14 Views of BAA

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Introduction

14.1. This chapter summarizes BAA's views presented to us in oral and written submissions. Further detail on individual issues is found in Chapters 3 to 10.

14.2. BAA was concerned that it should not be shoehorned into the standard utility mould. It differed from normal utilities in that it faced major competition; it grew quickly (at some twice the rate of the economy) and had a huge customer-led investment programme, as well as other investment programmes required for its own returns. Unlike normal utilities, BAA's customers were very well-organized companies, many bigger than BAA, which were more able to affect its profitability than vice versa. It also tended to generate the majority of its income from non-regulated sources, in particular retailing, which it considered to have been entrepreneurial in style over the last five years. Airport charges were heavily subsidized by that retailing activity.

14.3. If BAA was treated as a utility, it warned that it might become one resulting in lower performance, lower productivity, a requirement for higher dividends and so a reduced investment programme. Airlines and customers would suffer, with less airport capacity of poorer quality, leading to competitive gains for continental European hub airports. In effect, BAA said, in setting the price formula, regulators set not only a rate of return, but also the size of BAA's capital spend and its management style.

14.4. It was very important, particularly for airports given long investment lead times, that regulators recognized their wider duties to secure efficient, economic and profitable airports, and to encourage investment in facilities in time to satisfy anticipated demands by users. BAA interpreted this as setting a price control formula which would encourage management to invest in airport development. In its view, the 1991 MMC review had given important signals to BAA, investors and lenders about the shape of the future regulatory regime, which had underpinned BAA's strategies since then. It highlighted, in particular, guidance on the level of charges which the CAA had indicated would, on the basis of information then available, be at

or around RPI-1 in the long run, and the MMC's expectation that BAA should be fully compensated for the loss of EU duty-free and tax-free allowances, which the CAA had accepted.

14.5. BAA argued that in 1991 neither the MMC nor the CAA had reflected a definitive attitude on the linkage between charges and rate of return and had highlighted other financial measures which should be considered in setting the formula including interest cover, dividend cover, gearing, and earnings and dividend growth. This suggested that regulation would not be mechanistic, but broadly based and sensitive to the needs of the investors and lenders. In BAA's view, a clear signal was also given that BAA's regulation needed to look beyond each quinquennium in isolation, and consider the longer-term prospects for investment, productivity and service.

Review of the second quinquennium

BAA's mission

14.6. BAA said that since 1991 the driving force for development of its business had been the Company's Mission, `... to make BAA the most successful airport company in the world'. This was defined by three objectives, namely: `Always focusing on our customers' needs and safety; Achieving continuous improvement in costs and quality of our processes and services; Enabling our employees to give of their best'. These objectives were in turn specified in the six areas where the mission would be achieved, namely: safety and security; strategy; customers, suppliers and business partners; employees; shareholders; and the environment.

14.7. BAA stressed that the Mission was aimed both at excellence and good value for money through higher quality and competitive prices. The company had approached its achievement through the philosophy and techniques of continuous improvement (described further in Chapters 6 and 7), on which a new management style had been developed. BAA illustrated its success by looking in turn at the three main areas covered by the Mission Statement.

Customers

14.8. Since 1991 BAA's QSM (described in paragraph 6.6 *et seq*) had been used to measure customers' perception of the services they received at its airports. From the results, BAA concluded that passengers perceived the airports' facilities and services as good and that performance had been improving over the period, despite an increase in traffic of 20 per cent. In addition, BAA collected data on a range of delivered service measures which showed that mechanical equipment was in service typically for 99 per cent of the working day. It also monitored the opinion of airlines on a continuous basis, and although these were a sceptical and demanding audience, BAA judged that it had developed a constructive and improving relationship at Heathrow, Gatwick and Stansted. One area where the results showed that action was needed was property, and BAA's response, in the form of `The Property Challenge', launched in January 1995, is described in paragraph 8.57.

14.9. BAA pointed to a number of investments which it had made during the course of Q2 which had directly responded to customers' needs, for example: the Flight Connections Centre at Heathrow (costing £27 million); redevelopment of departure lounges at Heathrow Terminals 1 and 2 and at Gatwick North and South Terminals; the Fast Track Service, providing rapid passage through terminals for departing business class passengers; and the support given to British Airways in its programme of moving services from Heathrow to Gatwick, known as Project Jupiter.

14.10. Safety and security continued to be one of BAA's highest priorities. In 1994 BAA created the post of Safety Director and appointed an eminent safety expert to the Board of Directors from outside the company. It had also pioneered implementation of hold baggage screening, at a cost of over £150 million, and actively looked at new technology to improve passenger search techniques.

Processes

14.11. BAA explained that it had sought to improve the projects process by making a number of external appointments and studying best practice overseas. It faced particular difficulties posed by the UK building industry, which had patchy management, loose process control and was vulnerable to cost inflation. This had led BAA to concentrate on issues such as standardized components and avoidance of design alternations. Adopting a technique of value management to review all significant projects throughout the process up to construction had, in BAA's estimation, saved £30 million a year for the last two years. BAA had also launched its new *Project Handbook*, which is described in paragraph 9.8 *et seq*.

14.12. BAA had appointed a professional procurement director from the pharmaceutical industry to develop a coherent procurement strategy, while operational management had been improved through the development of a tactical forecasting model to predict changes to the level of business at a fine level.

14.13. BAA said that it was pleased that other control authorities had joined BAA's continuous improvement programme. For example, at Gatwick, Customs used to search bags from destinations such as Colombia by offloading them from baggage belts on to the floor and getting spaniels to jump over them to smell whether they contained drugs. However, as a result of BAA's Continuous Improvement programme it had put in an extension to one of the baggage belts where the spaniels could jump over the bags as they were moving, saving about 35 or 40 minutes per unloading.

Employees

14.14. In 1991 and 1992 BAA said that it offered, through the voluntary severance scheme (see paragraph 7.4), enhanced terms to any employee who preferred to leave. The programme was not compulsory, nor was it restrictive, and after a short period of readjustment BAA said that it found that processes had improved to the point where service quality was maintained at the new lower staffing levels, and had subsequently improved in a number of important areas.

14.15. BAA said that the development of employees had continued in the current `Freedom to Manage' initiative, described in Appendix 7.1, which placed greater responsibility with the front-line staff who were best equipped to understand customers' needs. The cumulative effect, according to BAA, was increased productivity over the same period that service quality improved.

Financial performance since 1991

14.16. BAA's financial performance over Q2 is described in Chapter 4. In summary, BAA told us that:

(a) Traffic had grown consistently and at a rate very close to 1991 forecasts. However, within that total, traffic had been higher at Heathrow and lower at Gatwick and Stansted as a result of the relaxation of traffic distribution rules.

(b) Total income had grown by 5 per cent in real terms, slightly slower than forecast.

(c) Operating expenditure had hardly grown, as a result of BAA's efforts to improve staff productivity, and was some 10 per cent below forecast in real terms.

(d) CCA profits had grown by 9 per cent in real terms, distorted by a decrease in depreciation resulting from the unexpected fall in the value of assets.

(e) Return on assets had also been distorted by devaluation of the airports' replacement cost assets resulting from the sharp unanticipated fall in construction prices.

(f) Capital expenditure had been distorted by the decrease in unit construction costs. At out-turn figures, capital expenditure had grown sharply from year to year, but BAA still appeared to spend 13 per cent less than forecast. In real terms, at 1991 construction costs, BAA's investment had been some 17 per cent higher than forecast, including unforeseen projects such as the Flight Connections Centre, Victor

Pier and the Terminal 3 infill building at Heathrow, Gatwick North Terminal improvements, and improvements to the western apron taxiways and stands (described in paragraph 9.2 *et seq*).

International comparisons

14.17. BAA argued that a number of clear and consistent trends stood out from international comparative studies by the IATA Airport Monitor and Cranfield University, whose results are described in Chapters 5 and 6. These studies showed that, at the BAA London airports:

(a) charges were low compared with their competitors;

(b) service quality compared with the best airports in the world;

(c) operational efficiency was high; and

(d) levels of sales and quality of service were highly regarded.

The third quinquennium

The regulatory framework

14.18. BAA's view that the regulation of airports was unique and different from that of normal utilities has been referred to. As far as the regulatory framework was concerned, BAA strongly supported an RPI-X approach to price control, which it said had over the past ten years produced real decreases in airport charges, as well as increased and better focused investment and enhanced service quality. However, it opposed incorporating a profit-related term in the formula on the grounds that this would dilute the incentive effects of price control and require strict monitoring, which was inconsistent with the philosophy of light-touch regulation. In BAA's view, a volume-related term posed similar difficulties and would act as a disincentive to airports to create additional capacity by operational innovations at the margin. It added that traffic in Q2 had been in line with forecasts, and the traffic forecasts for Q3 reflected a high degree of agreement between BAA, the CAA and airlines.

Limitations of conventional regulation

14.19. BAA argued forcefully that a conventional `rate of return' driven approach to price control (deriving a price which produced a CCA ROCE equal to the cost of capital) was inappropriate for airports and failed to meet the duties of airport regulators. Unlike most utilities, BAA was heavily reliant on unregulated commercial income, which reduced user charges and generated earnings for shareholders. BAA said that it had expended much effort and innovation to develop this income, often through projects which only generated return during the course of the next quinquennium and beyond. Its motivation would be undermined if the gain from long-term investments was lost at the end of each quinquennium through application of a fixed rate of return methodology. At worst, this could lead to tactical game-playing in which it timed innovations to follow price reviews, rather than to precede them, reducing performance and in the long term leading to higher charges. It submitted that the whole style of management would be pushed towards a utility approach, rather than innovative and customer-led commercial management and its quality-based approach would lose its driving force.

14.20. BAA also argued that there were considerable uncertainties associated with the `rate of return' driven approach to regulation, which the CAA had acknowledged:

(a) There was no single proven method of calculating cost of capital. The CAPM raised difficulties including: the basis for establishing the market equity premium; the assessment of risk, using beta coefficients (which might vary according to the method of calculation) or a qualitative assessment of risk; and the effect of capital structures.

(b) The calculation of return on assets had associated uncertainties such as: the basis of land valuation; the basis of building valuation; the basis of revaluation (whether by retail prices or construction costs); the difficulty of forecasting construction costs and the sensitivity of the results to errors in forecasting; the treatment of capitalized interest and AICC; and the rates of depreciation used.

