support.

2. RECENT DEVELOPMENTS

Constructive engagement (CE)

2.1 We welcome the process for more open and transparent negotiations between airlines and airports on key commercial issues. However, for such a process to work requires a full commitment by both sides to share information and to discuss and respond to issues. In several cases, particularly the Heathrow master plan and Heathrow East Terminal (HET) project issues, we do not believe BAA have approached the CE process in a fully transparent way. As such,

additional regulatory incentives or penalties may be required to help overcome the problem of asymmetrical information in the process.

EU regulatory developments

2.2. We share the CAA's concern regarding the potentially costly and unnecessary extension of regulation that the proposed EU draft Directive on Airport Charges would entail. However, we are spending some EUR 11 billion a year at European airports, the majority of whom have no real incentive to control costs and charges. We therefore believe a Directive is necessary for the rest of Europe to incentivise their airports to reduce costs and meet agreed service levels and to eliminate distortions of competition to maintain a level playing field.

Competition authorities' review of UK airports market

2.3. We have fully supported the Office of Fair Trading UK Airports Market Study and the reference to the CC for an in-depth inquiry. Our views can be summarised:

- We do not believe the current structure provides the best incentive to expand airport capacity in S. E. England
- We fully agree with the OFT preliminary finding that there are grounds to believe that BAA's high regional market shares, the system of economic regulation of airports, and capacity constraints combine to prevent, restrict or distort competition with adverse consequences for customers and consumers using these UK airports.
- We also agree there is a reasonable prospect that appropriate remedies would be available if the CC were to find an adverse effect on competition, and that these may take the form of requiring BAA to divest some of its airports, or recommendations regarding the regulatory system, or both.

2.4 We therefore welcome the in-depth inquiry by the Competition Commission into the supply of airport services by BAA within the UK. We look forward to the CC undertaking a comprehensive review of this important issue, on which we will of course be very pleased to provide any further information on request and attend a Hearing if this is considered helpful.

2.5 The travel industry is a competitive environment. BAA should be making efforts to attract and keep their airline customers by supporting their needs and matching their aspirations. While the CAA welcomes the OFT report and possible reference to the CC, we note it says this will have no impact on the BAA price control review process. This is disappointing in that airport ownership may not be the major issue if economic regulation can be significantly improved to provide the appropriate remedies

Air Transport White Paper progress report

2.6 We fully support the introduction of mixed-mode and the need for the 3rd runway at Heathrow to provide the necessary capacity. If any related costs are to be considered for inclusion in the next control period it is even more essential that a lower and more realistic cost of capital be applied. In this regard, while we welcome the CAAs initial proposal for a reduction in the over-generous 7.75% cost of capital we believe this should be lower than the CAA's proposed figure of 6.2%.

2.6 The White Paper also says that BAA should regularly publish and update the LHR master plan. The plans published to date are not considered to be adequate and do not clearly show a third runway or another terminal. The master plan should be the physical depiction of the BAA long-term business plan, but so far there does not appear to be one.

Designation of airports for price control

2.7 The consultation and discussions on proposed updating of the designation and de-designation criteria of airports including possible de-designation of Stansted and Manchester, is closely linked to issues within the CC review of Heathrow and Gatwick. A summary of our response of 20 April 2007 to the Department for Transport on this issue is therefore provided here:

- We agree there is a strong case for updating the existing criteria for designation and de-designation of airports for price control purposes.
- We generally agree the proposed revised criteria for designation and de-designation.
- Nevertheless we could not support consideration of de-designation of any airports until such time as we are aware of the Government's revised criteria, and more importantly on the conditions and process for re-designation.
- This structured process must include clear criteria with an automatic and timely review of the airport's designation status in the event of a significant material change such as a change in ownership.
- Airports are natural monopolies that provide essential facilities and services, and market forces do not necessarily or adequately discipline such monopolies.
- Independent economic regulation is necessary and desirable to incentivise the natural monopoly to deliver continuous improvements in cost-efficiency and service quality.
- However, the economic regulation system for UK airports should be simplified, less costly and resource-intensive.
- We have no experience or assurance that existing UK and EC competition law can provide sufficient protection from the risk of exploitation by airports in the absence of regulation.

