

## CHAPTER 10

### Rents and property

10.1. Property accounts for about two-thirds of the assets invested in BAA's commercial facilities. Rents of £24·8 million accounted in 1983–84 for about 8 per cent of BAA's income, and 17 per cent of its non-traffic income. Income from 'services'—primarily on-charges to tenants for utilities such as space heating and electricity—amounted to a further £25 million. Seventy-two per cent of 'rents and services' income is generated at Heathrow, and a further 17 per cent at Gatwick.

10.2. Property lettings are distinguished from trading concessions by the form of grant to the occupier, and the way in which the rent or fee is calculated. There are four main types of grant:

- (a) *Licences* are used for check-in and for other types of desks within the terminals, giving BAA as landlord the flexibility to move desks to meet changing demand; licences are also used for a range of miscellaneous grants.
- (b) *Short-term tenancies* account for most transactions; they cover grants of floor space at rack rents for uses such as offices, pier accommodation and warehouses, and are also used for short-term purposes. Length of term varies from indeterminate up to about five years. Tenants cannot use the let property except for the narrow purpose specified, and in general cannot assign or sub-let.
- (c) *Long leases* are granted at rack rents for terms of more than five years. They are fairly few in number.
- (d) *Ground leases* are usually granted in conjunction with building agreements for the lessee to fund the building or other works which will be for his own occupation. The length of the ground lease has to be adequate for investment by the lessee and varies from 21 to 125 years. Some of the more substantial airport developments have been provided under this type of grant, for example maintenance bases, warehouses, office blocks, flight catering bases, fuel farms and hydrants. In general, sub-letting is prohibited but assignment is permitted subject to consent by BAA. As an alternative to consent, most assignment clauses give BAA the right to buy back the lease at current market value. In Scotland most leases prohibit sub-letting and assignment.

10.3. With some exceptions payment to BAA is at a fixed annual sum and not, as with concessions, a percentage of the occupier's turnover. Main exceptions, however, include a recent office development on Northside at Heathrow, where payment was a cash premium plus a percentage of rack rents; five airport hotels with payments calculated as a proportion of turnover; and the fuel supply at Heathrow, discussed in paragraphs 10.23 to 10.26. Care is taken not to grant a tenancy at a fixed rent for an activity which could be subject to a concession.

## **Objectives and policies**

10.4. BAA has four main objectives in the leasing of property:

- (a) furtherance of its statutory duty 'to provide at its aerodromes such services and facilities as are in its opinion necessary or desirable for their operation';
- (b) optimisation of the use of all accommodation including land;
- (c) maximisation of rents; and
- (d) in appropriate cases, for lessees to fund provision of facilities.

10.5. BAA interprets its statutory duty as preventing it from investing in activities not related to an airport and from letting property in central areas for such activities. Joint ventures in any case require permission from the Government, which has been refused several times. BAA allocates accommodation only to companies which have a definite civil aviation and airport connection, and for a specified use. When supply of accommodation exceeds demand, however, this policy has been relaxed for short-term tenancies.

## **The leasing/renting process**

10.6. Commission staff have discussed the process of leasing and renting property with Head Office and airport property staff. Examination of files at Gatwick, Heathrow and Glasgow airports showed that both the policies of BAA discussed above and the formal processes established by Head Office were being followed.

## **Utilisation of property**

10.7. Some office accommodation has become vacant at Heathrow, where some 44,000 square feet of BAA office accommodation was unlet in August 1984, plus a further 38,000 square feet at a privately financed development on Northside (see paragraph 10.3). This resulted from the recent recession and in particular the retrenchment by British Airways. The rental value of BAA unlet accommodation was estimated by BAA at £490,000 per annum, but with some further loss of income to BAA through voids on the Northside development. BAA projections summarised in Table 10.1 suggest that the amount of unlet accommodation is likely to increase with the opening of Heathrow Terminal 4 (because airlines transferring there will release accommodation in the central area). BAA expects supply and demand to be back in balance by 1989-90, though still with some mis-match between terminals.