(c) There was no reason why over a given period shorter than the life of the total investment, cost of capital should equal the accounting rate of return. The two should only coincide over a specific accounting period if the life of assets and the depreciation phasing was designed to reflect economic consumption of the assets. These conditions did not necessarily apply in practice.

(d) Under the single till, total return was `manipulated' through less than half of the airport's income and, as a result, small variations in judgment on the `correct' return could require large changes in airport charges.

14.21. The shortcomings of equalizing rates of return to the cost of capital were, in BAA's view, exacerbated where investment was made in large lumps and capacity utilization varied significantly, for example at Heathrow over the next ten years. During Q3 BAA would be investing heavily in new capacity at the same time that existing facilities would be heavily used. The costs of investment would only emerge in Q4 when BAA would have to depreciate the investment and its capitalized interest, and make interest payments, at the same time that capacity utilization was very low. To achieve the same fixed rate of return in each quinquennium, prices would have to fall while BAA invested, since the costs of existing capacity would be divided between a large number of users. They would have to rise immediately after Terminal 5 was commissioned since there would be a large increase in fixed costs without an immediate equivalent increase in traffic. BAA said that this defied normal competitive commercial logic that prices rose where demand exceeded supply and fell when the situation was reversed. As a result, BAA's finances would deteriorate sharply in Q3, and would only recover if charges were raised sharply in Q4.

BAA's proposed framework

14.22. Instead, BAA argued, regulation should be on the basis of a broader methodology which took account of rates of return, but also paid particular attention to the return required on new investment and the implications for the financing of the capital programme. Its proposed model, illustrated in Figure 14.1, was, it said, based on a compromise between charges high enough to encourage investment and low enough to protect users from unreasonable charging. BAA assumed that investment would be encouraged if the expected financial performance of planned projects met normal minimum commercial criteria. Under the model, an assumed level of X would be combined with other forecasts to produce a full financial forecast for the quinquennium and a project appraisal for Terminal 5. The results would then be subjected to three separate tests:

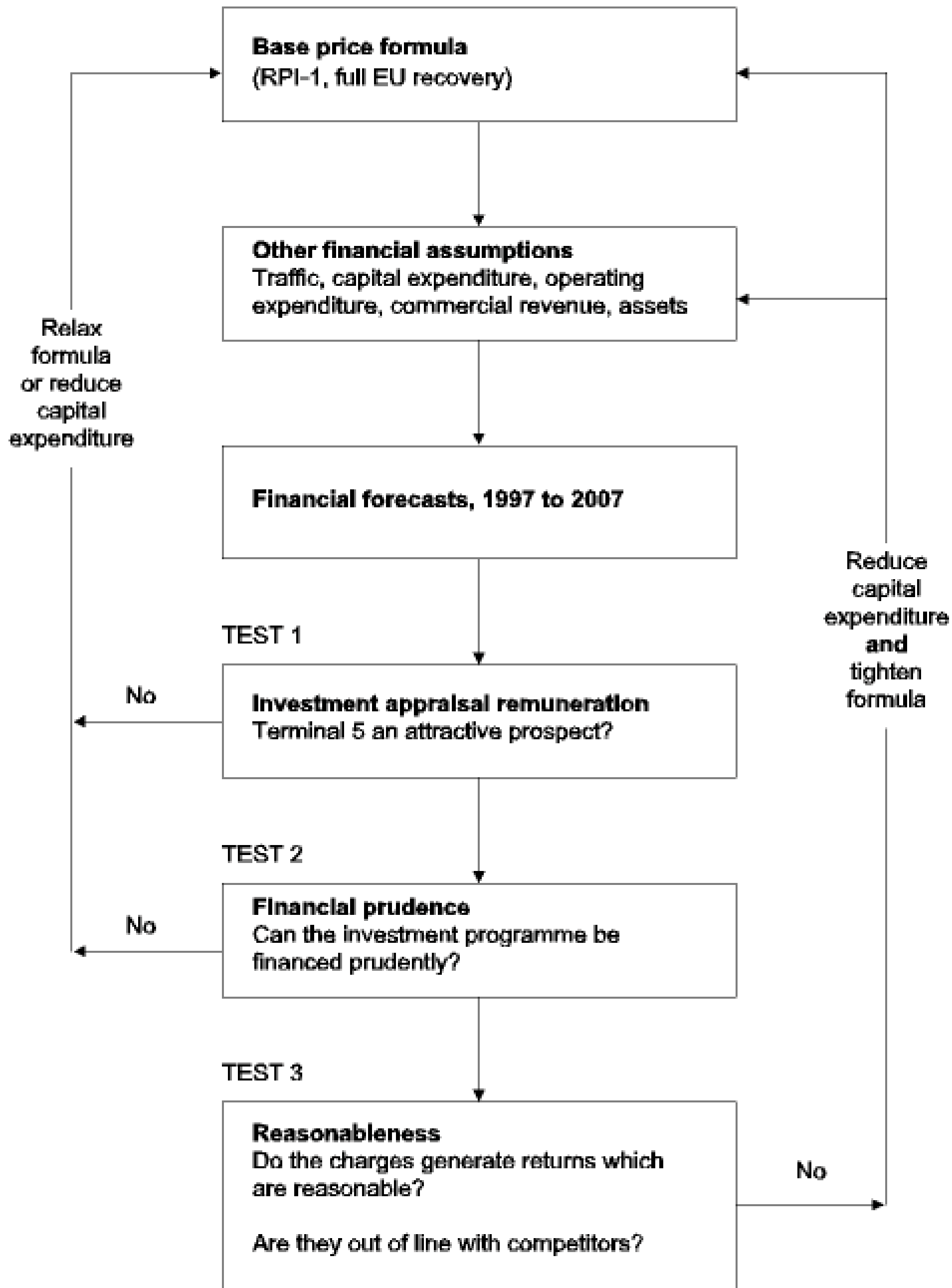
(a) an investment test: the results of the investment appraisal for Terminal 5 would be considered against financial criteria to determine whether a reasonably minded company could be expected to proceed with the project;

(b) a financial test: the whole financial forecast, including the complete investment programme, would be considered, to establish whether a reasonably minded management would consider that the investment programme could be funded at reasonable cost, and with normal margins of financial prudence; and

(c) a price and profitability test: a cross-check, to ensure that if charges and profits were high enough to meet investment needs they would not be unreasonably high compared with returns enjoyed by commercial companies, or charges of other airport operators.

FIGURE 14.1

BAA's proposed pricing formula model



Source: BAA.

14.23. According to BAA, if the formula was too low to pass the test of encouraging investment, it should either be eased, or the regulator should reduce the expected level of investment. If the formula was at the minimum level necessary to encourage investment, but generated higher returns than acceptable, or higher charges than were competitive, then the regulator might want to cut the level of charges, but should also reduce the capital programme.

BAA's assumptions

Traffic

14.24. BAA said that the business environment for traffic would be increasingly volatile and competitive, unlike that facing utilities. There was consensus that traffic demand would grow over the next ten years, and its traffic forecasts were broadly comparable with those of the CAA and British Airways. These assumed that until Terminal 5 opened, growth of traffic at Heathrow would be progressively restricted by lack of terminal, apron and road capacity, leading airlines to make greater use of other European hubs.

14.25. There was increasing competition for air traffic between different airlines using different airports, particularly for transfer and cargo traffic; between different airports, competing for footloose originating traffic as well as transfers; and between aviation and other modes of transport, particularly rail on short-haul routes. The transfer passenger market was highly competitive. Passenger choice was determined both by airport facilities, and the services and price options offered by airlines using different hubs. Transfer passengers were currently at an all time high, making up some 33 per cent of passengers at Heathrow for the first six months of 1995/96, with virtually all the traffic growth at Heathrow and Gatwick accounted for by transfer passengers. Meanwhile, continental hubs such as Schiphol and Frankfurt were investing heavily in transfer facilities to facilitate further growth, for example Schiphol had recently opened a major new terminal area and was planning a fifth runway. Cargo was a particularly fiercely fought market, where location was less important than services and facilities. Regional UK airports were also energetically marketing themselves for direct international services, particularly to the USA. Since 1985 Manchester Airport had attracted international services to Chicago, Atlanta, Singapore, Hong Kong and Dubai, amongst other cities, whereas previously passengers to these destinations would usually have travelled through Heathrow or Gatwick.

14.26. BAA's response in terms of investment to meeting airlines' needs during Q2 is described in paragraph 14.9. It also planned to redevelop the British Airways Heathrow cargo area, jointly with British Airways. To meet competition from other airports, BAA said that it would need to respond with new and enhanced products and services in lounges, gates, baggage systems and other facilities.

14.27. BAA said that short-term trends in traffic were becoming more unstable as airlines increasingly competed for the footloose traffic, notably transfers, as mentioned above. Furthermore, a new generation of low-cost airlines had emerged, which were vulnerable to recession. Stansted, which lacked large volumes of regular high-yield passengers, had developed its own market by working jointly with two innovative carriers which relied on low pricing and focused marketing to create new markets. Ryanair, in particular, had markedly developed the Stansted to Ireland market with its exceptionally low-cost operation. Air UK had developed a local market for short-haul scheduled services.

Commercial revenue

14.28. Commercial activities generated over half the airports' income, according to BAA, and virtually all their profits. These activities, which were far removed from normal utility businesses and operated in a market of volatile demand and significant competition, nevertheless contributed to the airports' finances under the single till and were critical to the level of airport charges permitted.

14.29. Commercial revenue was sensitive to the volume of traffic, but also the traffic mix. For example, domestic passengers generated less income than international, and Irish and Japanese passengers bought more than Americans. To compensate for the decline in sales of tobacco and spirits, BAA told us that it had developed new markets in specialist tax-free airside shops, albeit with lower margins than duty-free sales. BAA had also tried to improve passengers' perceptions of the value for money of airport shopping to which

their price guarantee, and world-wide `no quibbles' refund offer, had contributed. Nevertheless, BAA still had to innovate, customers were increasingly sophisticated in their expectations of quality and value for money, and the increasing proportion of frequent flyers tended to spend less often.

