

CAA policy update for the Q6 airport price control review

Response by British Airways, 16 July 2012

Background – about British Airways

British Airways is one of the world's largest airlines, carrying approximately 32 million passengers worldwide annually on around 750 daily flights. We employ around 39,000 people, the vast majority of these at sites throughout the UK, and have an annual turnover of around £8.5 billion.

The airline's two main operating bases are London's Heathrow and Gatwick airports, with a smaller base at London City Airport serving New York and European destinations. From these three bases, British Airways flies 237 aircraft to 152 destinations in 75 countries. In addition to its passengers, the airline also transports cargo – more than 750,000 tonnes around the globe each year.

In 2010 BA completed its merger with Iberia of Spain to create the International Airlines Group (IAG). Our combined business offers flights to 205 destinations throughout the world on a fleet of 415 aircraft. We have also commenced a joint business agreement with American Airlines (AA), which further extends benefits for our customers. The combined network of BA, Iberia and AA serves 433 destinations in 105 countries with more than 5,180 daily departures.

Introduction

As a major operator at both Heathrow and Gatwick airports, British Airways understands the importance of the regulatory regime in ensuring the best possible outcomes for our passengers. Our primary objective for Q6 has always been, and remains, to secure an outcome that delivers meaningful benefits for our passengers at a price that they are willing to pay.

As such, British Airways wishes to play an active and constructive role in the Q6 process and welcomes any opportunity to engage meaningfully with the

regulated airports. To be clear, we do not see Constructive Engagement as a zero sum game. We are clear in our view that we wish, and indeed require for the sustainability of our own business, that the regulated airports are profitable, sustainable, and competitive.

We also welcome the opportunity to respond to this Consultation Document and the opportunity to continue our constructive dialogue with the CAA.

Finally, and for the sake of clarity, we wish to point out that bmi is now a wholly owned subsidiary of British Airways. This response, made by British Airways should also be viewed by the CAA as a response on behalf of bmi. If there is any conflict or inconsistency between the views expressed in this document and those previously submitted by bmi, then the CAA should give weight only to the views of British Airways.

Chapter 2 – Impact of the Government’s reform of economic regulation

Question 1: How should the CAA develop a strategy for airport licensing?

British Airways recognises that the CAA is at an early stage in considering the development of airport licences and we welcome the opportunity to participate in this process. We would also be keen to continue to engage with the CAA as their thinking on the draft licences continues to mature.

Evolutionary approach

In principle, we are supportive of an evolutionary approach. However, it is important that stakeholders in the industry are given as much clarity as possible about what the airports’ final licences will look like. The aim in doing this would be to minimise uncertainty.

Where licence conditions do not begin at the licence introduction date, certainty will be aided if there is a clear start date or set of circumstances that would trigger these additional conditions. The Ofgem approach provides a

useful case in point here. Ofgem has developed standard licence conditions to cover the obligations of its licensees as a group. Different sections of these conditions (or even particular conditions) may be switched on or off so that they apply or do not apply in each licence. This provides certainty about what each licence condition looks like but then gives the regulator flexibility in the application of these conditions.¹

Any review of licence conditions should not be ad hoc. For example, licence conditions could be reviewed at the same time as the price control process is taking place and stakeholders should be given an opportunity to feed into the process.

The inclusion or absence of licence conditions and modifications of licence conditions should also be subject to appeal to the Competition Commission by both licence holders and providers of air transport services whose interests are materially affected by the decision. This will provide an additional means by which licence conditions will evolve over time.

Best practice

In our view, an effective licensing regime must:

- ensure the standard of service provided to customers;
- limit regulatory risk; and
- minimise the costs of compliance.

¹ See for more discussion Ofgem (2008) “Modifications of electricity transmission standard licence conditions – way forward document”

As with other areas of regulation, it is likely that these goals involve a trade off and will need to be balanced in a way that furthers the interests of users of air transport services, as the CAA's likely primary duty.²

To ensure the licence conditions further the interests of users, there will need to be effective consultation during the decision making process.

The good regulation principles contained in Section 21 of the Legislative and Regulatory Reform Act 2006 should also be a useful in developing licence conditions. In particular, conditions should be transparent, provide accountability, be proportionate and consistent and should be targeted only at cases in which action is needed.

Chapter 3 – Ensuring Q6 is passenger focused

Question 2: How can the CAA ensure that its review of economic regulation is passenger focused?

Before addressing the CAA's questions in this Chapter, it is important to state that British Airways supports the CAA's rebuttable position that passenger interests align with those of the airlines. British Airways operates in a highly competitive market, and as such, understanding and delivering for our passengers is both the central focus and the lifeblood of our business.