- Experience of “lighter-handed” regulation in other countries has allowed exploitation of airline customers.

3. REGULATORY APPROACH

3.1 We generally support the CAA proposals retaining the broad features of the current regulatory approach to setting price controls at Heathrow and Gatwick. We certainly support the case for the CAA setting out more explicitly how it proposes to prevent the risks of high leverage from being transferred to users.

3.2 We do not believe however that the current structure provides the best incentive to expand airport capacity in S. E. England. While we accept there are costs and benefits with economic regulation, and that regulation is second best to competition, we believe regulation is still essential where competition is absent or limited. Nevertheless the economic regulation system for the UK airports should be simplified, less costly and resource-intensive. The outcomes of the last price cap review indicate that the current system is too complex for too small a marginal benefit.

Separate regulation of BAA’s airports

3.3 At the last review we vigorously proposed and supported the separate regulation and financial ring fencing of each of the BAA airports. We believe separation is consistent with the principle of more site-specific costs and charging, ensures better transparency, and minimizes the opportunity for cross-subsidization or revenue diversion.

3.4 It can be argued that the operation of airport systems can facilitate economies of scale and allow for capacity to be developed within that system if there are restrictions at particular airports. Our experience however is that this mostly leads to unacceptable and unfair cross-subsidies.

3.5 Different price caps better reflect the differences between the airports’ operations and their level of return, enable better signals as to where investment is required, and help to compensate for the lack of viable competition at the three major south east airports. We therefore welcome the CAA proposals to extend and deepen this approach for the next control period.

Regulatory asset base (RAB) regulation

3.6 We generally support continued use of RAB based regulation. However, our concern is that BAA is motivated by the objective to optimise shareholder benefits by using investment to maximise the guaranteed return on its RAB, and may be less motivated on where the investment takes place. There is a view that

the current regulatory regime encourages BAA to invest. Consequently this may lead it to work within the planning system to pursue investment where it is easiest to achieve, but not necessarily where it most meets the needs of customers for timely, efficient and cost-effective investment in new airport capacity.

Single Till

3.7 We have consistently and robustly supported retention of the single till approach. Application of the single till is recognition that the possibility to develop commercial revenues is created by airline activities at the airport. This is acknowledgement of the symbiotic and essential relationship between airports and airline users, and is confirmed in the joint IATA/ACI interpretation of subparagraphs 22 (I) and (vii) of ICAO Document 9082/7 on policies for airport charges.

3.8 BAA has suggested that application of the single-till provides less incentive for them to invest in its commercial business. The CAA has therefore encouraged BAA to consider longer-term incentive mechanisms to increase commercial opportunities and to involve the airlines in the development of any such proposals. BAA has indicated that it is considering a number of alternate mechanisms that might achieve this. It is BAA's intention to invite the airlines to engage in a constructive dialogue with BAA during the remainder of this year, to see if a joint perspective can be achieved before the CAA considers the Competition Commission's views on the price control proposals. The airlines look forward to participating in discussions but in the meantime the airline community strongly adheres to the single till concept.

4. TRAFFIC FORECASTS

4.1 Demand forecasts are a key component in the determination of the price caps. The airlines hold a strong view that the recently produced revised BAA forecasts are significantly understated.

4.2 We note that the CAA's initial proposals are based on low-case scenario forecasts. Therefore, these forecasts are at the bottom end of a likely range for passenger growth and already incorporate material risks such as delays in the start of very large Airbus A380 operations on certain routes. The use of these conservative forecasts should therefore act as a baseline, with more realistic and higher growth forecasts likely to be developed and agreed during the remainder of the review.

4.3 We are however extremely disappointed by BAA's subsequent proposals in January for even lower traffic growth forecasts. While particularly impacting on 2008/09 and 2009/10 with an estimated drop of -2.8% and -2.6% respectively,

the overall reduction would result in an estimated additional 2-3% per annum on charges.