14.30. BAA said that a large proportion of its duty-free and tax-free income was generated by sales to passengers travelling between points in the EU. The loss of this income on 1 July 1999 would affect its business in a number of ways beyond the direct loss of revenue. Reduced sales volume would reduce BAA's buying power leading to lower margins on goods sold duty-free and tax-free to passengers outside the EU. The power of the duty-free `brand' would be undermined and could affect the readiness to buy of passengers who were travelling outside the EU. BAA said that in view of the innovation and development which it had already taken in the last five years, the scope to compensate for the loss would be limited.

Capital expenditure

14.31. BAA said that its proposed capital expenditure programme, which is described in paragraph 9.29 *et seq*, was large, but necessary to meet the needs of airlines and passengers. Failure to complete the programme would result in lower quality and capacity, leading to dissatisfied customers, which in turn would damage the UK aviation industry.

BAA's financial forecast

Base model

14.32. Taking the business environment and the capital programme together, BAA produced a base financial forecast for the period up to 2006/07. The forecast relied on two critical assumptions, both derived from the CAA's conclusions at the end of the last review, namely: RPI-1 for airport charges at each airport throughout the period; and full recovery of any revenue lost through the abolition of intra-EU duty-free and tax-free allowances when this occurred in 1999. It also assumed that the airports could continue to extract performance gains whilst improving service quality (BAA's assumed productivity increase of 4 per cent had been discussed with the CAA). In view of the sensitivity of construction costs, it had used two forecasts. The first was from independent advisers, DLE, leading building cost experts. Their forecast reflected the belief that current low levels of construction costs were unsustainable in the long term, and that there would be a particular upward pressure on costs as the bulge of millennium projects was undertaken. Since BAA recognized the sensitivity of results to construction costs, it had also commissioned an alternative forecast from WT, which had projected an increase in construction costs ahead of inflation, but at a slower rate. The results are set out in Tables 14.1 and 14.2.

14.33. BAA said that the forecast showed a progressive deterioration of BAA's finances over the period. Even as earnings continued to rise in Q3 all the financial ratios (interest cover, dividend cover and gearing) deteriorated progressively, as did ROCE. After Terminal 5 opened the situation became even more acute. Operating profit growth was affected by the additional depreciation from Terminal 5 and earnings growth turned sharply negative as this was compounded by interest charges. The return on capital also fell sharply.

14.34. In BAA's view, the financial prospects for Q4 were critical to this review. The opening of Terminal 5 in 2003 was inevitable once a decision had been taken to undertake the investment. The financial prospects for BAA's airports made them highly unusual operations. The continual demand for investment in excess of cash flow made them consistently cash negative over a very long period, with the prospects for positive net cash generation deferred for 15 years or more. These changes were particularly striking where the level of airport charges moved consistently at RPI-1 throughout the ten years. It said that the clear implication was that any attempt to target an equal rate of return in the two quinquennia was bound to result in violent swings in the level of prices charged to individual airlines not related to any short-term change in the costs they imposed.

TABLE 14.1 **BAA base forecast RPI-1 (DLE)**

£ million, out-turn prices

	1995/ 96	*1996/ 97*	*1997/ 98*	*1998/ 99*	*1999/ 2000*	*2000/ 01*	*2001/ 02*	*2002/ 03*	*2003/ 04*	*2004/ 05*	*2005/ 06*	*2006/ 07*	*Averages Q3*	*Q4*
Operating profit (HCA)	382	[												
Operating profit (RCA)	371													
Post-tax and -interest earnings	281													
Interest cover (HCA)	7.9							*Figures omitted. See note on page iv.*						
Gearing HCA (debt/equity) (%)	20													
Dividend cover (HCA)	2.7													
ROCE HCA (%)	12													]
ROCE RCA (%)	10.4	9.7	8.8	7.8	7.1	6.4	6.1	5.4	4.5	4.5	4.2	4.3	7.24	4.58

Source: BAA.

TABLE 14.2 **BAA base forecast RPI-1 (WT)**

£ million, out-turn prices

	1995/ 96	*1996/ 97*	*1997/ 98*	*1998/ 99*	*1999/ 2000*	*2000/ 01*	*2001/ 02*	*2002/ 03*	*2003/ 04*	*2004/ 05*	*2005/ 06*	*2006/ 07*	*Averages Q3*	*Q4*
Operating profit (HCA)	382	[												
Operating profit (RCA)	372													
Post-tax and -interest earnings	281													
Interest cover (HCA)	7.9							*Figures omitted. See note on page iv.*						
Gearing HCA (debt/equity) (%)	20													
Dividend cover (HCA)	2.7													
ROCE HCA (%)	12													]
ROCE RCA (%)	10.4	9.7	9.0	8.3	8.1	7.4	7.0	6.3	5.3	5.3	5.0	5.2	7.9	5.4

Source: BAA.

14.35. BAA combined the capital expenditure programme, and the operating performance forecasts to produce a financial appraisal of Terminal 5 based on the scheme currently before the Terminal 5 public inquiry (described in paragraph 9.32 *et seq*). The results using both DLE and WT construction cost forecasts are set out in Table 14.3 and, according to BAA, describe a project which at RPI-1 would be a drain on both profits and cash for an extended period after its opening. Although the WT forecast mitigated the severity of the impact of the construction costs, it did not obscure the underlying negative impact of the scheme on the group.

TABLE 14.3 **BAA's appraisal of Terminal 5 at RPI-1**

	DLE	*WT*
IRR (post-tax nominal) (%)	[	
NPV at 13%, £m		
First year of positive cash flow (after interest)	*Figures omitted.*	
First year of contribution to earnings	*See note on page iv.*	
Net effect on cash flow until 2006/07		
Net effect on earnings until 2006/07		]

Source: BAA.

BAA's investment test

14.36. BAA then subjected the base forecast to the three tests described in paragraph 14.22. BAA said that the normal encouragement for a potential investor to commit resources to a project was the expectation that the return on that project would exceed its cost of capital or hurdle rate. Turning to Terminal 5, at the base case RPI-1 pricing formula, this project had an estimated return of [*] per cent (see Table 14.3). BAA derived the hurdle rate for Terminal 5 by taking its overall cost of capital adjusted for its relative riskiness.

14.37. BAA's standard cost of capital was 12 per cent post-tax nominal, set using the CAPM based on the following assumptions: a risk-free rate of 5.75 per cent derived from the yield on long-term gilts net of a term premium and an adjustment for tax; a market equity risk premium of 8 per cent based on a wide range of published studies; and a beta coefficient of 0.90 from the LBS Risk Measurement Service. By comparison, BAA noted that the mid-point of the low ranges in the MMC report on Scottish Hydro[1] was an equity risk premium of 4 per cent, which with gearing of 15 per cent would produce a cost of capital of 8.9 per cent post-tax nominal. BAA noted that no regulator to date had combined such a low premium with the low riskless rate used by LBS. A mid-range view would take an equity premium of 6 per cent (suggested by the Bank of England's August 1994 bulletin),[2] which would produce a cost of capital of 10.5 per cent.

14.38. According to BAA, Terminal 5 was more risky than the company overall and was subject to additional risks such as:

(a) construction cost overruns and delays;

(b) traffic would not grow as forecast;

(c) retail risk due to both traffic risk and the potential decline in sales as a knock-on effect of the loss of EU duty-free;

(d) regulatory risk; BAA argued that not only did regulation not reduce risks within a quinquennium, but it imposed its own regulatory risk since regulators could not bind their successors; and

(e) the scale of the Terminal 5 project (involving £1.5 billion) magnified risks, since a failure could threaten the long-term prosperity of the business overall.

[1] Op cit.

[2] *Investment appraisal criteria and the impact of low inflation,* Andrew Wardlow, Bank of England Quarterly Bulletin, August 1994.

*Figures omitted. See note on page iv.

14.39. BAA therefore chose a hurdle rate of 13 per cent for Terminal 5, although it said that the degree of risk associated with the project would justify a premium of several percentage points over the company's average cost of capital. BAA pointed out that the premium would still only be 4.1 per cent if the regulatory low alternative cost of capital of 8.9 per cent were used. The forecast IRR of [*] per cent at RPI-1 was well below this cost of capital. Therefore, according to BAA, the financial appraisal of Terminal 5 at RPI-1 was not one which would encourage a reasonably minded company to invest.

The financial test

14.40. BAA said that while lenders and investors would have different priorities, they would share a common concern that there was a fair prospect of their investment being adequately remunerated within a reasonable time-frame, taking account of the risk profile of BAA's business.

14.41. BAA said that it would be looking to lenders for over £4 billion in new debt, equivalent to an average of over £400 million a year for the next ten years. They would know that BAA would be seeking continued funding on a large scale concentrated on a single project; there was no prospect of positive net cash flows in the foreseeable future and BAA would find it unusually difficult to escape difficulties by short-term cash raising or investment freezing. If BAA was unable to demonstrate to lenders that it was able to maintain satisfactory financial ratios, the security of its debt would fall, and the credit rating would be downgraded, which would not only increase the cost of BAA's debt (and therefore its cost of capital), but reduce the range of sources from which BAA could borrow. Ultimately, it would place a cap on BAA's total debt and the rate of new borrowing, which would, in turn, curtail the number of investments BAA could make.

14.42. According to BAA, shareholders' interests were relevant in that the Board of Directors had a fiduciary duty to its shareholders not to authorize investments which either reduced shareholder value, or put shareholders' funds at unacceptable risk. The Board of Directors also had to allocate resources between competing investment proposals in the best interests of shareholders, and BAA already had projects outside the South-East airports which offered higher returns than airport development. The attitude of shareholders was an important signal to lenders. For example, a fall in share price might suggest that the company was not being managed effectively and the cost of capital would increase causing lenders to reduce their support. On the other hand, BAA said that it could not use a rights issue to finance investment. Neither BAA, its investors nor its lenders looked to equity to finance investment in the core business, for good reasons: the business was cash generative at a gross level and so internal financing was expected and equity financing would represent a major change in policy. At the RPI-1 base case, BAA said that Terminal 5 would not cover its cost of capital; the prospect of any returns would be too distant to interest most investors; and the issue would dilute earnings per share for an extended period. Given BAA's previous record of financing major capital expenditure from internally-generated funds and new borrowing, shareholders would question why continued investment in the core business could not be internally financed.

