ANNEX C

Europe Economics' report for CAA, Advice on the application of long run incremental cost estimates for Gatwick and Stansted, December 2012

Comments by M.A.G

Introduction

1. This purpose of this note is to provide high level comments on Europe Economics' (**EE**) estimate of the Long Run Incremental Cost (LRIC) for Stansted airport. It does not address wider issues in the EE report, such as the use of LRIC in other sectors, and the advantages and disadvantages of using a LRIC based approach to inform estimates of the competitive price for Stansted.

Summary

2. Our views on EE's LRIC estimate can be summarized as follows:

   (a) We note EE's reference (page 32) to the CC's view that the appropriate increment for setting price caps at Stansted should be "*the entire airport (cost of a new Greenfield airport) or SG2 as a proxy for the cost of building a new airport and then apply this cap to all assets at Stansted, existing and new*". We also note EE's view (page 68) that the most appropriate increment would be a 'whole service' increment – this is assumed to be the modern equivalent asset value of Stansted airport on the existing site, with a capacity of 35mppa. EE also state (page 32) that the CC's view is broadly in line with theirs, "*although using a new runway and terminal as a proxy for the whole airport would depend on evidence that customers are willing to pay for the additional capacity*".

   (b) We agree with EE and the CC on the issue of the appropriate increment. In this note we have focused on EE's estimate of Stansted's LRIC based on Increment Four (modern equivalent asset replacement of 35mppa facility), although we consider that EE's Increment Two (SG2) is also an appropriate indicator of Stansted's LRIC.

   (c) We note that any assessment such as this is entirely dependent on the reasonableness of the principal assumptions. EE's sensitivity tests (pages 115-118) show that the estimates of LRIC are highly sensitive to a range of variables. As such, estimates of LRIC need to be treated with caution, and can only be one input to any assessment of the reasonableness of airport pricing. This is consistent with EE's own view (page 43) that "*Before any price limits were set on the basis of a LRIC calculation, the input assumptions would need to be subject to greater scrutiny*".

   (d) As yet, we have not undertaken a detailed analysis of EE's assessment of Stansted's LRIC. However, we have an immediate and fundamental concern that the simplifying assumptions used by EE in their assessment of the LRIC for Increment Four – which they consider to be the most appropriate increment – bias the result downwards by a material degree. In particular, EE's assumptions on traffic growth towards full capacity are totally unrealistic and (as shown in EE's own sensitivity tests) a more balanced approach to this issue would be expected to lead to a materially higher estimate of LRIC. The remainder of this note focuses on this single issue and its implications.

Comments

3. EE's Increment Four is based on constructing a new airport (Modern Equivalent Asset - **MEA**) on the existing site, in a single phase with a capacity of 35mppa. Further, it is assumed that the airport opens in 2016/17, operating immediately at full capacity of 35mppa throughout its economic life. Based on these (and other) assumptions, EE calculate the LRIC as £6.28 per passenger.

4. We have not yet considered the totality of EE's assumptions. However, it is clear from EE's own sensitivity tests that their simplifying assumption that the replacement airport is operating at full capacity throughout its economic life has a material impact on the assessment of LRIC. EE show the results of a sensitivity test under which traffic at the replacement airport grows from currently forecast levels (in 2016/17) towards full capacity of 35mppa (or alternatively if the building of the new airport is delayed until traffic has reached 35mppa). According to EE this increases the assessment of LRIC from £6.28 to £7.48 (+19%).

5. Even this sensitivity test is reflective of an unrealistic scenario, albeit less unrealistic than the base scenario. If the objective of the exercise is to estimate the average incremental cost of constructing a new airport, then it must reflect the market reality that any airport will grow gradually from an initial position on opening. A reasonable starting point would be the historic traffic growth of Stansted itself, which at the time the new terminal opened in 1991 was handling less than 2 mppa. Such a pattern of traffic build-up would inevitably have a material impact on the present value of revenues (aero and non-aero), offset to some extent by a lower PV of operating costs. This would be expected to give rise to a much higher estimate of LRIC. An efficient developer/operator would seek to offset this by phasing the development of the airport, leading to a lower PV of capex. However, capex in building a new airport is inevitably front-loaded (the runway and much of the taxiway and roads system have to built first, along with a 'starter set' of terminal and support facilities), such that the compensating impact on LRIC would be expected to be more limited. Taking into account the slower traffic growth and the phasing of capex, it seems highly likely that the resulting estimate of LRIC would be even higher than EE's sensitivity test of £7.48.

6. We are also concerned that EE's simplifying assumptions on the capital costs of an MEA replacement for Stansted may understate (or not include) the material preparatory, planning, surface access & connection costs that are necessary for any new major airport development. A thorough review of these and other assumptions is required before the EE report could be regarded as sufficiently robust to be used in the context of a price control process.

7. We also note EE's acknowledgement (page 50) that a LRIC estimate based on an MEA approach would be expected to be higher than a RAB-based price cap. EE accept that the principal reason why their analysis produces a counter-intuitive result is their assumption on traffic growth (they also acknowledge that they have adopted an inconsistent traffic growth assumption for Increment Four as compared with their other LRIC Increments). This further reinforces the unrealistic nature of EE's point estimate.

8. We therefore suggest that a more realistic scenario would be for EE to amend their Increment Four to reflect a phased development of an (efficiently designed) 35mppa facility, in line with the historic (and forecast) traffic growth of Stansted. This will inevitably require some high level

assumptions about the phasing of capex (etc), but we feel that such an approach (however flawed) is bound to give a more realistic indication of LRIC than is currently shown in EE's report.

9. In the absence of such a scenario little reliance can be placed on the LRIC estimates in EE's report. Should a single point estimate of LRIC be required, a lower bound for such an estimate would be the EE sensitivity test of £7.48, based on a phased build-up of traffic to 35mppa. The use of any lower figure would clearly be flawed as it does not reflect the fundamental dynamics of airport development as represented, indeed, by Stansted's own experience.

10. More generally, EE's estimates of LRIC are based on an implicit assumption that the price profile reflects a constant (real) yield per passenger throughout the economic life of the asset. Of course, this is only one of a range of potential price profiles. Indeed the CAA has noted the potential for prices to vary over time "*around a long term average level*", and that this variation "*may limit the ability to determine the competitive price level with a significant degree of accuracy*".[1] In a competitive market it might be expected for prices to be set at low levels (i.e. below the average LRAIC) during the early years of an airport (where there is substantial spare capacity), rising over time to above-LRAIC levels such that over the project's total economic life the cost of capital is achieved. In the case of Stansted, for example, very low returns (below the weighted average cost of capital) have been observed since the airport's opening in 1991. A refinement of EE's analysis might usefully include consideration of alternative price profiles, and how these might be used to show ranges of pricing against which Stansted's current yields can be compared. It would also be helpful for the CAA to provide further guidance as to how such issues of price profiling around a long term average level might be taken into account in assessing the reasonableness of an airport's prices and the comparison with (and determination of) the competitive price level.

[1] Guidance on the Assessment of Market Power, CAA April 2011 (paragraph 3.17).