Interim submission by BA to the CAA for the final Q6 proposals: Capex commitments

1. Introduction

1.1 This note is an interim submission by British Airways to the CAA's final Q6 proposals for Gatwick Airport. It concerns the absence of any capex commitments under GAL's proposed Commitments.

1.2 BA has previously set out its concerns with the Commitments approach and explained why we believe a RAB based settlement is necessary to constrain GAL's market power and why that would better serve the passenger interest. Nevertheless, and without prejudice to our position, we thought it would be helpful to set out a particular concern that we have with the absence of commitment to capex outputs in the Commitments.

1.3 We have also contributed to an ACC interim position paper, submitted on 22nd October, which covers concerns over particular Commitments terms. Our final response to the CAA consultation will also set out why we consider the Commitments price to be excessive and inefficient.

2. The absence of any Capex Commitments

2.1 The CAA calculations of a "fair price" were based on an assumption that GAL would spend £791m over 5 years, or £1144m over 7 years under the "core" programme. This is equivalent to an average of £158.2m over 5 years or £163.4m over 7 years. This compares with GAL's "Commitment" to spend only £100m a year on average over the 7 year Commitments period.

2.2 This means that under a Commitments regime, GAL could, at its complete discretion, reduce the proposed capex programme by 39% without any loss of income. If this reduction was made under a RAB based settlement, rebates would have to be made either under a core/development approach, or with traditional triggers. Furthermore, under Commitments, future profits would not be related to the company's capital assets, so there would be a strong financial incentive to under-invest, where GAL would not suffer financial disadvantage.

2.3 For example, it is highly likely that GAL would choose not to build P6 because the formal PSL standard is likely to be met. To offset longer term risks, or risks associated with unforeseen circumstances, by careful stand planning they could increase required towing to achieve higher PSL. Handlers might ultimately not be able to achieve these towing levels and as a result tows would be refused. GAL would then point at the conditions of use, which they have unilaterally changed so as not to pay off pier rebates for flights where tows have been refused by our agents. The result is that even if GAL were to fail the PSL, which seems unlikely, they could require airlines to resolve the problem at their own expense. Beyond the 7 year Commitments period, there is no guarantee that the 95% PSL would endure.

2.4 The Commitments approach would also make it likely that GAL would skew any investment towards projects that delivered incremental commercial revenues, which would be uncapped, or towards projects that reduced their own operating costs.

2.5 While the service quality regime would put some pressure on the airport to invest in areas where the service quality standards would otherwise fail, it is clear that the relatively modest cost of failure could be insufficient to support a business case involving significant investment. In any case, many such investments are not related directly to SQR standards.

2.6 We accept that a RAB based approach can over-incentivise capex development in a way that is inefficient and adverse to passenger interests. This is not an intrinsic problem with a RAB based approach, but results from particular regulatory decisions, including a tendancy to allow for almost all capex proposed by the company and by setting a generous cost of capital that exceeds the company's underlying cost of capital, allowing the airport to profit from the difference. Under a RAB approach, neither triggers nor a core/development approach penalise an airport for failing to carry out inefficient investment, as these mechanisms are designed simply to return some of the expenditure the airport has not incurred and/or to allow investment to be redirected to more worthwhile projects. Therefore the CAA already has tools to constrain inefficient investment under a RAB approach, while still providing incentives to invest where GAL themselves otherwise receive no direct benefit. There is a very strong case, for example, for including the P6S project as "development" rather than core, given the large uncertainty surrounding this project, thereby removing it from the price calculation.

2.7 Under Commitments, the significant financial benefits of either delaying or reducing investment (compared with the programme on which the CAA has assessed its fair price) would accrue to GAL's shareholders in its entirety, whereas the costs of delay or reduced outputs/standards would be incurred by airlines and their passengers. It is difficult to see how this would be in the interests of passengers.

2.8 There is a further risk that GAL might be able to compel airlines to pay more because they are not obliged to make any investment or to meet any deadline. They might therefore say that investment X would proceed only if airlines agreed to increase the Commitments price by Y or if particular airlines agreed to pay Z more under bilateral agreements. GAL could therefore exploit its market power by compelling airlines to pay extra for something, even when it has been included within the agreed capex programme.

3. Capex controls under a Commitments regime

3.1 BA considers that the risk of capex underspend is best mitigated by retaining the RAB based approach and adjusting regulatory decisions to reduce incentives to overinvest, especially the cost of capital and the decision to allow all investment into the RAB, even where inefficient. However, if a Commitments based approach is adopted, GAL should include Commitments to deliver projects that are important to customers and to rebate savings made from cancelled, reduced or delayed projects.

3.2 The obvious approach would be to replicate a simplified version of capex triggers in the Commitments, focusing on certain categories of projects, including those:
(a) where there is high risk of cancellation (such as Pier 6 south[1]); and
(b) where there are benefits to users but little or no financial benefit to the airport (eg the Early bag store); and
(c) where GAL would have incentives to delay/reduce projects without being constrained by the SQR regime (eg upgrading of check-in areas).

[1] BA does not support the P6S project. However, if the Commitments/fair price is based on building it, GAL should either commit to deliver it or compensate airlines if they decide not to. Including a capex commitment would require them to negotiate with airlines when they are ready to decide. If GAL is not prepared to commit to the investment, the Commitments price should be reduced accordingly and there would be no commitment.

3.3 Under a simplified triggers approach, the Commitments would include, for each project, at least:
a) the date for beneficial use;
b) key outputs/dimensions (eg 3,000 bag capacity for the Early Bag store); and
c) rebate amounts for cancellation and delay.

3.4 Delay rebates would be based on established Q5 trigger sums. Cancelled projects should return the full costs as per the CAA calculations for a fair price. Projects where outputs are reduced should return a reasonable proportion of the cancellation amount, reflecting the savings made.

3.5 The amendment provision, set out in Paragraph 6 of Schedule 2 to Schedule 1 of the Conditions of Use, could be used to vary the capex commitments with airline agreement. The airport would also have the option to request a licence change using Airports Act provisions. Therefore the capex commitments would provide the necessary flexibility to alter the Commitments where appropriate in the light of changing commercial circumstances.