14.43. BAA adopted a number of financial ratios as appropriate measures to determine whether its future capital expenditure was capable of being financed, including:

(a) Interest cover of 3.5. BAA said that the norm for minimum interest cover was 3 to 4 and its own internal target was normally set at 3.5 for its long-term plans, to leave a reasonable margin to allow for downturns in the business (particularly since the base case forecast did not make any provision for unexpected adverse events or major downturns). The margin above crisis levels of cover was particularly important since BAA's sterling loans contain covenants requiring cover to exceed 2.

(b) Gearing with a maximum debt equity ratio of 50 per cent. BAA said that this was the normal bench-mark, though it was recognized that it could rise for short periods of time. BAA's current gearing was 31 per cent, close to the median for FTSE 100 companies of 32 per cent, but its base case forecast showed that this gearing rate would rise inexorably as new debt was taken on. BAA's gearing target was underpinned by the covenants attached to its European Investment Bank debt, which obliged BAA to have shareholders' funds, excluding revaluation reserves, greater than debt.

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*Figures omitted. See note on page iv.

(c) Earnings growth target of 8 per cent earnings per share growth annually with no consecutive years showing earnings per share falls within a quinquennium. Since it had consistently retained a high level of earnings for investment in the company, BAA claimed that its shareholders sought growth above average. It accepted that it was less vulnerable to the UK business cycle than some other companies, and so its target was based on the median performance of FTSE 100 companies in the growth period of the cycle rising to the upper quartile in the recession period of the cycle.

(d) Dividend growth target of 8 per cent real with no quinquennium showing average annual growth below 6 per cent and no real fall in dividends from one year to the next. Given BAA's low yield of some 2.7 per cent (30 per cent below the current average), it said that expectation of future dividend growth was essential to the value of BAA's shares. Market expectations were that dividends would grow by about 10 per cent a year nominal, or 7 per cent a year real in the short to medium term. While BAA continued to have major capital expenditure requirements, long-term dividend growth should not exceed earnings per share growth, which would mean that BAA had to borrow more to fund its capital expenditure requirements, contrary to gearing and interest cover targets. From 1982 to 1994 (when inflation was under 6 per cent for ten years and under 10 per cent at all times), dividend growth was around 5 per cent real. BAA said that, given its need to retain earnings to support its capital expenditure, a low payout approach with consequent requirement for relatively rapid growth remained appropriate.

(e) Dividend cover target of 2.5 times. BAA argued that the appropriate levels of earnings and dividend growth implied that dividend cover should remain constant over the long term. To date, BAA had adopted a relatively high dividend cover in the range 2.7 to 2.9, compared with a FTSE 100 average of around 2.

14.44. Under the base case of RPI-1: BAA would be unable to meet interest cover levels from 2000/01 (or 2001/02 for WT's estimates); it would exceed required gearing levels from 2001/02 (or 2002/03 according to WT's estimates); dividend cover would be unacceptable from 2003/04; and earnings growth would be unacceptable from 2003/04. It was unsustainable for a company to breach these ratios over a five-year period, and the consequence would be a cycle of deteriorating finances, causing rising interest costs, leading to the closure of sources of funds and ultimately to an inability to finance continued investment without incurring costs and risks at a level unacceptable to lenders and investors.

The prices and profitability test

14.45. Finally, BAA compared its profits with the returns earned by other companies and prices with the levels of charges levied by competing and comparable airport operators, to see whether the level of profits was unreasonable.

Rate of return

14.46. BAA regularly provided information to its airlines on both HCA and CCA bases and derived ROCE forecasts, set out in Table 14.4, from base case estimates. In calculating the ROCE, BAA applied the definition of assets used in its statutory accounts to both CCA and HCA bases, which it believed gave a fair mid-value. In particular, the assets included interest capitalized since 1988/89, but no capitalized interest on that part of the asset base which existed before that time. The assets also included AICC, but in the CCA accounts these were held at cost, not at value.

TABLE 14.4 **Average ROCE**

	Q3		*Q4*	
	DLE	*WT*	*DLE*	*WT*
CCA	7.2	7.9	4.6	5.4
HCA	9.9	10.1	7.0	7.7

Source: BAA.

14.47. BAA compared its CCA returns with National Accounts Data on two bases: all companies, and non-manufacturing on shore companies. BAA's forecast returns for the next five years fell below those for four of the past five five-year periods for both bases, and the returns forecast for the following five years fell to around half the levels experienced in the last 25 years (8.2 per cent for total economy and 9.4 per cent for non-manufacturing on shore companies). It said that, even allowing for BAA's slightly lower level of risk, the suggested forecast returns were not above a reasonable range and fell well below that range after 2002.

14.48. It then compared BAA's HCA returns with a shorter series of national accounts figures, covering the period 1970 to 1991. The average for the series was some 20.2 per cent, with returns of 20.9 per cent over the ten years 1981 to 1991 and 19.5 per cent between 1987 and 1991. On an HCA basis, the airports' forecast returns would be regarded as low, with figures significantly below even the lowest average profitability for UK companies (recorded in 1981).

14.49. BAA argued that it could reasonably have profits above or below this average level, given that the evidence available showed that the profits of UK companies covered a wide range. It was the regulators' duty to seek an efficient and economic airport operation and this invited a more sophisticated view of returns than a simple attempt to make the formula match the cost of capital, or an industry risk-adjusted average. A company which operated more efficiently, constructed the appropriate capital facilities at lower costs, and provided excellent service, while charging low prices by international standards, should be expected to make higher returns than a company where the management had failed to provide these benefits. Under this approach, part of the benefits of added value should go to customers, but part should equally go to shareholders to reward their investment, and encourage their stewardship of the performance of the company.

14.50. Turning to prices, BAA pointed out that the international studies referred to in paragraph 14.17 all showed the same general result, that Heathrow and Gatwick were significantly cheaper than their main competitor airports. At the base case of RPI-1 it saw no reason to believe that this comparison would change in the next ten years. Any additions for loss of EU duty-free and tax-free revenue at the London airports would also have to be reflected in charges at other airports, leaving overall relativities broadly as they were today. BAA had commissioned Symonds Travers Morgan to compare Heathrow's charges with charges at other airports which had recently undertaken major investments, as shown in Table 14.5. BAA concluded that the current level of charges appeared to be below the minimum level compatible with continued major investment. Indeed, the level of charges at BAA's London airports was now so low as to be a matter of concern to its smaller competitors, and Luton Airport had already expressed serious concern about low prices at Stansted.

TABLE 14.5 **Charges at airports undertaking major capacity additions**

Airport	*Index of charges*
Kansai (new airport)	100
Frankfurt (new terminal)	44
Munich (new airport)	36
Amsterdam (terminal extension)	35
Brussels (new terminal)	32
Paris (new terminal)	32
Manchester (new terminal)	30
Macau (new airport)	30
Denver (new airport)	30
Heathrow	19

Source: BAA.

14.51. BAA concluded that the airports' forecast returns at RPI-1 for Q3 were reasonable on a CCA basis when compared with the National Accounts Data, while for Q4 they were significantly below the national averages. On an HCA basis returns were already low, and returns would fall to even lower levels over Q3 and beyond. These low returns would persist in a climate of low prices. If prices were to remain at their current low levels relative to other airports, returns at around or slightly above average levels would be evidence that the gains from efficiency and commercial performance were largely being passed on to customers.

TABLE 14.6 **BAA base forecast (DLE) RPI+ 0 then RPI+ 2**

£ million, out-turn prices

	1995/96	*1996/97*	*1997/98*	*1998/99*	*1999/2000*	*2000/01*	*2001/02*	*2002/03*	*2003/04*	*2004/05*	*2005/06*	*2006/07*	*Average*	
													Q2	*Q3*
Operating profit (HCA)	382	[												
Operating profit (RCA)	371													
Post-tax and -interest earnings	281													
Interest cover (HCA)	7.9							*Figures omitted. See note on page iv.*						
Gearing HCA (debt/equity) (%)	20													
Dividend cover (HCA)	2.7													
ROCE HCA (%)	12													]
ROCE RCA (%)	10.4	9.7	8.9	7.9	7.3	6.7	6.4	5.9	5.2	5.4	5.3	5.6	7.4	5.5

Source: BAA.

TABLE 14.7 **BAA base forecast (WT) RPI+ 0 then RPI+ 2**

£ million, out-turn prices

	1995/96	*1996/97*	*1997/98*	*1998/99*	*1999/2000*	*2000/01*	*2001/02*	*2002/03*	*2003/04*	*2004/05*	*2005/06*	*2006/07*	*Averages*	
													Q2	*Q3*
Operating profit (HCA)	382	[												
Operating profit (RCA)	372													
Post-tax and -interest earnings	281													
Interest cover (HCA)	7.9							*Figures omitted. See note on page iv.*						
Gearing HCA (debt/equity) (%)	20													
Dividend cover (HCA)	2.7													
ROCE HCA (%)	12													]
ROCE RCA (%)	10.4	9.7	9.1	8.5	8.3	7.7	7.4	6.8	6.1	6.3	6.2	6.6	8.2	6.4

Source: BAA.

The value of X

14.52. Having concluded that a base price formula of RPI-1 with full EU duty-free and tax-free recovery for the next ten years was too low, BAA considered what was a realistic level of pricing. In BAA's view Q3 and Q4 were inextricably linked. Long-term investments needed to be undertaken with the best possible view of charges over the long term. While there was no certainty as to the decisions of regulators in later quinquennia, it was important that the regulator at the end of Q3 left charges at a level which offered at least a reasonable prospect of long-term financial viability and economic returns from investment.

14.53. BAA said that even a ten-year formula of RPI+ 4 would not meet all its financial ratios, but it had a realistic view of what the regulator could propose, in the light of airlines' preferences and public opinion. It wished to avoid unnecessary charge increases and recognized that BAA should play its part in bridging the gap between current charges and an economically justifiable level. It therefore proposed that the regulator should aim for a ten-year formula equivalent to RPI+ 1.

14.54. BAA argued forcibly that this should be profiled across Q3 and Q4. Airport users did not like sharp oscillations in the level of charges and real price reductions in each of the next five years would give a misleading signal as to the long-term trend of rising charges. The subsequent sharp increases in user charges from 2002/03, to achieve an acceptable rate of return after Terminal 5 opened, would be both unanticipated and disruptive to airline finances, which should be avoided by more gradual price rises. In any case, BAA was not sure it would be able to impose such sharp price rises on airlines, which would have already suffered two very significant increases to charges in order to compensate BAA for lost EU duty-free and tax-free revenue.