4.4 In our view, these revised BAA proposals contain significant double counting and over-estimation of risks, completely over riding assumptions that had been developed in the Constructive Engagement process. They also attach a permanent effect to the lower-levels of traffic growth following the August 2006 security scares. However, in our view the majority of the effect on demand is likely to be temporary, with almost full recovery by the commencement of Q5.

4.5 Shocks in the global airline industry over the last few years - from "9/11" to SARS - demonstrate that much of the impact on demand is temporary and that there is a significant 'bounce back' in demand once the temporary effects subside. It should be considered that the fundamental growth drivers of a high level of demand and use of larger aircraft remain in place for Q5 for the capacity constrained LHR and LGW airports with relatively higher yield and less price sensitive traffic.

4.6 In this regard it should be noted:

- Heathrow traffic is relatively inelastic.
- The Air Passenger Duty (APD) is likely to be absorbed at capacity constrained airports.
- Oxford Economics forecast a 30% decline in fuel costs by 2010 – equivalent of a 7-8% fall in unit costs – which would more than off set APD.
- Jet fuel prices so far this year are 15% below the 2006 average – if they stay at this level this already off sets the 2.3 to 4.4% rise in fares due to the ADP increase.

4.7 It is incorrect for airports to assume they bear all the risks of lower passenger volumes. It should be recognized that lower than forecasted volumes have a significant impact on airlines' finances even though it may not immediately impact the airport charges levels. In these circumstances it can even be claimed the airlines assist and subsidise the airports through their marketing efforts to fill available seats and schedules.

4.8 We believe the BAA is being unnecessarily conservative in an unjustified move to transfer risk to the airlines. The revised forecast must be subjected to detailed study by the CAA and for agreement within the Constructive Engagement process.

5. SERVICE QUALITY (SQ)

5.1 We have consistently proposed and supported the application of a SQ scheme. In addition to ensuring agreed minimum facilities and standards for our

charges, it is recognized that such standards reduce the temptation for “thrifting” by airports challenged with price cap regulation.

5.2 The airline community is paying the full cost of operating and capital charges and in return, rightfully expects to receive uncompromised levels of service. The airline community expects nothing less than excellent levels of service from BAA. The current agreed compensation methodology where BAA provides some small financial compensation to the airline community when levels of service drop below an agreed standard is not intended to act as the agreed target for service levels. In all cases BAA’s goal should be to exceed the minimum standards as much as possible and to provide the excellent levels of service for which the tenants are paying.

5.3 It is noted that following our proposals to the CC the current service quality rebate regime was introduced by the CAA as a remedy to the CC finding that: *“In failing to conduct themselves so as to make prices paid sufficiently reflect the level of service provided, HAL and GAL have pursued a course of conduct which may be expected to operate against the public interest”*.

5.4 The CAA must ensure that airports cannot exploit their significant market power on the service quality side, especially where cost efficiency targets are met but at a cost of reductions in service quality. The second main purpose of an SQ regime is to focus the airport management attention on those elements that are important to the airlines and their customers. Not surprisingly our priority is for “hard standard” elements that directly affect our service and punctuality.

5.5 While we recognize the SQ regime terms are unlikely to directly compensate airlines for the delay or service quality failures, consideration should be given to increasing the 3% of airport charges currently at risk. We believe the current system allows BAA to offer relatively poor service on the basis that they are prepared to pay the relatively small financial penalties. Increased risk sharing is required to ensure that airports fully take account of the importance of service quality on the competitive position of its airline users.

5.6 We agree with the CAA that more robust measures must be considered for direct security queuing and pier service levels. We expect this activity, as with the requirement to increase the 3% of airport charges at risk, to be progressed through the constructive engagement process. In addition to consideration for raising service standards we understand this will also consider potential new service measures including transfer passenger security queuing, control post security queuing and aircraft manoeuvring equipment.

5.7 As mentioned in our response of 29 November 2006 to the CAA on the security queuing rebates at Heathrow and Gatwick, we believe it is unreasonable to allow suspension of rebates for ‘shock’ reasons. Airport users have a right to expect that realistic and robust contingency measures have been considered and

held in place. At the time of the “shock’ airlines and their passengers were obliged to pay the same full level of airport charges despite the significant cost and extreme inconvenience. The airports must be incentivised to provide the agreed levels of service.