We also note that those who have sought to challenge the CAA's position have only been able to produce a small number of theoretical curios to support their position, and that none of them have any basis in fact. And indeed where there is evidence, it actively contradicts these highly theoretical examples.

² These objectives are drawn from work by the regulator in Western Australia, the Economic Regulation Authority (ERA). See ERA(2006) "Best Practice Utility Licensing"

British Airways invest a great deal of time and energy in understanding and delivering for our passengers. We have already shared our vision of the airport of tomorrow (our Airport Futures initiative) with the CAA, along with how we gather and understand the views of our passengers.

The CAA have already made several visits to understand our customer focus, and we look forward to continuing our open and constructive dialogue with them.

Establishing the passenger's interests:

As the CAA indicate, establishing and understanding the need and interests of "the passenger" does not lead to a single answer – as passenger's needs vary between individuals, and an individual's needs vary from journey to journey.

However, there is a strongly established alignment between the interests of airlines and the interest of the passenger. No single organisation is able to speak on behalf of every passenger at each of the regulated airports. However as the largest airline, operating from three terminals at Heathrow, with a commensurately broad passenger base, a parallel may be drawn between the needs of British Airway's passengers and the needs of Heathrow's passengers.

We receive detailed feedback on our products and service from more than 400,000 passengers a year. We achieve this through a number of different channels. British Airway's primary tool in understanding our passenger's experience and expectations is our "Think Customer Survey". This is one of the largest passenger surveys in the UK, including onboard and online surveys. Passenger feedback is also gathered from our customer relations teams, our colleagues serving our passengers across the world, our 2.8 million Executive Club members, our Travel Advisory Board comprised of key influencers and stakeholders across a range of sectors and from our global

account management teams selling the British Airways product around the world.

At a full service airport, like Heathrow, there is a need for a reliable base level of passenger service provided by the airport as part of the passenger's airfare.

Airlines can help agree the core targets and measurements that will ensure passengers' key priorities are met in key elements of the airport journey, examples include

- Speed through security
- Welcome and friendliness of passenger facing staff
- Cleanliness of airport facilities
- Way finding and ease of getting to their departure gate
- Lighting
- Air conditioning/heating throughout customer areas
- Pier service availability
- Reliability of connecting between flights (both passenger & baggage)
- Passenger flow within the airport

Having a set of commonly agreed and delivered targets campus wide, would in addition to supporting the role of Heathrow as a hub airport, ensure passengers receive a common, acceptable level of service as a minimum regardless of airline. Higher differentiated levels of service can be agreed on a bilateral basis where additional levels of service are needed.

We must ensure that the regulatory approach facilitates the passenger needs of today without it blocking or impeding the delivery of future passenger expectations by slowing the delivery of change.

Recommendations to ensure economic regulation can be passenger focused

Airlines are regulated by the market and will naturally lose market share to competing airlines if they don't deliver what the passenger wants at the right price. Focusing on the airport delivered products and services e.g. welcome and friendliness of security staff, which don't answer to the market, should remain central to the CAA approach.

Question 3: How can regulatory incentives towards service quality be improved?

Before discussing the existing service quality (SQ) regime and how it might be improved it is important to be clear where the current regime came from and the objectives that airlines and their customers hope that it will achieve.

The current regime has its roots in public interest findings made by the Competition Commission (CC) against BAA. In short, and to paraphrase, the CC found that in the absence of regulation, the regulated airports had abused their dominant position by providing an inadequate standard of service.

The current SQ regime was put in place to ensure that regulated airports deliver the quality of service that airlines and their passengers pay for and expect. It is certainly true that at Heathrow and Gatwick at least, the prospect of paying rebates has sharpened the focus of the airport operators and service standards have improved. To the extent that this is true, we believe that the current regime has been successful.

British Airway's primary objective in examining the SQ regime is that the airport operator provides us and our passengers with the level of service that we have paid for, that will allow us to provide the service our passengers expect on time and to cost. To be absolutely clear, our interest is securing this agreed level of service rather than securing a rebate. We are committed to providing our passengers with the first class experience that they expect when they book with us, and in that context a rebate from the airport for failing to provide a service properly is a poor substitute, for both us, and more importantly, our passengers.

In our view, the SQ regime should have two attributes: it should cover all those services that are essential (whether they face the passenger or the airline) to facilitate the smooth running of an airline (ie delivering the passenger experience); and that the standards should be set to ensure a consistent base level of service across the airport. If subsequent to that, airlines wish to differentiate themselves from their competitors by buying additional services, then they should be free to do so, provided of course that in those negotiations, the airport does not abuse its dominant position.