14.55. BAA therefore submitted that it could not assume a formula higher than RPI+ 2 in Q4 when making decisions about investment now. With RPI+ 2 in Q4 and a ten-year target of RPI+ 1, it followed that the formula for Q3 could be no worse than RPI-0. Its resulting financial forecasts are set out in Tables 14.6 (DLE) and 14.7 (WT), with the Terminal 5 financial appraisal shown in Table 14.8. While BAA said that these forecasts did not meet its own financial tests, it was up to BAA to find additional process improvements to bridge the difference.

TABLE 14.8 **BAA appraisal of Terminal 5 at RPI-0, RPI+ 2 and RPI-1 thereafter**

	DLE	*WT*
IRR (post-tax nominal) (%)	[	
NPV at 13%, £m		
First year of positive cash flow (after interest)	*Figures omitted.*	
First year of contribution to earnings	*See note on page iv.*	
Net effect on cash flow until 2006/07		
Net effect on earnings until 2006/07		]

Source: BAA.

14.56. In conclusion, therefore, BAA proposed a price control formula of RPI-0 for the London airports for the years from Q3 accompanied by a clear recognition that prices might need to rise in subsequent periods, to allow the airports to invest sufficient capital to meet the needs of users.

BAA's response to the MMC's proposals on airport charges

Regulatory asset base

14.57. As described in Chapter 4, BAA said that it adopted an approach to asset valuation which would reflect the values which would apply in a competitive market. A large proportion of the airports' assets could be valued on an open market basis as their future cash flows did not reflect regulated income. For investment properties, which were not dependent on price-controlled revenues, the correct basis was open market value. In the case of assets employed in price-controlled areas, the competitive basis was the current depreciated replacement cost on a modern equivalent asset basis, including nugatory capital expenditure.

14.58. BAA was not in favour of the suggestion of deriving a regulatory asset base which took the capital value at some previous point, such as the 1991 regulatory review, revaluing it in the light of the RPI, and adding new investment at cost (adjusted for depreciation) in order to avoid potentially significant fluctuations due to changes in construction costs. Unlike some privatized utilities, where rolling forward the asset base was the most appropriate method, it was possible to derive an open value for BAA. BAA was also concerned about the stability of the regulatory regime if the method of valuation (which was used in 1991) was changed at its first test. However, BAA said that if its regulator was determined on a `roll-forward' approach to asset valuation, there were only two bases which would be appropriate (both of which gave a similar value to BAA's preferred method, about £3.7 billion as a closing value for 1994/95):

(a) a roll forward of the book value of the depreciated replacement cost assets from their closing 1991 value and the insertion of investment properties at their current market value; and

(b) a roll forward of the share value after the last regulatory decision, at 31 March 1992.

14.59. Financial ratios were particularly important to BAA, which said that it was currently taking the best out of the capitalist system and had to continue to do so to meet its financial ratios. BAA considered that interest cover followed by gearing were the crucial ratios in deciding whether to carry out the investment programme. These were much more important than an arbitrary percentage return and an arbitrary asset base, which were subject to considerable uncertainty. BAA said that the regulator's view on return had to be flexible and long term, and should not rely on massive increases in charges five years from now.

14.60. BAA was concerned that the financial burden of the capital expenditure programme, not only of Terminal 5 but also to refurbish the Central Terminal Area, was so large that it broke all BAA's financial ratios at RPI-1, and even at RPI-0 for Q3 followed by RPI+ 2 for Q4 would not meet all financial ratios. It had not seen any forecast, based on a rate of return of 7.5 per cent in each quinquennium, which generated sufficiently robust financial ratios to allow BAA to build Terminal 5. It was not possible for the Board of Directors to commit such a huge sum if BAA's prices were below the level at which it could get a reasonable return. Cash was crucial to the investment programme; if it did not have enough cash, BAA said that it would have to cut spending. It said that the biggest risk it faced was to run the cash position down to such an extent that it was no longer able to direct its own affairs.

14.61. BAA argued that the Terminal 5 project was so huge and the risk associated with it was so difficult that it could not as a company separate the two quinquennia completely. As far as the profile of the formula was concerned, BAA said that any decision which lowered prices rapidly at the start of Q3, to meet a constant rate of return target, would hit its cash situation immediately, which was the worst possible approach. The impact would be to constrain its investment programme, because cash was finite. Equally, BAA said that in practice it would be impossible for it to extract from airlines the kind of price rises which would be required to meet a constant rate of return in Q4 were Terminal 5 constructed.

14.62. BAA said that if regulators were to impose a profile which lowered charges significantly for Q3 and then raised them significantly during Q4, investors would regard their holding as much less attractive than hitherto, and the share price would fall. This would almost certainly result in a lower dividend. Investors would not want such a high proportion of retained earnings reinvested in the company, with the further consequence that they would put pressure on BAA to raise the dividend. So there would be a cycle of tighter cash restraints than at the moment. Lenders would look to BAA to cut capital expenditure,

otherwise BAA's credit rating would fall, debt would become more expensive and the sources of debt would shrink. As a result there would be higher dividend cost, higher interest costs and more restricted and more expensive credit, and BAA would hit the constraints of its financial ratios sooner than it otherwise would have. The management of the company would be forced to take dramatic measures to address the issue of cash shortage, which would affect the level and prioritization of the investment programme.

System formula

14.63. BAA supported a single system formula for regulating the three airports as a whole. It was concerned about the long-term regulatory signal of departing from a system approach. A difficulty of the past system had been lack of flexibility because Heathrow and Gatwick each had its own separate formula as well as the system formula. It was important that BAA had a degree of freedom in setting prices for these two airports, although it had no intention of recovering Stansted's losses elsewhere.

Productivity

14.64. BAA's approach to productivity was a system of quality management with an emphasis on process improvement and process management. It explained that the theory of process management was to look at all the outputs of the process and seek a better way of managing to enable both quality and productivity to be improved. Given lower traffic growth in Q3, BAA's forecast 4 per cent productivity improvement would require a real reduction in manpower which would be very challenging. But to get process improvement which gave both quality and productivity, BAA could not pre-plan the number of employees it required. Instead, the 4 per cent target was based on BAA's estimate of a very good performance by UK industry standards.

Coverage of the single till

14.65. BAA argued that advertising did not fall under the definition of operational activities, and therefore should not be included in the single till. It said that it was freely competitive, and a completely separate activity from airport operations. There was a competitive market for advertising. For example, an advertiser could sell to passengers in central London from a billboard, on the underground from billboards and signs on trains, from BAA advertisements, or through airlines' in-flight magazines. In other words, advertising was a continuum of available sites. BAA added that judgments at the margin of the single till about what should and what should not be included inevitably led to approximation in calculating the rate of return (particularly since those judgments were sensitive) and it was therefore difficult to be precise in estimating the correct rate of return.

Compensation for loss of EU duty-free and tax-free revenue

14.66. BAA submitted that the MMC's estimate on its alternative assumptions of the net loss of EU duty-free and tax-free sales of £55 million was a highly conservative one, which it would not be able to achieve. Elements were, in its opinion, impossible to achieve, and it strongly refuted the MMC's position. BAA said that it would have to assume in its own financial forecasts for planning purposes that it would be unable to meet the figure, which would have knock-on effects on BAA's investment appraisal and financial planning. As far as the mechanism of the D factor was concerned, BAA said that the correct balance of compensation would be 75 per cent in 1999/2000 and 25 per cent in 2000/01. The best timing would be to apply the adjuster from April 1999 to avoid the need for a second review of airport charges when EU duty-free and tax-free sales came to an end on 30 June 1999.

Public interest issues

14.67. This is a summary of BAA's views on a range of public interest issues raised with us and described in Chapters 11 to 13. Further detail and evidence provided by BAA is found in Chapters 3 to 10.

Quality of service

Service standards

14.68. BAA was in favour of arrangements for measuring performance to agreed standards based on a partnership approach with airlines and clearly defined responsibilities for service provision. It said that many of these standards and measures were already in place (although it could not set standards for HM Immigration). BAA said that service standards should reflect that there was shared responsibility for many services, for example baggage systems were provided and maintained by BAA but they were operated by airlines and their agents. It agreed with airlines that service standards should be agreed in consultation between the airports and users and not be defined by the MMC as part of this review.

14.69. It thought a rational and analytical approach should be adopted in setting service standards, drawing a distinction between the aspirational target levels of performance which BAA might set itself and appropriate minimum standards, determined in consultation with airlines and including an assessment of passenger expectations as measured by QSM. To meet the best interests of passengers and the airline community as a whole, reciprocal standards covering airline and airport activities would be required. Operational equipment was multi-user and any airline which misused equipment would have an immediate negative impact on others. Given the complexity of many systems, these 'failures' could be mistakenly attributed to BAA.

14.70. BAA said that it had practical reservations about the application of penalties. Determining the cause of failure could be excessively complicated for shared facilities and BAA could be exposed to penalties for failures due to factors beyond its control. Penalties might jeopardize the no-blame culture and provide an incentive to skew measurement results, and in BAA's view they would have to be symmetric to reflect the joint responsibility for service provision while asymmetric penalties could divert management focus from improving service to minimizing failure. BAA said that it was willing to undertake to implement trial SLAs and for the results to be reviewed by the CAA. Reporting on its current discussions with British Airways on trial SLAs, BAA said that it hoped to reach agreement on all outstanding matters by 18 July 1996. Subject to agreement with British Airways, BAA would operate trial SLAs with ghost penalties for stand availability, jetties, security queues, and departure baggage (Terminal 1). These trial SLAs would run until 31 March 1997 and within three months of the end of the trial BAA would review the trial and incidence and effectiveness of ghost penalties; propose amendments, development or discontinuation of SLAs; identify other areas where SLAs might be applied; and publish findings and consult users on its plans. BAA undertook that, in the event of disagreement on the future proposals, it would inform the CAA, and participate fully and constructively in any investigation the CAA might undertake and implement its conclusions.

14.71. BAA said that planned preventative maintenance regimes were in place at each airport terminal, with engineering sections operating on a 24-hour shift-working basis, and more than 90 per cent of planned maintenance was conducted in off-peak periods. It added that any maintenance carried out during operating hours, either for safety or operational reasons, would be agreed in advance with airline customers and alternative arrangements made if necessary. BAA was improving its planned maintenance procedures by introducing a computerized planned maintenance package (linked to the fault reporting systems), which was currently on trial in Heathrow Terminal 3 and Gatwick North Terminal.