10.8. A significant proportion of the spare accommodation foreseen in the central area is in Terminal 3 and Queens Building. BAA told us that it is necessary for some of the accommodation in Terminal 3 to be held vacant in order to close down areas of the terminal for redevelopment, and that it is safeguarding accommodation in Queens Building for potential moves of airlines into Terminal 1. Allowing for these factors, the amount of vacant accommodation is relatively limited compared with the total amount of office

TABLE 10.1 Overall supply and demand for office accommodation, Heathrow

		<i>square feet</i>					
		1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
Terminals 1-4 and central Area	Supply	31,200	132,200	153,000	153,000	153,000	153,000
	Demand	5,200	78,200	105,800	129,800	139,800	149,800
	Excess supply	26,000	54,000	47,200	23,200	13,200	3,200
Northside, cargo and other areas	Supply	69,700	69,700	75,700	75,700	75,700	75,700
	Demand	15,400	32,000	39,000	56,000	73,000	90,000
	Excess supply	54,300	37,700	36,700	19,700	2,700	-14,300

Source: BAA.

Note: Projections take no account of possible new developments, but only of possible increases in demand. 'Northside' includes the privately financed development at Cardinal Point.

accommodation at Heathrow (about 1 million square feet), and BAA considers it not far out of line with vacancies resulting from normal turnover in tenancies.

10.9. However, in response to the temporary excess supply of office accommodation at Heathrow, BAA has relaxed its letting policy in the central area to allow a wider range of organisations to take short-term 'contracted out'<sup>1</sup> tenancies. This enables the Authority to restore its basic letting policy when the market recovers. Lettings totalling approximately 4,200 square feet were granted in 1983 in Terminal 2 and Queens Building to organisations such as a building society, a business centre, Diners Club and a solicitor's practice. In non-sensitive areas outside terminals, positive steps have been taken to market accommodation to a wider range of organisations. As a result, a number of lettings have been made in peripheral areas to non-aviation companies.

10.10. At Gatwick, BAA has provided office accommodation in line with traffic forecasts of growth in demand at the airport. Following the recent recession, a number of carriers either ceased service at Gatwick, for example Pan Am and Transworld, or went out of business, eg Laker and Braniff. The reletting of accommodation was difficult until the recent recovery of growth in North Atlantic traffic. During 1984-85 the amount of unlet office space decreased from 44,000 to 29,000 square feet (from 20 per cent to 13 per cent of the total), though a large part of this reduction is accounted for by the allocation of space to BAA Head Office staff. A further 3,000 square feet of accommodation have recently been let, and half of the remainder is under offer; the balance (nearly 6 per cent of the total) is all that remains available until the North Terminal opens. As at Heathrow, a number of short-term lettings have been made to non-aviation activities.

10.11. Landside accommodation at the Scottish airports is advertised when supply exceeds demand; to maintain a high occupancy rate companies are offered short-term tenancies, in some cases at reduced rents.

10.12. There is significant under-utilisation of cargo facilities constructed by the airlines on ground lease at Heathrow. BAA cannot re-allocate those sheds where capacity is under-utilised, and is therefore having to consider the

<sup>1</sup>That is, from the provisions of the Landlord and Tenant Act 1954.

construction of extra cargo facilities to meet new demand. BAA has told us that it is prepared to relax user clause restrictions if better use of facilities results. It has, for example, permitted trucking to and from the transit sheds at Heathrow and in certain cases has relaxed the prohibition on sub-letting in return for payments negotiated with the ground lessees having regard to the value of the space sub-let.

10.13. British Airways told us that the restrictive conditions in leases and tenancies discourage the best use of land and buildings, and do not allow airlines to exploit their business to the full by maximising the use of property assets. It quoted a particular example where the Authority requested an additional rent of £30,000 per annum to allow sub-letting of surplus hangar space. The Authority argued that this hangar was part of premises held by British Airways under an old ground lease, and that British Airways enjoys a large profit rent on this lease with rents payable to the Authority of about £500 per annum, compared with current market value of over £30,000 per annum. Since British Airways wished to be released from the restriction of certain terms so as to benefit financially, the Authority believed that it was reasonable, and usual in the circumstances, for the landlord to seek some benefit from the granting of consent. BAA told us that it was willing to approve the sub-letting of other areas, subject to payment of an appropriate consideration.

#### Rents

10.14. BAA policy is to charge:

- (a) Open market rents for existing accommodation.
- (b) Either the open market or the economic rent (the rent necessary to give an adequate return on investment in a property project including the notional cost of land), whichever is the higher, for new accommodation. This means that where the rents necessary to earn an adequate return on an investment are in excess of market rents BAA will seek an appropriate agreement prior to construction. An example of this approach was the British Caledonian transit shed extension at Heathrow.
- (c) Open market rents for ground leases and long leases, subject to arbitration at review.
- (d) Hybrid rents, being a ground rent with an element linked to turnover.