In terms of the CAA's potential areas for improving the SQR scheme:

- i. Priorities and simplification: British Airways believes that the SQ regime should cover all of the key features of the airport provision (whether it be passenger or airline facing) which are critical to the airlines providing an effective, efficient service to the passenger. As such we believe that the coverage of the current regime (with perhaps the odd omission) is about right.

To simplify the regime by removing elements of it would, in our view, both undermine the public interest remedy proposed by the CAA, but also leave passengers exposed to abuse by airport owners with substantial market power.

It would be a misunderstanding of the regime to argue that any one element of the regime is more important than the other, as we require all of the elements within the regime to work properly in order for us to deliver for our passengers. The SQ regime provides assurance that the critical elements making up a baseline of service will be provided across the airport.

If the CAA were interested in further sharpening the incentives then perhaps a preferable approach would be to increase the amounts of money at risk on each measure.

- ii. Greater flexibility to respond to shifting priorities: In principle, British Airways would support measures which improve the flexibility of the regime, and the ability for the CAA to ensure that interventions are targeted where they are needed most. However, we question how pragmatic it might be to apply additional flexibility to the SQ regime. So for example:
- a. how would changes to the regime targets be fed through into opex and capex programmes and the overall level of the price cap?; and
 - b. the regime is designed to ensure an appropriate level of service is provided by the airport both directly to the passenger, and to the airlines. If the regime varies according to changing passenger priorities it would miss key features such as the functioning of control posts and staff search. Would airline suggestions of hanged priorities be considered?
- iii. Strength and balance of financial incentives: The establishment of bonuses would be to misunderstand the purpose of the regime. The regime is there to ensure a level of service from the airport that allows us to ensure that each of our passengers move easily through the airport, boards our aircraft on time and that the aircraft, passenger, and their bags leave on time. As such the service standards are set to ensure that this can happen. An improvement in say toilet cleanliness above the standard, whilst welcomed does not fundamentally affect what the regime is for ie it does not markedly improve the passenger experience or help us get them away on time. It is British Airways firm view that bonuses have no place within the SQ regime.

If however, the CAA were to further develop the concept of bonuses then we would argue that the principle of symmetry should apply. At present the rebate scheme does not compensate the passenger or airline fully for the cost of service non-delivery. We would argue that if the airport was to be rewarded for what we regard as positive, but unnecessary 'outperformance', then it should also be punished for failing to meet those targets, or at least bear the full costs of its failure. Consequently we would see the introduction of bonuses as being consistent only with the introduction of penalties.

- iv. Balance between passenger facing and airline facing targets: British Airways agrees with the CAA that in practice this distinction is likely to be spurious. However, in some respects it is helpful to maintain the separation. For example there are many features of the SQ regime (for example control posts and staff search) which the passenger does not see (and would therefore be missed if the regime focused purely on passenger feedback) but would have a serious impact on the passenger experience if the level of service in the regime was not provided.
- v. Balance between objective and subjective measures: In our view the regime should be based on measures that are as objective as possible. It is imperative that the regime and its application is transparent, objective and auditable. That is not to say that there is not a place for subjective measures as these too form part of the regime.

However, in our view, the purpose of the regime is to ensure that the regulated airports deliver critical services to passengers and airlines in order to allow the airlines to operate effectively on behalf of their passengers. This purpose lends itself, where it is possible to collect data, to an objective decision – either the service is provided or it is not.

In addition, objective measures have the benefits of transparency, auditability and fairness, which we believe are key components for a successful regime.

Furthermore, although the perceptions and feedback of our customers is critical to us, British Airways would not want to see the objective elements of the regime diluted with subjective tests. So for example, we fully reject HAL's proposal for a hybrid service standard around central search. To paraphrase the proposal HAL argue that they could marginally fail the objective measure but a 'fail' would not be logged if passenger perceptions of the queue did not fall below a certain standard. For completeness HAL also propose a 'fail' if there is a marginal objective pass but a subjective fail.

To us, this seems to misunderstand the purpose of the regime at the airport. The critical path here is that the passenger moves seamlessly through the airport with the minimum of disruption to catch their flight, which leaves on time. To emphasise the point, it seems to miss the point to us, that a passenger could spend so long in central search that they miss their flight (arguably a larger negative experience) but that HAL pass the standard because the passengers enjoyed the entertainers HAL had provided to entertain the queue.

- vi. Operational Resilience: British Airways supports the CAA's view that improving the passenger experience should also mean improving the airport's resilience to disruption. However, this does not mean that our passengers should write HAL or GAL an open cheque. The CAA's emphasis should be on ensuring that the regulated airports operate efficiently and effectively and recover from disruption in the same manner that a competitive airport would. The airlines have invested heavily in equipment

at airports to deal with snow disruption in recent years, and within the overall context of affordability, the emphasis should now be on the airports to demonstrate that they can operate them effectively and recover from disruption efficiently.