Transfer baggage

14.72. BAA told us that the transfer product had fundamentally changed over Q2, and the proportion of transferring passengers had increased from 23 to 35 per cent at Heathrow. HAL had been partly responsible, by creating facilities at Heathrow which allowed passengers to transfer in comfort. As a result, airlines had become more interested in transfer traffic and, retrospectively, in transfer baggage. At the same time, hold baggage screening requirements meant that, for the first time, transfer bags would have to be brought to a central place to be screened, fundamentally altering the existing baggage transfer system. The development of airline alliances at Heathrow, for example between British Midland, Scandinavian Airlines Systems and American Airlines Inc, had led to increased numbers of passengers transferring between Central Terminal Area terminals.

14.73. BAA said that the established working practice at Heathrow and other airports gave airlines responsibility for the transfer baggage process. BAA provided the baggage system infrastructure according to airlines' requirements, and recovered costs through separate charges based on baggage throughput. Incorporating the costs of the transfer baggage infrastructure into airport charges would create significant winners and losers, and there was no airline consensus on the issue. The annual cost of the transfer baggage facilities at Heathrow would be approximately £20.3 million, with completion of the Terminal 1 to Terminal 4 link, equivalent to about 8 per cent of airport charges income. British Airways would pay some 86 per cent of the total transfer baggage system costs, which would be roughly halved if the system moved to airport charges.

14.74. BAA had been willing to invest in the facilities airlines required, such as the Terminal 1 to Terminal 4 transfer baggage system, and any underinvestment resulted from an unwillingness on the part of airlines to remunerate the facilities. For example, HAL originally proposed a £5.6 million development for the Terminal 3 Shelterspan transfer baggage facility, but the Terminal 3 airlines had only been prepared to underwrite a development costing £2.1 million. Shelterspan was undersized and would need significant further development and investment to meet demand.

14.75. BAA explained that the Terminal 1 to Terminal 4 transfer baggage system was very complicated and had slipped (by about 12 months to the current target date of March 1997) because of the Heathrow Express tunnel collapse; changing and increasing airline requirements; higher than anticipated growth in transfer traffic; the impact of 100 per cent hold baggage screening requirements; and enhancements to avoid the problems encountered at the new Denver airport.

14.76. BAA said that the transfer baggage misconnect rate was currently up to 70 bags per 1,000 at Heathrow. It believed the transfer baggage process needed to be improved and the misconnect rate reduced significantly. Airlines classified the reasons for misconnection as: late flight arrival; flights sold with sub-minimum connect times; improperly tagged baggage; failure by the originating carrier to deliver bags in time; and failure by the departing carrier to deliver bags in time. BAA noted that according to recent target times agreed with Heathrow handling agents, transfer bags were in the possession of airlines for 74 per cent of the time and the AOC contractor for a further 14 per cent of the time. Surveys conducted between July and October 1995 showed that bags were on average ten minutes late entering the system, with instances of them entering up to 50 minutes late. BAA therefore believed improvements to the airlines' processes were required without which additional investment would not necessarily raise performance to desired levels.

14.77. BAA said that recently a high-level joint AOC/HAL Project Board had been formed to consider improvements to the transfer baggage systems and processes. The group's terms of reference included short-term improvements for 1996; transfer baggage infrastructure developments; and airline baggage process improvements.

14.78. Initially BAA said that the redistribution of airlines with the opening of Terminal 5 meant that inter-terminal transfers were expected to halve to about 3.2 mppa with the completion of Terminal 5-Phase 2. Therefore, it argued that the requirement for investment could not be determined until the distribution of airlines between terminals had been agreed and the effect of improvements in operating practices by airlines had been assessed. HAL had incorporated a notional £8.5 million in the capital programme for further investment in 1998/99. However, there was no provision for major tunnel projects in the next quinquennium. Tunnels linking Terminal 1 to Terminal 3 and Terminal 3 to Terminal 5 were likely to cost about

£120 million to £150 million and the cost of transferring a bag via these tunnels from Terminal 5 to Terminal 4 would be around £6.40 during Phase 1 of Terminal 5.

14.79. However, the representations made by airlines during the MMC review had in BAA's view established the need to define the responsibilities of different parties in the transfer baggage process. At a meeting with airlines in April 1996, all parties had agreed that the handling of baggage, including its loading and unloading from aircraft, and input and extraction from sorting systems was the responsibility of airlines and their handling agents. BAA took responsibility for identifying the airport infrastructure necessary to ensure quick, reliable transfer of baggage between flights, and for facilitating the provision of that infrastructure, either by direct BAA investment or by third parties.

14.80. BAA said that infrastructure referred to fixed equipment and buildings, and any assessment of infrastructure would take account of scope for other action, including improvements in handling practices to achieve satisfactory performance. Infrastructure solutions would take account of physical constraints imposed by Heathrow's layout and intensity of use. Finally, in accepting responsibility, BAA said that this did not mean infrastructure should be remunerated through airport charges, and charges should on principle be cost-related probably on a per bag charge. BAA would assume responsibility for monitoring airline performance in handling, seeking operational solutions to failures in co-operation with airlines.

14.81. To address the short term, the HAL/AOC Project Board had agreed that HAL and the AOC would each second two project managers to form an action team under direction of the AOC's representative from Air Canada, with overall responsibility for the effective operation of the transfer baggage system. In the longer term, BAA said that with airline agreement, HAL was recruiting an airline expert to work alongside the HAL transfer project manager, and would select an independent international expert process management consultant to direct further analysis and recommend generic process and infrastructure solutions. The Project Board would use these experts to identify and agree projects and process changes necessary to achieve satisfactory performance. Funding for minor infrastructure projects would be found from BAA's rump expenditure category of capital expenditure, and the notional allowance of £10 million in 1998/99 in BAA's revised capital expenditure programme. Should the Project Board identify a need for much larger projects, BAA would discuss the options available with airlines, including third party finance; reprioritization of the Q3 capital programme; or inclusion in the Q4 capital programme.

Off-pier coaching

14.82. BAA emphasized that the need for some off-pier coaching was a feature of operations at all airports. Airlines also used coaching to improve aircraft utilization, for example when aircraft were shifted between domestic and international services. Evidence that BAA had struck an appropriate balance between coaching and pier service was shown by the good overall QSM disembarkation scores at Heathrow, Gatwick and Stansted. BAA had invested significantly in pier-served stands during Q2, such as the construction of Pier 4a, Europier, and Victor Pier at Heathrow, plus extensions to Pier 4 and the construction of the Eurolounge at Gatwick North Terminal.

14.83. BAA said that since the use of remote stands was a normal feature of airport operations, and the level of pier service was reflected in the value of X, it was appropriate for the rebate to be revenue neutral for BAA and act as a mechanism for distributing charges amongst airlines according to the level of benefit they received. Since 1992/93 the total level of rebate revenue had remained relatively constant, but had declined as a percentage of total airport charges revenue to around 0.55 per cent at Heathrow and 1.1 per cent at Gatwick. During consultations in 1992, when the remote stand rebate was set at 30p, airlines were largely unanimous in support of increasing the rebate to £1.00 for all passengers departing from remote stands, as opposed to a rebate linked to service levels. This was implemented in 1992/93 but as the off-peak charge had risen through the equalization process BAA had increased the rebate to £1.20 in 1996/97 and introduced it at Stansted for the first time. It told us that it had recognized that this might be too low to fully recompense airlines for the costs of coaching, and had started work to identify an appropriate figure. The figures it had been quoted were between £1.30 and £1.50 for Gatwick and around £1.80 at Heathrow, and its strategy was to move progressively up to those figures.

14.84. The provision of off-pier coaching services at Heathrow had historically been the responsibility of airlines. British Airways and British Midland provided their own services, while other airlines procured

the service from a third party through Heathrow AOC. Since the AOC was not an incorporated body it could not therefore enter into formal contracts and had been unable to provide the current coach operator with sufficient security of tenure to encourage investment in new equipment. Heathrow AOC approached HAL in 1995, proposing that HAL assume responsibility for off-pier coaching, with costs incorporated in the airport charges, but it was clear that British Airways (which constitutes around 60 per cent of the off-pier coaching requirement at Heathrow) wished to continue operating its own coach service. After exploring several options with Heathrow AOC, it had been agreed that HAL would manage the competitive tender of the off-pier coaching operation and provide surety to the selected operator for the purchase or lease of new vehicles.

14.85. BAA said that it operated a non-discriminatory stand allocation policy, the objective of which was to maximize the number of passengers receiving pier service. Generally, a slightly higher proportion of passengers than ATMs received pier service (for example, at Heathrow in 1994/95 93 per cent of passengers and 91 per cent of ATMs were pier-served), so it was slightly more likely for a small aircraft to require coaching. This was reasonable since it was operationally easier to coach passengers for a small aircraft than a large one. There was no discrimination in stand allocation in favour of national carriers. For example, in 1995 94.4 per cent of passengers on British carriers at Gatwick received pier service, compared with 99.1 per cent of passengers on US carriers.

Other facilities

14.86. BAA said that the provision of transport for special needs passengers was traditionally the responsibility of airlines. There were currently two services at Heathrow: one provided by British Airways, and another by Heathrow AOC. After consultations it became apparent that Heathrow AOC's proposal to incorporate these services into airport charges did not have the approval of all airlines (notably British Airways), and in any case HAL involvement would not reduce the costs of the Heathrow AOC's operation, so changes to the arrangements had not been pursued.

Investment

Failure to invest

14.87. BAA repeated that it had invested more (in real terms) than forecast at the 1991 review. Airlines appeared to be concerned about underinvestment in essential operational equipment, but quoted only transfer baggage facilities, where, BAA contended, problems were due to the unforeseen and rapid rise in the number of transfer passengers and inefficiencies in airline procedures as described above.

14.88. BAA said that if airlines wanted a particular investment, they should be prepared to pay a price which provided a fair return to investors. The system was frustrated only where either the beneficiaries were not those paying for the facility, or if the regulator forced the level of charges below that which would justify the projects (despite the users' preference for more investment, albeit with higher charges).