Charges for licences for facilities such as check-in desks are based on the costs incurred in providing and maintaining the facility plus the cost of the space used.

10.15. The policy of charging market rents at Heathrow was challenged by BOAC and BEA before the Select Committee on Nationalised Industries, 1970–71. The Authority argued that the policy followed the definition of the Landlord and Tenant Act 1954, market rent being the rent at which ‘the holding might reasonably be expected to be let in the open market by a willing lessor’, and that as space is short at the airport

the policy of open market rents is a useful sanction in preventing tenants taking more accommodation than they need. . . . If a tenant turned down an offer of accommodation because the rent was more than he was prepared to pay, another tenant could in general be found at the quoted rate.

This response was accepted without adverse comment by the Select Committee; in practice applicants entered into negotiation with BAA.

10.16. Main factors in determining open market rents include rents at which similar accommodation has been recently let; allowance for characteristics of the property; and evidence of trends in supply and demand for accommodation within the airport, and generally. For reviews on the expiry of a tenancy, the rent if disputed can be determined by the Courts under the Landlord and Tenant Act 1954 (see footnote to paragraph 4.11). In practice, although BAA has had many references to the Courts, all these have been settled by agreement. Rent reviews during the term of a tenancy are subject to private arbitration.

10.17. It is BAA policy to review rents as frequently as possible so that they are kept up to date both for inflation and for any real growth in market value. Reviews of rack rents are usually at not less than three years and licence fees for desks are usually reviewed every two years. A number of ground leases inherited by BAA in 1966, however, have long fixed terms without rent reviews, or with infrequent reviews to fixed amounts. The rental payments on these leases are considerably below current market values; an example is mentioned in paragraph 10.13. Modern ground leases have provision for frequent review—with reference, for example, to open market value of land or premises—and for arbitration in the event of dispute.

10.18. The Board does not request or receive formal submissions on rental performance compared with off-airport trends. It agrees an overall target for rental growth, and targets for each airport are settled by the Managing Director (see paragraphs 5.13 to 5.22). A review of trends in rental compared with those elsewhere in the economy was carried out for Heathrow (see paragraph 4.26) and a similar study has recently been initiated for Gatwick. BAA told us that there is constant surveillance of the off-airport market at other airports.

10.19. The detailed results of the comparative study for Heathrow mentioned above are shown in Table 10.2. Rents at Heathrow generally increased more rapidly over the period 1974 to 1983 than rents elsewhere. Increases in warehouse rents equalled or exceeded increases in the general level of prices, as measured by the Retail Price Index, and increases in the Cost of New Construction Index; but some Heathrow office rents, in common with national trends in office rentals over the period, have not kept pace with inflation. Office rents in the central terminal area at Heathrow are above those in surrounding towns (eg Staines or Slough); BAA said that this does not reflect policy but is attributable to economic market forces. British Airways, however, argued that rents and licence fees are forced up by under-provision of the facilities needed by airlines.

### **Investment, and disposal of property**

10.20. BAA said that it does not undertake speculative development. Offices are only constructed where there is known demand or a tenant pre-signed. For development outside central areas, the Authority sometimes leases a site to allow the tenant to fund the development at his own risk. BAA needs to construct certain facilities to meet forecast growth in demand and, in the case of cargo sheds, because it cannot re-allocate existing under-used capacity. BAA also

TABLE 10.2 Comparability of rental performance, Jan 1974 to May 1983

Index Jan 1974 = 100

<i>Heathrow—Offices</i>	<i>Index</i>	<i>Heathrow—warehousing</i>	<i>Index</i>
Cargo terminal office block Bdgs 520	410	Bdg 139	320
Cargo agents building—Bdg 521	400	Cargo terminal—Bdg 521	320
Northside—Norwood Crescent	290	Former bonded stores building	450
Epsom Square	400		
Terminal 1 2nd floor	200		
Terminal 2 offices	280		
Terminal 3 North wing	340		

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<i>Investors Chronicle/Hillier Parker</i>	<i>Index</i>		<i>Index</i>
All offices	170	All industrials	230
West End	140	London	240
Central London	130	South-East England	230
South-East England	210		

Retail Price Index	330
Cost of New Construction Index	300

Source: BAA.

referred to its statutory duty to provide the facilities at airports necessary for their proper operation; not all such facilities are profitable.