5.8 We support continued maintenance of the asymmetric penalty term, which more closely replicates normal commercial agreements. This is in line with our requirement to ensure we receive agreed minimum facilities and standards for our charges.

5.9 While delay performance is the most important SQ element for airlines, we agree the CAA view with regard to the aerodrome congestion term. This term does not compensate users for delays, and therefore we consider it inappropriate to implement an air traffic movement term.

6. OPERATING EXPENDITURE

6.1 We estimate that one third of the benefit from the proposed reduction in cost of capital has been negated by BAA’s spiraling operating cost increases.

6.2 We are concerned that the forecast operating expenditure in relation to the passenger forecasts indicates a significant unit costs increase of around 13% per passenger at Heathrow, which is on top of the estimated 20% increase in Q4. This is clearly an area, together with cost allocation, that justifies a more robust approach against the background of the CAA consultants’ studies. On this evidence we believe the 1% efficiency factor appears relatively weak and should be closer to 2%.

6.3 We would query why a fully operational Terminal 5 at Heathrow leads to higher costs over the whole period. We accept that there may be some initially higher costs as operations are transferred, but Terminal 5 should offer cost efficiency savings over the longer term that would be reflected in lower operating costs.

6.4 With regard to security operational costs, airport users have a right to expect that realistic and robust security contingency plans have been considered and are in place.

6.5 The airline community expects BAA to look at all available means to upgrade levels of service at security search stations with minimum increases in cost. The solution is not as simple as just adding more screening stations and more personnel. BAA also needs to look at alternate work methodologies and staff deployment strategies.

6.6 We agree with the CAA view that it would be inappropriate for the annual cash contributions paid by BAA, agreed as part of the ADI/Ferrovial takeover, to be passed onto users. We therefore suggest that the increase in value is excluded from the pension costs allowance for Q5. We also suggest the balance of some GBP 175m overpayments from the pension holiday in Q3 be returned to users in Q5.

6.7 In this regard we would also point out that the generous BAA pension scheme is in strong contrast to the airline industry that has been obliged to significantly reduce pension benefits and costs, and has contributed to the industry's 33% improvement in labour productivity and 14% reduction in non-fuel unit costs since 2001.

7. NON-REGULATED AERONAUTICAL REVENUES

7.1 A natural concern of the users is that economically regulated airports may be tempted to optimize revenues from the existing or new non-regulated revenue streams. We therefore welcome the CAA support in requesting the airports to agree forecasts of these revenues with the airlines. We also believe there must be full consultation, transparency, justification and agreement with users prior to any proposed charges to the structure or levels of non-regulated charges. Agreement is required on the principles for setting, revising and consulting on each of the non-regulated charges.

8. COMMERCIAL REVENUES

8.1 We welcome the CAA proposal to increase the BAA's own commercial revenue projections by at least 4%. This is in line with the CAA consultant's study indicating the BAA forecasts are too conservative. BAA claims that the incentive to increase commercial revenues is reduced by the inclusion of these revenues in the single till. In our view however the application of the single till, together with robust economic regulation, have been the main reason for LHR charges remaining below the claimed or estimated market clearing levels. It should also be noted that our expectations for higher demand forecasts (*see also 4. "Traffic Forecasts" above*) than the current baseline used would lead to higher revenues than currently projected.

9. CAPITAL EXPENDITURE

9.1 While we recognize the need for investment to raise service levels across Heathrow we note that indicative price caps are based on BAA's full capital expenditure program including the proposed Heathrow East Terminal (HET). It should be noted that although we support the development of the HET facility

that will help create a level playing field competitively with Terminal 5 in addition to modernizing and expanding Heathrow, we have not yet seen a business case and also believe the related commercial revenue forecasts may be too conservative.