14.89. If there were benefits to airlines from additional capital projects which were far in excess of costs, either the projects could be added to the capital plan and remunerated through airport charges (and BAA had received no suggestions to this effect) or airlines would pay an additional charge for use of enhanced facilities. BAA emphasized that additions to its capital plan could not be managed unless either the value of X was set at a level to permit BAA to receive reasonable returns and maintain prudent financial ratios or else such projects could be made to be attractive in their own right through an additional specific charge.

Poor-quality investment

14.90. BAA said that Victor Pier was provided, at the request of British Airways, to provide pier service to stands which had been designated remote since the terminal was built in the early 1980s. BAA knew that it would get low usage from the pier because of the long walking distances, and therefore set a limit on the expenditure it was prepared to make. Its length was governed by the stand layout which catered for wide aircraft with large wingspans. It said that the external design and appearance of the structure was not attractive, but substantial further expenditure was unlikely to be an airline priority since this would not reduce the length of the pier or increase pier service.

14.91. Pier 4A was a temporary structure which would be demolished as part of the works necessary to accommodate new-generation large aircraft after the turn of the century, and the QSM scores of passengers arriving from the Republic of Ireland were higher than for Terminal 1 as a whole. Charlie Pier in Terminal 1 was an old structure, which would be redeveloped in Q4 as part of the Central Terminal Area redevelopment, and, BAA said, major expenditure now would be difficult to justify. DOT requirements demanding segregation of arriving and departing passengers for all new piers made major modifications to existing structures very expensive. Finally, redevelopment of the domestic pier at Gatwick was envisaged within the capital budget.

Consultation

14.92. BAA said that airlines were consulted in detail on each project in the investment programme. Where the projects were not planned to start for several years, the consultation might only be on the broad concept, but, as the project moved into the design stage, consultations became more detailed. For those projects which were closer to execution, such as for hold baggage screening, specific working groups were established with airlines. Every year airlines were provided with an analysis of the total capital programme for the forthcoming three years in the document *Investments and Issues*. BAA consulted AOCs on the 12-year programme, but also the IATA, the International Association of Charter Airlines, the ATA, BATA, ABTA and a whole range of airlines, through the Joint Charges Forum and the South East Airports Group.

14.93. Notwithstanding BAA's view that it had done all it reasonably could to achieve a dialogue on the capital programme, BAA told us that it had arranged a separate meeting with airlines to try to identify their problems and provide for reinforced consultations in the future. It had proposed to update the capital programme each year and consult airlines upon it, highlighting any revisions and the nature of those changes. Consultation would take place with airline charges experts, through the AOCs and the South East Airports Group. Airlines had said that they were satisfied with this approach.

Airport charges

14.94. Following the arbitration between the UK and US Governments on user charges at Heathrow in 1991, BAA told us that it consulted airlines on the future structure of charges. During this consultation process, airlines were largely unanimous in supporting the elimination of peak passenger charges and agreed with BAA's suggestion that the equalization process would have to be phased in over a period of years, although they disagreed markedly on the length of time this process should take. Carriers with mainly off-peak activity wanted a longer equalization process than those with a higher proportion of activity in the peak. BAA had proposed a four-year equalization period which was incorporated in the settlement of the UK/US Government dispute in March 1994. The process had produced an uneven pattern of change in the level of charge increases for each airline at the three airports in 1995/96 (when compared with 1994/95) and this would continue through to 1998/99. Significant increases were not confined to short-haul operators, but also affected long-haul operators with a high proportion of off-peak activity.

14.95. BAA said that fixed-rate landing charges at Heathrow had been part of the charging structure since 1985 and had been extensively reviewed by the CAA. The economic basis of the flat-rate charge was that of congestion pricing, where the opportunity cost of using the runway became the same for all aircraft regardless of size. The effect of flat-rate weight charges had significantly reduced the number of smaller aircraft using Heathrow, but many important feeder services to UK domestic points remained.

14.96. BAA said that Stansted covered its variable costs by a wide margin, so the fact that it was pricing below average total cost, therefore, not covering the costs of actual investment on a single year basis, did not distort competition. The bulk of Stansted's staff costs were essential, for example there were a number of fixed installations which had to be manned and maintained, such as the fire service, and these costs were fixed in the short and medium term. BAA had delayed investment in order to maintain the momentum towards break-even, and in favour of easing bottlenecks and improving services at Heathrow.

14.97. BAA said that it had fully refuted the question of whether there was an incentive for Stansted to charge low prices because extra traffic was, in practice, remunerated at the system rate. If BAA had been limited by the system cap and was obliged to charge below the cap at Heathrow and/or Gatwick, then there could have been an incentive to charge less than loss-minimizing prices at Stansted, since any traffic attracted from outside the BAA group would have generated income, not at the Stansted charge, but at the rate permitted by the system cap. In fact, BAA had been constrained by the Gatwick and Heathrow caps and not by the system cap.

14.98. On the question of whether BAA's ability to finance losses at Stansted had resulted in prices that were lower than they would otherwise have been, BAA did not dispute that the British Airports Authority had used its overall financial resources to invest in Stansted. With hindsight, the investment had been too large and too soon, mainly due to the larger throughput at Heathrow than forecast. BAA had responded by increasing investment at Heathrow and suspending further work on the first phase of Stansted and delaying further investment in capacity there. Had BAA sold Stansted (or given it away), the new owner would have had to price to attract and build up traffic in order to optimize the long-term return on assets. In other words it would have pursued a loss-minimization policy.

14.99. BAA said that it had differentiated between noisier and less noisy aircraft in its airport charging policy since 1980. It had gradually increased the surcharges over chapter 3 aircraft (on the basis of ICAO certifications) to 30 per cent for chapter 2 aircraft and 60 per cent for non-certified aircraft. As the industry moved to ICAO agreed phase-out of chapter 2 aircraft by 2002, the proportion of chapter 3 aircraft was rising swiftly. In December 1995 the ICAO failed to define any further regulatory criteria for aircraft with noise performance better than chapter 3 criteria. To begin to align the airport charging structure with the aircraft fleets, BAA (following consultations with airlines) implemented a 10 per cent rebate at Heathrow for aircraft which had noise characteristics significantly better than chapter 3 criteria from 1 April 1996 on a trial basis only.

Non-airport charges

Rents

14.100. BAA's views on rents are described in detail in Chapter 8. It was BAA's view that both the current rent levels and the rental movements which had occurred during Q2 were reasonable. At the start of Q2 there were some significant increases in certain rental levels at Heathrow, due in part to relaxation of the traffic distribution rules and the subsequent large increase in the number of airlines at Heathrow. The significant drop of rental levels off-airport as a result of oversupply were not applicable to the airport property market and airport rents moved ahead of declining off-airport rents.

14.101. BAA recognized in 1993 that in some cases rents had risen too quickly and took action at a cost to the company of approximately £1.5 million a year. Following this, a rental freeze for terminal accommodation was introduced holding property at 1993 prices until at least April 1996. The freeze did not apply to rents at their peak, as many rents had already been reduced in 1993 (as detailed above) by up to £15 per square foot. The freeze did not extend to property outside the Central Terminal Area and Terminal 4. In other areas BAA believed tenants had a genuine choice of renting space from either the airport company or from other landlords outside the airport boundary, creating an element of competition and ensuring that airport tenants paid genuine open market rents. Following a CAA ruling, BAA said that it had to tender all vacant transit sheds. This process gave an indication of market value which could be used as evidence at rent reviews. BAA recognized that variances existed between rental levels for transit sheds on- and off-airport, but it believed these were reasonable when all factors were taken into consideration (such as additional handling and transportation costs which were necessary off-airport and the existence of open

market rents). BAA now published rental guide prices for all types of property on the three airports to increase transparency.

14.102. BAA had also made a number of initiatives, termed `The Property Challenge', in part acknowledging the need to improve its property strategy (described in paragraph 8.57).

14.103. Over the last five years BAA had increased the supply of lettable space at the London airports by 1.3 million square feet, and had invested £10 million since 1993 on improving quality and providing an increased choice for tenants. It had plans to increase space further by developing the 43 acres released by British Airways.

14.104. BAA said that negotiations were currently under way between HAL/AOC Rents Group, on proposals to implement a mechanism for future rent increases for terminal and Central Terminal Area property, which would provide limits within which a negotiated settlement could be reached. The current freeze had been extended to 30 June 1996 while the negotiations continued.

14.105. In discussions, BAA said, airlines had made it clear that they wanted rent control for 1997 and thereafter. BAA had proposed a 4.5 per cent increase in average rents to apply from July 1996, but pegging high rents and bringing low rents up to a level appropriate to the accommodation. For the future, it had proposed a formula to guide future rent negotiations based on movements in relevant indices of traffic growth, the RPI, costs of construction and off-airport rents. Since airlines wanted a flexible approach, BAA had proposed a `cap and collar' band, with increases limited to a range between zero and twice the indexed figure. BAA said that it had initially been encouraged by airlines' responses, but surprised by subsequent criticism. Nevertheless, it hoped that there was scope for agreement.

14.106. It proposed a two-tier compliance system for this `voluntary restraint'. First, it would offer each year for external audit, information on the four indices, and how rents moved against those indices. This would be provided both to airlines and the CAA. If complaints arose these could be pursued under section 41 of the Airports Act. Secondly, BAA suggested an annual review of actual rental income against that forecast at the time the airport charging formula was set, with explanations of the differences, and with regular updates to the CAA and airlines. BAA added that if it were to act improperly, the matter could be determined by the CAA's response to any complaints under section 41 of the Airports Act. If the CAA was unhappy with the overall rent level, it could store that issue up to the next quinquennial review (although it would not be able to adjust the current working of the formula).

14.107. As far as check-in desk fees were concerned, these were not in airport charges under the terms of the Airports Act. It had consulted the IATA and airlines in September 1995 on whether check-in desk remuneration should continue as a separate charge or be included within aeronautical revenue, and the consensus of airlines present was for the status quo.

14.108. On long-term land leases, BAA said that British Airways and HAL had completed an agreement on 31 March 1995 to restructure long-term leases held by British Airways over 224 acres of BAA land at Heathrow. British Airways had requested an extension of the 60-year term to provide the basis on which to invest in modernized facilities in the years to come. HAL also responded to British Airways' request to modernize some of the restrictions which previously applied to the historic leases. In return, British Airways agreed to release 39 acres of development land back to general airport use. Far from distorting competition between airlines, BAA said, this restructuring provided opportunities for other airlines in a situation where there was a shortage of development land.

