

BAA plc

A report on the economic regulation of the London airports companies
(Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd)



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Members of the Monopolies and Mergers Commission as at 10 June 1996

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¹These members formed the Group which was responsible for this report under the chairmanship of Dr Derek Morris.

Note by the Civil Aviation Authority

In accordance with section 45(7) of the Airports Act 1986, the Secretary of State for Transport has directed the CAA to exclude from the published report certain matters publication of which appear to the Secretary of State to be against the public interest or the commercial interests of a person. Accordingly certain figures and text have been omitted. The omissions are indicated by a note in the text.

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Part I

Summary and Conclusions

1 Summary

1.1. Under the references made by the Civil Aviation Authority (CAA) on 11 December 1995 (see Appendix 1.1), we are required to recommend the maximum levels of airport charges at Heathrow Airport Ltd (HAL), Gatwick Airport Ltd (GAL) and Stansted Airport Ltd (STAL), for the period of five years beginning on 1 April 1997. We are also required to consider whether any of the three airport companies have, at any time during the five years ending with the date of the references, pursued a course of conduct (in relation to matters specified in the references) which has operated, or might be expected to operate, against the public interest.

1.2. Airport charges currently account for about one-third of the income of the three airports, but in considering the maximum level of airport charges we have taken into account BAA plc's (BAA) projections of income from its other, commercial, activities at the airports. During the current five-year period, changes in revenue per passenger from airport charges have been restricted to 8 per cent below the change in the retail price index (RPI-8) in the first two years; RPI-4 in the third year; and RPI-1 in the last two years. BAA is expected to earn a significantly better rate of return on assets over this period than predicted, but primarily due to the impact on the valuation of its asset base of lower than expected construction prices.

1.3. During the course of the inquiry it was clear that airlines were equally or indeed more concerned about aspects of performance rather than charges, in particular the absence of service standards at the airports; current poor facilities for handling of transfer baggage at Heathrow; BAA's investment programme, including its arrangements for consultation on the overall level of investment and on individual projects; and other aspects of BAA's operational activities that are not formally within the scope of the charging formula, in particular rents. In each of these areas, BAA has taken action to improve its procedures for consultation and its policies and we found insufficient evidence to identify a course of conduct in these matters in the five years prior to the reference that has operated or might be expected to operate against the public interest. We nonetheless consider it essential that BAA maintains current progress on issues which are so important to the effectiveness of its user airlines over the next five years. We are not in a position to recommend that the CAA requires this unless as a remedy to one or more adverse findings, and of course it is not open to us to find a course of conduct against the public interest merely to give ourselves that power, but in each case the measures now initiated must be pursued if the legitimate interests of airlines and passengers are to be met.

1.4. Among many other issues raised with us, however, we found a number of other courses of conduct to be against the public interest and have put forward appropriate remedies. These issues concern the current charges for airside licences for airline catering and cleaning services supplied from off the airport; quantitative restrictions on the use of employment agency staff at Heathrow; restrictions on the sale of airline tickets at Gatwick; and instances of failure to allow the prominent positioning of information desks other than at very high rentals at Heathrow.

1.5. In our recommendations on airport charges we have taken a number of considerations

into account. We believe it appropriate to allow for a cost of capital of the BAA airports somewhat above the mid-point of a range of 6.4 to 8.3 per cent. In considering the return on assets, we have felt it appropriate to have regard to a measure of capital value that is less sensitive to unpredictable movements in construction prices, or to the assessment of open market values currently used for investment properties: we have, therefore, based capital value on the book value of assets at the time of our previous report (the 1991 MMC report)¹ subsequently revalued by the RPI and adjusted for new investment less depreciation. We have taken into account the need to reduce current returns on that capital value towards the cost of capital, but only over a period; the need to avoid charges at such a low level that it would require unrealistically large subsequent price increases when new investment becomes operational, which could deter new investment; the scope for greater manpower and productivity savings than assumed by BAA; and the desirability of basing compensation for the likely loss of intra-European Union (EU) duty-free and tax-free income in 1999 on demanding assumptions as to BAA's ability to generate alternative revenues.

1.6. BAA proposed that airport charges per passenger be allowed to increase in line with the RPI, and that an increase in charges be allowed, of 85 per cent of the duty-free and tax-free profits at risk, when the current concession on sales of intra-EU duty-free and tax-free goods is withdrawn. However, on the basis of the above considerations, we have recommended that revenue from airport charges per passenger at Heathrow and Gatwick together should increase by no more than the change in the RPI less three percentage points in each year of the period (a formula of RPI-3); within that overall formula, charges at Gatwick should increase by no more than at Heathrow. We have recommended a separate formula that would limit the increase in revenue from airport charges at Stansted to no more than RPI+ 1 in each year of the period, although prices might not necessarily be increased by that amount. Finally, we have recommended that both charging formulae should allow an increase in airport charges of 15 per cent when the current concession on sales of intra-EU duty-free and tax-free goods is withdrawn (equivalent to less than one-half of the duty-free and tax-free profits at risk), one-half of that amount to be introduced on that date (currently expected to be 1 July 1999), and the remainder at the beginning of the subsequent financial year (1 April 2000).

¹*BAA plc: a report on the economic regulation of the South-East airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd)*, MMC 2, published by the CAA, July 1991.