9.2 The airline community has not yet seen any cost breakdown for HET into constituent components and is therefore unable to endorse the project. Significantly more transparency on the cost of the project is required including benchmark analysis against other recent major European airport terminal projects.

9.3 We also support the requirement for an appropriate inter-terminal baggage system that will benefit all the user community. Further consultation is however required to determine the requirements, with operational and financial business cases, for an appropriate baggage system. As with HET, this should be subject to further discussion as part of the constructive engagement process.

9.4 We note that capital expenditure is the largest cost driver in the initial price caps proposals. In Q4 some GBP 0.5b has additionally been spent against the Q4 plans, and the Q5 spend is estimated to be some GBP 1b higher mainly due to HET.

9.5 Naturally we expect that all investments must deliver value for money and efficient operations. Studies including WTP, Curry & Brown and C&B/Avia reinforced our concerns that BAA capital expenditure delivery was not providing value for money. In addition to these projects being subject to further constructive engagement at LHR we look to the CAA to ensure BAA's project management and costs are at the required level. We would welcome greater scrutiny of BAA investment plans where substantial cost reductions may be possible.

Investment Triggers

9.6 During the last review we proposed and fully supported the application of trigger incentive mechanisms to ensure timely delivery of projects in line with user requirements and priorities. Experience indicates these successfully achieved their objectives, and we therefore welcome study on the scope to broaden this concept to encompass more general incentives on delivery of the investment program. This work is expected to continue via the Constructive Engagement process (*see also 12.2 "Price Control Design" below*)

Pre-financing

9.7 We have always argued strongly against pre-financing, which is one of the reasons for the unacceptable and in our view unnecessary high level of charges

in Q4. Airlines should only pay for agreed investments on an “as and when used” basis. We do not support pre-financing because:

- Pre-financing through user charges is more expensive for airlines, users and the wider economy.
- Provision of an upfront pool of money gives inefficient incentives for investment management.
- It is unfair as there is no guarantee that airlines paying for future facilities to day will be the same using the service.
- Pre-financing is unjustified - the wider economic benefits created by aviation means that others, including Governments, should assist.
- It is also considered unnecessary and discriminatory as pre-financing through charges is not generally applied in other transport industries.

10. REGULATORY ASSET BASES (RAB)

10.1 We recognise that it is standard regulatory practice for the RAB to be used as an expression of the regulatory worth of the company rather than a strict representation of the company’s asset base. Nevertheless, we have had a number of concerns that still require clarification regarding the transfer and disposal of BAA airports assets and their impact on the RAB. We would particularly like clarification and justification that the different treatments that are applied to the transfer of assets are appropriate. We are not convinced by the CAA’s belief that the policy of not subtracting the value of write-offs from the RAB could be detrimental to the reasonable interests of the users.

10.2 Our major concern is that not reducing the RAB for write-offs could overstate the RAB and lead to excessive payments by airlines. We are also concerned that the sale of land could impact the future master planning and development of the airports.

11. COST OF CAPITAL

11.1 We welcome the CAA proposal to reduce the cost of capital in recognition that the cost of financing infrastructure business has fallen. However, while we welcome the reduced proposal of 6.2% for Heathrow we believe this should be lower than the proposed figure of 6.2%. The high sensitivity of the price cap to changes in the cost of capital means it is essential to ensure its calculation is correct. In our view, the 7.75% cost of capital allowed in Q4 was too generous, especially compared to the actual ability of BAA to raise finance at much cheaper rates.

11.2 An overly generous cost of capital was arguably a key factor in BAA's ability to offer shareholders a £750m bonus and 40% increase in dividends as part of its defense against the ADI/Ferrovial takeover bid.

11.3 As such, where the CAA states it is providing consistency with Q4 in erring towards the upward end of estimated ranges, for example for the cost of equity, it is in our view repeating the mistakes of last time and providing an overly generous return.

11.4 We believe that this is an area where the CC can offer significant value based on its expertise and experience across a range of industries. The cost of capital is a central component, with relatively small changes of 100 basis points or so in the rate having large impacts on the price cap determination. We welcome a thorough review of the key issues by the CC. In particular, some concerns we have are:

11.5 Given that other parts of the price control review - such as conservative traffic growth forecasts and the constructive engagement process - provide a degree of risk-sharing and incentives for greater investment, there does not appear to be a need for extra caution through a higher than necessary cost of capital rate. Closer alignment of business drivers would provide the best incentive of all.