- vii. Continuous improvement: British Airways agrees with the CAA that the SQ regime should encourage a performance culture rather than regulatory compliance. Whilst we support the current regime, it is also true that culture within the airport operators could be improved still further. So for example, and anecdotally, when referring to central search performance we often hear language such as 'x more fails allowed this month' rather than language associated with delivering for the passenger.

- viii. Competitive equivalence: in the context of the new regulatory regime that is likely to be used to set Q6, we are unclear quite what competitive equivalence means in practice. However, in the context of SQ, British Airways believe that the regime should set a base level of service by the airport, and that this level should apply across the whole airfield and in each terminal. All airlines at a regulated airport should be assured of the same basic level of service.

Encouraging sector-wide collaboration

British Airways shares the CAA's objective of improving the end-to-end passenger experience. Indeed, our Chief Executive has already written to the CEOs of the CAA, HAL and GAL to suggest such an initiative.

However, British Airways believes that there is a distinction, and indeed a clear separation needs to be maintained, between things that we might like to improve on the end-to-end passenger experience in the Q6 period (ie 2014-2019), and things which can be done within the Q6 settlement.

It is our view that in the context of aviation, that economic regulation is intended solely and unambiguously for the containment of substantial market power exercised by the designated airports. Consequently the focus of the Q6 settlement should be exclusively on the goods, services and prices of the designated airports.

However, this does not undermine our commitment to improving the end-to-end experience of our customers, and we remain committed to working with the CAA, the regulated airports and others to achieve this objective outside of the regulatory settlement and process.

Improving airport/airline governance

British Airways welcomes and supports the intentions behind the CAA's statement in this section. We would welcome a statement in the licence which requires the airport operator to ensure that its Conditions of Use are fair, non-discriminatory, transparent and subject to appropriate consultation. We would want to ensure that appropriate consultation also meant not just a proper process, but that the consultation was meaningful.

British Airways would like to see the Conditions of Use document form part of the overall licence, so that licence holders would be subject to the discipline of appeals by airlines to the CC when considering changes to the Conditions of Use. We believe that this simple step would promote both transparency and, accountability, and effective and meaningful consultation.

Chapter 4 – Rationale for continued economic regulation

Question 4: What is your view on the rationale for economic regulation at LHR, LGW & STN?

Test A: does the airport have “substantial market power”?

In general British Airways supports the CAA's view that Heathrow has substantial market power (SMP). We believe that the evidence gathered by both the CAA and previously by the Competition Commission with respect to Heathrow's market power is clear and conclusive. It is somewhat strange, given the overwhelming weight of evidence that HAL do not accept that they have SMP, as in our view the scarce resources of the airlines at Heathrow and the CAA would be more effectively deployed in achieving a positive outcome to constructive engagement. Nonetheless, British Airways remains committed to supporting the process and the CAA's current position on Heathrow.

British Airways would dispute the CAA's comment that *'connecting passengers are the passengers for which Heathrow appears to face the most competition,...'*. This seems to us to misunderstand who is competing for what. It is true that the competition for transfer passengers is fierce, but it is competition between airlines not airports. In short, transfer passengers are a function of airlines based at an airport. British Airways competes with other network carriers for transfer passengers, and happens to be based at Heathrow. It is not the airport that competes for passengers, it is the airlines.

For an airport to compete for transfer traffic it would have to compete for airlines that provide that rather than for the passengers themselves. However, Heathrow is full and therefore has no incentive to compete for new airline traffic, and the CAA have already indicated that high switching costs mean that network carriers are captive at Heathrow. Consequently, HAL does not face competition in the market for transfer passengers.

In any case, airlines adapt and develop their transfer services largely on factors that have nothing to do with airports – eg commercial agreements with other airlines, the timing of different flights, pricing incentives and exchange rate differences. Clearly the quality of the airport transfer and the structure of

airport charges can assist or impede this process, but it has a relatively small influence compared with other factors³. The example of the Star alliance at Heathrow shows that despite the good airport transfer facilities, there is relatively little transfer traffic between these airlines at LHR because it is not in the commercial interest of the airlines concerned. We also disagree strongly that commercial and retail revenues should be excluded from the market power assessment, as these revenues are intrinsic to the airport operation, would not exist in isolation and the “single till” is the natural model in a competitive market. It is difficult to follow HAL’s argument that high switching costs for airlines would not affect competition between airports.