10.21. An internal audit report on the management of property at Heathrow criticised a previous property investment decision by the Executive for giving insufficient weight to open market rentals as advised by the professional staff. Subsequently, the Executive agreed that if market rents were lower than 'economic rents', the former should be used to establish upper limits to the capital costs of new property projects. BAA told us that the airside offices known as Building 820 were likely to be the last instance of a development where open market rents were insufficient to earn an adequate rate of return. We note that upon completion of this project there was a mis-match of supply and demand for this type of accommodation.

10.22. BAA only sells property which is surplus to requirements. There is a sale in prospect for a 1-acre plot of land in the vicinity of Heathrow, and some land may be sold at Prestwick. The Authority has identified various other parcels of land for which no precise airport-related development has been established but most of these are retained for future airport-related needs. It is BAA policy to consider the acquisition for future airport development of any sites which become available adjacent to airports.

### Fuel supply at Heathrow

10.23. In August 1984 BAA entered into a new arrangement with the suppliers of aviation fuel at Heathrow; this replaced several separate arrangements with groups of oil companies formed into consortia. The fuel suppliers' turnover is estimated at between £400 and £450 million per annum. In the earlier

arrangements, partly inherited by BAA and embracing some 40 agreements, oil companies leased the physical facilities needed to supply aviation fuel, and some of them also paid BAA a charge based on the quantity of fuel supplied.

10.24. The Authority told us that the leases had a common end date in 1991 and this, with the need to arrange for the supply of fuel at Terminal 4, provided a basis to re-negotiate the arrangements with the oil companies. Prominent amongst the new arrangements were the replacement of the previous rents and quantity charges by a rent indexed to RPI, with two stepped increases related to passenger growth. This resulted in a [\*] increase in the payments to BAA.

10.25. The Authority was also concerned to ensure that the new long-term arrangement (21 years) did not confer an absolute monopoly on the existing nine suppliers of aviation fuel, but would allow the entry of other suitable suppliers. This was effected on the basis of the world-wide agreement between oil companies known as the Joint Users Hydrant Installation. However, this agreement allows the fuel suppliers discretion in accepting a new entrant; the Authority insisted on clauses in its arrangement which allow a potential entrant, approved by BAA, to ask the Authority to call in an arbitrator if the new consortium claims lack of technical competence. A new entrant must pay a share of the cost of the facilities. The nine fuel suppliers now established as the Heathrow Hydrant Consortium have provided us with the agreement which secures the operation of the system. Entry to the consortium is restricted to a 'marketer of aviation fuel'.

10.26. British Airways told us that it had applied for membership of the consortium but difficulties had arisen; it is now considering taking legal action against the consortium. For its part BAA has recently given British Airways permission to build and operate fuel tanks on the airport, subject to the caveat that it may be required to share those tanks with another new entrant because of the shortage of land at the airport. The particular site will initially be let for a limited term as it may be required for other airport development.

### **Fuel supply at Gatwick**

10.27. The Authority told us that eight oil companies comprise the Gatwick Hydrant Consortium. Payment is made to BAA under leases for the facilities, and there is a quantity payment. BAA believed that the new arrangements made at Heathrow would be suitable for Gatwick. It had put this proposal to the consortium but negotiations had not yet begun, one problem being that the leases have longer to run than at Heathrow.

10.28. British Caledonian told us that costs were increased and competition reduced because each of the four companies it buys from at Gatwick has its own line to the aircraft fuelling points. It would prefer the system widely adopted in the United States where one approved agent operates a common fuel line system. This reduces costs and permits a number of oil companies to supply fuel through the common system, which increases competition between them.

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\* Figure omitted. See note on page iv.

## Conclusions

10.29. Examination of files and discussions with airport staff showed that the policies and procedures for leasing were being followed in detail.

10.30. Although there is at present some vacant office accommodation at both Heathrow and Gatwick, this represents a small proportion of total office accommodation at the two airports. BAA projections suggest that the excess supply should be absorbed within five years.

10.31. The increase in rents at Heathrow airport has been greater than the national average, although some office rents at Heathrow have not kept pace with inflation. The level of rents at Heathrow is also generally above that in surrounding areas. BAA policy for determining rental levels appears reasonable.

10.32. There is provision in the new fuel agreement at Heathrow for entry of new suppliers to the hydrant consortium; it will be easier to judge the effectiveness of this provision when the result of British Airways' application to join the consortium is known. BAA should increase competition in the supply of fuel at Gatwick when the present fuel arrangements are re-negotiated.