11.6 We remain unconvinced on the need for any significant systemic or catastrophic risk allowance within the cost of capital. Should any such risks crystallise airlines are likely to feel the impact before airports, so it could be queried why the airlines are paying for a risk that is likely to have a larger impact on themselves.

11.7 In addition, we do not agree with the 60% gearing rate that is proposed. We fully support the CAA stated position not to accommodate any particular financing arrangements in its determination. However, we do believe that given the significant changes in infrastructure investment and finance over the last few years, the "normal level that an efficiently financed airport might be expected to achieve" is much higher than 60%. Changes toward wholly debt financed companies in the water and rail industries show that higher gearing levels can still be consistent with investment grade credit ratings and lower financing costs.

11.8 We are concerned at BAA's threats not to invest in line with the agreed capital expenditure plan unless they receive what they consider to be a "satisfactory" rate of return guaranteed by the regulator. BAA should be willing to respond to reasonable returns, and not be allowed to use the expectation of a higher cost of capital as a condition for making essential and agreed investments. The regulatory framework provides for a rate of return on the RAB, and together with the application of price triggers we consider this is sufficient incentive for BAA to invest.

12. PRICE CONTROL DESIGN

12.1 We generally support continued application of the revenue-yield approach with RPI-X, the current approach to volume risk and the use of capital investment triggers. We agree there should not be any flexible revenue profiling between control periods to reflect outturn market conditions, and that a separate condition should be maintained for non-passenger aircraft.

Capital investment incentives

12.2 As mentioned in 9.6 “*Capital Expenditure*” above, we fully support the application of trigger incentive mechanisms to ensure timely delivery of projects in line with user requirements and priorities. Through the Constructive Engagement process the airlines have tabled a first draft range of potential triggers, dates and price impacts for BAA to consider. The airlines are also consulting on more detailed specification of these triggers amongst themselves. BAA and the airlines agree the number of triggers should not exceed ten, to avoid excessive complexity, and that the scope of the triggers for Heathrow should include:

- Terminal 5 (opening of Phase 1 and completion of Phase 2/satellite c)
- HET and eastern apron development (in phases to be defined)
- Terminal 4 package to be defined, but including a check-in extension.
- Terminal 3 package to be defined.
- The inter-terminal baggage system.
- Other possible items as and when further clarity and agreement is reached on the capital programme.

Air transport movement (ATM) incentives

12.3 While we agreed the introduction of an aerodrome congestion term we also agree with the CAA that it is not appropriate to introduce an ATM incentive (see also 5.9 “*Service Quality*” above)

Pass through costs for changes in security requirements

12.4 While we accept there can be significant costs as a result of Government additional security requirements, we strongly support continued application of the current 75% pass-through subject to minimum thresholds on the current scale. We firmly believe this is necessary to encourage the most cost-effective implementation of any such additional requirements.

13. PRICE CAP RANGES

13.1 While we recognise that the proposed price cap ranges are only indicative at this stage, the proposed central RPI+5.8% each year for Heathrow in

particular, is unacceptable. This would result in an average 50% increase in costs for users at Heathrow on top of the 50% increase over the current control period. We are not seeing this level of increase from airports anywhere else in Europe or worldwide, many of which have equally extensive investment programmes relative to their size.

13.2 The economic view that prices at LHR may be below their economic market clearance rates should not be used to justify such unacceptable increases. It needs to be considered that the current rates have evolved against a previously robust system of economic regulation on the BAA, which has also rightly driven the airports to increase their commercial revenues within the single till.

13.3 We believe a more effective economic regulation of new investment, application of realistic lower cost of capital, robust and challenging efficiency targets on operating expenditure and commercial revenues, together with more realistic traffic forecasts, must be applied to reduce the proposed price caps.

Geneva 14 May 2007