British Airways also agrees broadly with the CAA’s initial market power assessments for Gatwick. At Gatwick, it is important to note that Test A asks whether an airport has SMP or is likely to acquire it. Current DfT growth forecasts indicate that demand in South East England will outstrip supply given current Government policy to rule out any new runways at London’s major airports. It is therefore important to consider the effects of this growing capacity shortage as well as reviewing the current position. In any case, GAL should not, in our view, expect the CAA to set out the behaviours it would expect to see as evidence for increased competition between Gatwick and other airports. Competition can take different forms. Rather Gatwick should provide evidence it considers to be relevant to the CAA for assessment. We also think the CAA has been as clear as it can be about the legal test at this stage, considering that the decision will be taken under legislation that has not yet been enacted. The Competition Commission’s report on the BAA airport market can also give some indication of the factors important in airport competition⁴.

At Stansted, we have not considered the CAA’s assessment for passenger flights, but we do consider that the airport does have SMP in relation to freighter flights, given that such services are largely excluded from both

³ The CAA’s passenger research - for example Fig 3.1 of the consultation paper – shows the relatively small priority attached to airport facilities compared with other factors.

⁴ For example in Appendix 10.1 of the CC’s 2009 report and in paragraph 10.105 where the CC sets out some of the benefits to be expected from airport rivalry.

Heathrow and Gatwick under the traffic distribution rules. In 2007, the Competition Commission found that STN had acted against the public interest in the discriminatory way it levied charges on freighters and imposed a Public Interest remedy. This constitutes strong evidence that the airport has SMP over freighter flights.

Test B

British Airways agrees broadly with the CAA's summary of the UK competition law regime and the direction of its analysis. We would however make the point that the law against exploitative abuses not only includes charging prices that extract more than a reasonable profit and bear no relation to the economic value of the goods or services (excessive pricing), but also extends to all conduct that causes detriment to end consumers practices, including through restrictions of output or choice/innovation.

As set out above British Airways believes that Heathrow, Gatwick and Stansted (as regards freighter flights) have SMP.

British Airways is of the view that the general competition law regime would not be sufficient to ensure that harm was not caused by airports' SMP, particularly as capacity continues to be constrained in the South East. British Airways considers it a high risk that an airport will abuse its market power and, as the CAA correctly points out, the competition law regime generally applies ex post to the potentially abusive conduct in question, such that it can only deter (rather than expressly prevent) harm from being suffered by end consumers.

The further reasons identified by the CAA as to why reliance on competition law may be difficult are valid in British Airways opinion. Such cases do tend to be very complex, lengthy and costly, with competition authorities continuing to be reluctant to intervene for fear of disturbing or stifling new entry and innovation. Indeed, despite the publication of Guidance on exclusionary

abuses⁵ by the European Commission (to whom the UK competition authorities have regard to in their own law making) in 2009, there continues to be a lack of guidance on exploitative abuses. Furthermore, as the CAA identifies, guidance and precedent is even more limited as regards reasonable airport charging levels specifically, which likely further reduces the confidence of the competition authorities to take action against exploitative abuses in these markets on a case-by-case basis outside of a clear regulatory framework.

This reluctance exacerbates the lack of certainty in terms of the actual outcome of bringing an exploitative abuse case pursuant to general competition law. This lack of certainty may well increase the risk of abuse by an airport, with the lack of clear consequences emboldening it to act abusively, rather it being deterred.

Test C Benefits and costs of economic regulation

British Airways supports the CAA's conclusion that application of Test C would not appear to support deregulation of any of the airports before April 2014.

The motivation behind Test C is to ensure that the CAA uses the most appropriate form of regulation to correct for the competition problem it found in Test A. Furthermore, we understand that until the CAA has reached a firm conclusion on Tests A and B, that it would be premature to reach a firm conclusion on the form of regulation at each airport.

We discuss this in later sections of our response, but British Airways believes that at Heathrow and Gatwick at least, that there should be a strong presumption towards maintaining an upgraded version of the current RAB based price control process.

⁵ C(2009) 864 Final.

We agree with the CAA that the costs and benefits of regulation warrant continued regulation beyond 2014. Evidence provided by British Airways in a previous consultation response showed that Gatwick Airport had a financial incentive to increase airport charges. This is because the additional revenues from higher charges from captive customers would be likely to be significantly greater than the revenue loss from passengers who were priced out.

As a relatively crude example, it is worth considering the impact if charges were to have been 5% higher in the latest year (to March 2012), which is entirely conceivable absent economic regulation. The airport's revenue from (regulated) airport charges was £271.3m. A 5% increase would have increased revenues by £13.6m on one year alone. Even allowing for a small reduction in passenger numbers, the cost of regulation (as per the Airports Act approach) would not approach this if allocated on an annual basis.