14.109. BAA said that it was almost impossible for it to allow third parties a free rein in developing facilities in or close to terminal buildings. With limited land availability the grant of exclusive occupation to one airline might effectively deny other airlines equivalent accommodation. It was important for BAA to control the development of facilities for several reasons, to ensure that: electrical, heating and ventilation and plumbing and other engineering systems were adequately protected and enhanced; BAA's planning guidelines were maintained; airlines were equally treated; and disruption to passengers and other airlines was minimized.

Licences

14.110. BAA said that its 6 per cent catering levy was effectively a payment for the right to trade on-airport and, as such, was a perfectly normal commercial practice with several examples in competitive markets. On-airport operators effectively purchased this right to trade through renting property within the airport perimeter (this might be conducted through a third party, but the rents would be passed on to the airlines via the charge for the particular product). Therefore, both on- and off-airport operators were effectively purchasing the right to trade and, as a result, there was no discrimination. BAA had consulted with the IATA and airlines on whether a separate levy should be retained or the revenue incorporated into airport charges. The consensus was for the status quo. BAA confirmed that it would not raise the percentage rate of the levy from 6 per cent during Q3. It would continue to apply only to caterers based off-airport. However, if caterers tried to avoid payment of the levy on the full value of meals, it might introduce anti-avoidance measures, such as the imputation of an average value for meals.

GASHCO

14.111. BAA said that GAL's agreement with GASHCO was a ground lease, and was originally granted to nine individual fuel companies, named collectively as the `consortium'. The consortium requested GAL grant approval for the assignment of the lease to GASHCO, a new company which subsequently incorporated the assets of the consortium in 1988. Under the terms of the lease, BAA said that consent to such an assignment could not have been unreasonably withheld and BAA's lawyers confirmed at the time that GAL was not in a position to withhold consent.

14.112. By negotiating with GASHCO, BAA said that it was able to incorporate in the assignment a provision allowing the airport to audit GASHCO's books to satisfy itself that the charges were reasonably related to cost. Further, by negotiation and at the request of some airlines, BAA persuaded GASHCO to reduce its throughput charge in the first year. Prior to the assignment to GASHCO, there had been no transparency in the charges to the airlines which also paid for the operation of the fuel farm as part of the overall charges for fuel. BAA and GASHCO were able to show separately the GASHCO throughput fee, the GAL concession fee, and the remaining cost of fuel.

Ground handling

14.113. BAA explained that HAL's handling policy was that any of the eight airlines with existing handling rights could supply a third party handling service to any airline in any terminal. BAA said that it would face major difficulties if it sought to remove handling rights (due to historical rights and bilateral air services agreements) from existing handling airlines without their consent. But, it submitted, there were too many handlers at Heathrow to achieve operational efficiency. As a result, its policy stated that new independent handlers would only be allowed if there was an overall reduction in the number of handlers. This could be carried out by two or more handling airlines voluntarily surrendering handling rights to the independent handler.

14.114. BAA believed four handlers at Gatwick had been more than the market could bear, particularly at a time when traffic was declining from 21 to 18 mppa, and this had led to competition based on unsustainable low prices and poor service. Inevitably, it said, one handler had to withdraw from the market for economic reasons. It thought three competing handlers produced enough incentive for reasonable prices to be offered, but when GAL's management felt the market was large enough or there was evidence of price distortion then it would consider appointing another handler.

14.115. BAA believed the total market at Stansted was sufficient to support two independent ramp handling operators and permitting Air UK to self-handle on the ramp would seriously undermine the viability of the two existing handlers. However, a third handler, which could be a self-handling airline, might be necessary when the airport reached 7 to 8 mppa.

Concessions

VAT cash refunds

14.116. BAA told us that at Heathrow and Gatwick there were single dedicated concessions for VAT refunds, operated by VATBACK and Fexco Limited respectively with contracts on a three-year term from 1 March 1996. The concessionaires were contractually required to process all refund vouchers, including those which had been issued by other VAT refund operators providing a `one-stop shop'. In BAA's view a multi-concession operation would mean that customers holding alternative vouchers would have to queue at each operator's desk to receive their refund, which would be inefficient, particularly because of the limited time available to passengers once they were airside.

14.117. Following a complaint to the OFT in April 1995 regarding the failure of the then concessionaire to process other operators' vouchers, BAA said that it had held discussions with the OFT and outlined proposals to tender a one-stop shop, which had received tacit approval. All interested parties were consulted and interviewed before the tender, and approved the concept of the one-stop shop. The new contracts required the concessionaire to operate in a non-discriminatory manner and ensure that all VAT cash refund vouchers would be accepted.

Sale of cut-price tickets at Gatwick

14.118. BAA said that Gatwick AOC had voted against tour operators being licensed to sell their products via their own desks at the airport. Alternative provisions were in place, however, whereby a passenger could take a referral form completed by the tour operator to the Gatwick Travel Shop (operated by Thomas Cook). The form enabled the tour operator to specify the exact price at which it would like the seat to be sold. The Gatwick Travel Shop was one of two travel agents located at the airport; the other was situated in the railway station (and was not a GAL concessionaire). GAL thought there was insufficient demand to justify another full service travel agent. The contract to operate the travel shop was a competitively tendered concession with a fixed term, and, under the terms of the `Retail Value Guarantee', it included a requirement for the concessionaire to reflect high street pricing.

Restrictions on employment agency staff

14.119. BAA imposed limits in August 1995 via an amendment to the Heathrow ground handling policy, which included a complete restriction on agency staff working in the airside ramp area. These limits were imposed following the discovery that some airlines were using employment agency staff to carry out complete handling functions, thereby circumventing BAA's handling policy. Under the terms of the new draft Heathrow ground handling policy, which was currently under discussion with Heathrow AOC, HAL hoped to be able to satisfy airport handlers' staffing requirements whilst meeting the concerns about the levels of commitment by ramp staff toward airside safety and security.

14.120. Gatwick AOC opposed airside access being granted to tour operator representatives, including providers of executive services or any other non-essential personnel.

Vehicle hire

14.121. BAA told us that six car rental companies provided services at Heathrow and Gatwick. Whilst competition between operators resulted in a wide range of prices, vehicles, service and quality standards, BAA ensured via its contracts with operators that customers were not charged in excess of operators' national tariffs. This contractual obligation was in place, it said, to prevent the application of airport surcharges. The recently-introduced car hire service fee at the London airports was, according to BAA, just such a surcharge. Concessionaires were aware of the operating costs and the significant opportunity afforded by airports for high-volume operations and took this into account when tendering for contracts and offering a concession percentage. The surcharge was, in BAA's view, a poorly disguised method of increasing their margins partway through the contract period, which penalized the customer.

14.122. Answering specific complaints, BAA said that levels of service and customer satisfaction for car hire (as recorded by QSM) were good and BAA did not accept the argument that longer contracts would lead to better levels of service. For any new car rental contract, BAA undertook to review financial terms with existing concessionaires. Off-airport operators that did not have a concession agreement with BAA were licensed to pick up and set down pre-booked customers at allocated zones in the terminals and had no opportunity to tout for business amongst arriving passengers.

Central London duty-free shop

14.123. BAA said that it had explored opportunities to open a downtown duty-free and tax-free shop, but had no finalized plans. It did not have any objection in principle to other operators opening pick-up points on airport, provided the financial terms were consistent with normal concession agreements in terms of margin and space productivity.

Balance between commercial and operational investment

14.124. BAA said that expenditure on projects solely for retail use during Q2 amounted to some £35 million, while expenditure on projects attributable solely to airport charges or with no income stream came to about £350 million. Other commercial projects totalled almost £130 million. Of the projects with a mixture of uses, many involved very little expenditure on retail, such as Terminal 5, the Flight Connection Centre, Europier, Heathrow Express and the Stansted development.

14.125. BAA said that retail revenue streams had two advantages for airlines. Its contribution to the single till allowed traffic charges to be half what they would otherwise be. It also allowed projects which would enhance service or capacity to be carried out because of an attractive overall rate of return. For example, departure lounge and check-in areas had been expanded or improved on the back of comparatively low-cost commercial projects.

14.126. Nevertheless, BAA said, it had still managed to invest heavily in purely operational areas such as pier extensions and enhancements, hold baggage screening, new baggage systems and facilities for transfer passengers. This was in addition to the major projects such as the Heathrow Express and the new terminal at Stansted.

14.127. The new Terminal 1 departure lounge was, in BAA's view, an example of a project combining significant improvements in operational and commercial facilities for passengers. The number of seats, for example, increased from 830 to 1,900 as a result of the project. Passengers appreciated the choice and quality of the retail facilities, which enhanced their `airport experience'. BAA said that there was no evidence that retail facilities delayed passengers, and pointed to a BAA survey which showed that only 1 to 2 per cent of passengers reporting late to their gateroom were delayed in a shop or catering outlet.

14.128. BAA said that there were seven airline information desks in the new Terminal 1 lounge (operated by British Airways, British Midland, and Aer Lingus), located prominently and with unobstructed lines of sight near the exit to the pier. British Airways had proposed locating a desk for its exclusive use under the spiral staircase leading to the catering balcony. This was rejected on design grounds

as it would have blocked passengers' lines of sight and impeded flows, and BAA had kept the site undeveloped for these reasons.

14.129. British Airways had proposed, as a concept, a link from the high-yield check-in area to its CIP lounge in Terminal 4. This would have served only British Airways' high-yield passengers and could not have been replicated for other airlines, thus distorting competition. It would have also created an inefficient split security search operation, with low staff utilization for BAA.

14.130. BAA had recently reviewed its signage design, wording and use of pictograms, paying particular attention to visibility and legibility and including the special needs of visually-impaired passengers. Since late 1994 all new areas had incorporated the new style signing and existing areas were being upgraded on a phased basis.

14.131. The standard rental agreement for CIP lounges contained a clause reserving BAA's right to install an unmanned duty-free promotional site within the lounge. BAA had never exercised this right, however.

D J MORRIS *(Chairman)*

J BEATSON

R LYONS

M R PROSSER

G H STACY

G WHITTINGTON

A J NIEDUSZYNSKI *(Secretary)*

10 June 1996