At Stansted we consider there is a strong case at least for capping charges to freighters, given the lack of competitive constraints and the CC's Public Interest finding in 2007.

We also agree with the CAA's assessment that the new Civil Aviation Bill will allow a tailored approach at each airport and this should ensure that the benefits of regulation outweigh the costs.

Chapter 5 - The form of price regulation from 2014

Question 5: What do you think is the most appropriate form or model of for price regulation at each of the airports?

General comments on RAB based regulation

British Airways believes strongly that RAB based regulation at both Heathrow and Gatwick would be the form of regulation that would serve our customers

best. In this respect, we agree with HAL. However, we are keen to avoid any dilution of the single till at either airport.

It seems to us, that while appealing at first glance, that HAL's proposal that it should be able to develop projects at its own risk in return for keeping the rewards, also carries with it great risks for our passengers. Whilst it is true that there may be on rare occasions projects which the airport wishes to carry out but airlines do not feel are in the interests of their passengers, we do not feel that this will be common. Furthermore, we are nervous of allowing derogations from the single till in case they set precedents whereby the airport will develop all projects that earn a return at their own risk, and all costly projects within the single till – effectively allowing the single till to wither on the vine.

We believe that the single till has provided good incentives to the airport and over the years served our passengers well, and so would not be in favour of any diminution of this approach.

In terms of the potential drawbacks of the RAB based approach, British Airways agrees that perhaps in previous control periods, the regime has incentivised the quantity of investment rather than its quality. However, we agree with the CAA that there does need to be a rebalancing of the aims of capex in Q6, so that there is a greater focus on capex efficiency. We put forward proposals to tackle this in our response to section 6 of the consultation. The CAA should note that these proposals are identical to those put forward by British Airways on behalf of the airline community at Heathrow at the CAA's last capex efficiency meeting.

Heathrow

British Airways supports the CAA's proposal that the best form of regulation for Heathrow would be some form of RAB based regime. Our key priorities for Q6 are to ensure a settlement which delivers meaningful benefits for our passengers, and crucially, is affordable. In this context we are keen to explore incentives to encourage HAL to become a more efficient operator (in

terms of its opex) and constructor of facilities (in terms of its capex). In our view this exploration of incentives should also include discussions on the WACC as this fundamentally affects incentives to invest. We believe that it is neither in the spirit of constructive engagement nor helpful for HAL to decline to debate the WACC with airlines.

In addition, airlines operate in a highly competitive environment and so strong cost control, efficient operations, and best practice purchasing and project management are all essential for our day to day to success. We are keen to explore (as no doubt are other airlines) how our experience can be used to help HAL become more efficient and effective.

It is important to note in this context that our stance on opex and capex efficiency is not taken to criticise or damage HAL. Rather, we are concerned about the sustainability of prices at Heathrow, and keen to ensure that our passengers receive the maximum benefit for every pound they spend at Heathrow. Our intention is thus to protect our passengers' interests, and to help rather than hurt HAL.

We would also be happy to discuss the CAA's proposals to extend the period of the Q6 price control, but in the context of how it might help us deliver affordably for our passengers.

Gatwick

The degree of regulation at Gatwick may need to be adjusted according to the findings of the competition assessment and the CAA might wish to ensure that its approach to regulation does not impede the possibility of greater competition developing (for example if Government policy on runways changes during the next price control period). We do not consider that there is anything inherently distorting in RAB based regulation under a single till. Any airport in a competitive market would seek to earn its cost of capital on efficiently created assets and to cover its efficient costs – and this is what regulation seeks to achieve. However, the particular form of RAB-based

regulation historically used by the CAA does create the potential for distortion in the following areas:

- Remunerating assets in the course of construction over a fixed 5 year cycle requires airports and airlines to predict the precise capex cost of all new projects to be developed over the next 7 years (and probably even longer as some development will start towards the end of the period for implementation a few years later. Not only is it impossible to predict the capex cost with any degree of accuracy, but the associated opex and retail revenue implications also needs to be estimated and baked into the price cap. The effect of this is that an airport must include large contingency, uncertainty and risk sums within the budget and is conservative in estimating any financial benefits.
- Once the capex forecast is fixed, the CAA also has to estimate the timing of the spend. While it is useful for an airport to be able to adapt the capex programme in the light of market development, currently the benefit of any delay or underspend will accrue to the airport and this can give perverse incentives.
- The practice of giving service quality bonuses implies that outperformance against a measure is always in the passenger interest and the cost of this outperformance is always something the passenger is willing to pay for. There is no evidence that this is the case. Furthermore, the airport is given an incentive to underestimate the service quality that can be achieved so that they are more likely to achieve a bonus.
- The scrutiny of opex is inadequate given that this is the largest influence on prices and opex efficiency is vital for any competitive business.

We are therefore attracted to modifications in the approach to regulation that can reduce the distortions and move towards a more competitive model. For example, the use of a fixed capex budget that is reflected in the price cap, with development capex added in subsequently by mutual agreement with

airlines later in the process (up to a predefined cap). Service standards should be set at the level that airlines and our passengers are willing to pay for, with the possibility of top up agreements agreed commercially.

We would also note that non-regulated charges already provide a mechanism for differentiated services to be paid for separately. More thought is needed on the protections necessary to ensure that captive airlines are not exploited over prices charged for essential services.

Chapter 6: Improving regulatory incentives to deliver better passenger outcomes

Question 6: What are the priorities for improved efficiency incentives within the price control settlements?

We welcome the CAA's recognition that incentives are a critical part of the regulatory framework. We also support the view that complexity should be avoided and that incentives should be consistent with the principles of better regulation. Given the different characteristics of the airports, we consider that different incentive structures may be appropriate to reflect the particular circumstances of each operation.

In our view, the incentive structure created by economic regulation is integral to the way in which regulated airports operate their businesses. The Q6 review provides a valuable opportunity to undertake a fundamental assessment of the current regulatory structure and the incentives that it creates for the regulated airports.

We consider that in the case of operating expenditure (opex) and capital expenditure (capex) the evidence from Q5 (and earlier periods) might tend to suggest that the existing regulatory incentives are not currently functioning in the way that was intended and may, therefore, be in need of reform. On that basis, the remainder of this section comments on the issues set out in Chapter 6 of the CAA's document and explores opportunities to improve the

incentives that apply to opex and capex. This section looks first at the incentives to undertake capex, then opex before considering other incentive issues raised in the CAA's document.

Incentives to undertake capital expenditure

The CAA's consultation document notes that for Q5, both HAL and GAL projected significant capital investment programmes in the early part of the control period but their actual capex did not meet these forecast expectations. One explanation for this is that the regime provides an incentive on airports to front-load the plan before the cap is set and then to back-end load delivery. Airports benefits from this overstatement (underspend) and re-profiling in two ways:

- a cash-flow benefit as the level of depreciation and return in Q5 charges is based on the higher (front-end loaded) forecast plan.
- by retaining the difference between the allowed return on the higher forecast plan and the lower actual plan.

As noted by the CAA, and in previous submissions from the airline community, delaying or bringing forward expenditure in this way can have a significant financial impact on the airport and the benefit realisation for airlines. Additionally, as the RAB in Q6 will be rolled forward for 'actual' rather than 'efficient' capex there is limited financial incentive for the airports to deliver a given project for lower than the CAA assumed at the time of setting charges as any efficiency benefits will be passed through in future charges rather than accruing to the airport. This arguably creates an incentive for airports to err on the side of caution when making decisions about capital planning and delivery as ultimately the bill for all decisions will be picked up by passengers through airport charges.

In light of these concerns we consider that a new approach to the regulation of capex is required. An important priority for Q6 should be to design a regime which encourages airports to deliver the level of investment that is consistent with the needs of passengers and airlines users.

In developing the incentive framework for the regulation of capex in Q6 we consider that a balance needs to be struck between the encouragement of investment in time to satisfy the requirements of passengers, and the promotion of efficiency in terms of producing capacity and service quality at lowest cost. While the two are not mutually exclusive, there can be a tension between them. Encouraging investment will generally involve reducing uncertainty around the future remuneration of capital projects. Promotion of efficiency implies the regulator deliberately building additional risk into the regime by financially rewarding the airport for efficient performance and penalising it for poor performance.

Sectoral regulators have attached different weights to these two different sets of incentives. In particular, Ofgem and ORR regulate network businesses in which the capital programme can be defined with a reasonable degree of certainty in advance. Additionally demand and supply side conditions are less likely to fluctuate significantly in the short to medium term covered by the price control period. As a consequence, these regulators have tended to place greater emphasis on capital efficiency.

We believe that in Q5 (and in previous periods) the focus has been skewed too far towards incentives to spend capex, rather than on enhancing the ability of airports to improve efficiency. Within that context, the airline community at Heathrow has recently submitted a presentation to the CAA and to HAL setting out its views on these issues including how capital efficiency might have greater prominence in Q6. We fully support the approach set out in that presentation and have highlighted our views on the most salient points below.

It should also be noted that whilst we have couched the following sections with respect to Heathrow, we see no reason why a similar integrated package of capex efficiency measures could not be considered for Gatwick.

Principles for Capital Efficiency

We support the principles have been identified by the airline community to underpin any discussion on this issue, as follows:

- Principle 1: BAA's ownership of LHR should not confer any right for it to conduct any capex project it wishes. Only capex that is efficient, offers value for money, and is desired by passengers should be considered for delivery;
- Principle 2: BAA should be fairly rewarded for undertaking capex efficiently;
- Principle 3: Incentives on capex should be stronger for the efficient and timely delivery of projects than for delivering a project under budget;
- Principle 4: inefficient capex – either in terms of cost or timing should not be rewarded and should yield diminishing returns.
- Principle 5: all capital projects should be supported by a proper governance structure, which ensures transparency, has accountability through experienced leadership and delivers sound financial assurance.

In summary, these principles underpin a shared view among the airline community at Heathrow that the regulatory regime should contain strong incentives for investment, as the lack of investment is arguably a greater detriment than inefficient capex. However, we consider that these incentives need to be rebalanced somewhat to ensure that capex is delivered efficiently and to the benefit of passengers.

Against that background, we believe that 5 key improvements are required to the existing arrangements in order to incentivise greater efficiency in Q6:

- an improved process of governance giving airlines a stronger role at each project gateway;
- the introduction of more fixed price arrangements (rather than the current pass-through) for major projects;
- the use of expert reporters to improve assurance and build further confidence into the process for all stakeholders including HAL, airlines and the CAA;
- modification of the trigger regime to ensure that HAL is financially neutral to the profiling of the capital plan; and

- a change to the rules for rolling forward the RAB to discourage inefficient investment.

We develop each of these innovations in turn below.

Improved governance

An important dimension in achieving greater efficiency relates to the governance of capital projects. We fully support the airline community proposal to increase the level of engagement and involvement in the governance of capex projects by establishing a mechanism to ensure that capex projects are well managed and that they deliver appropriate benefits to passengers.

This proposal would involve airlines having both technical and financial representation at every gateway stage of a capital project, from explore and options development to integration and post investment appraisal (PIA) so that the airlines can be assured that the capital funds are spent on projects that add value to the passenger journey, and that key learning points are used in a virtual cycle of continuous improvement.

In this model all projects would be signed off by a Joint Governance Board (at Gateway 3) to ensure auditability and that the proposals are universally agreed. At this stage the project scope, costs, milestones and triggers are defined and therefore able to be measured. All projects would be supported by a business case capable of being reviewed by all parties. Business cases would include details of all project impacts on other building blocks i.e. commercial revenues, non-regulated charges and operating costs (either increase/decrease) so that these can be tracked and audited on a regular basis. All cost variances will be fully explained to a newly constituted Cost Review Board so that airlines can review the extent to which investments have delivered cost benefits/increases in line with expectations.

The details of this proposed new governance structure remain work in progress and we look forward to working with the airline community, HAL and the CAA to develop this framework over the coming months.

Use of reporters

A crucial aspect of achieving capex efficiency is to ensure that projects are properly specified and costed before they begin. A fundamental problem that regulators (and in this case airlines) face in working out the true baseline cost of a capex project is asymmetry of information. A number of mechanisms are available to help uncover true baseline costs. At one end of the spectrum is the menu / sliding scale approach.

Menu regulation was first applied in the UK by Ofgem in 2004 for electricity distribution and has been used in a number of subsequent price reviews in the energy and water sectors. Menu regulation seeks to overcome a number of related problems with existing approaches to RPI-X regulation. The basic premise of this approach is that the regulated company is offered a choice of different regulatory schemes ('a menu of contracts') with different risk and incentive properties. The menu approach is designed to give the company an incentive to reveal the appropriate level of expenditure rather than an overstated plan or one which otherwise benefits the company at the expense of its customers.

While the menu approach can be useful for revealing information it can be complex and administratively demanding. We maintain an interest in this idea, and a desire to explore it further. However, we are also interested in what seems to be a more streamlined approach of using independent surveyors or engineers to give a focussed assessment of costs and timelines etc in key projects. We believe that this is similar to the approach adopted by other regulators including ORR, NIAUR, WICS and currently, OFWAT, in their regulatory reporter regimes.

Under the model proposed by the airline community all capital projects would be subject to scrutiny by a Reporter at the direction of the airline community. This type of arrangement would help to provide airlines with greater assurance on an ongoing basis that capital costs, milestones, and benefits of the project are being delivered and that maximum efficiency is achieved.

The current suggestion is that a de minimis portion of the overall capital budget (e.g. 0.5% of BAA's 'on cost') is made available to the airlines to fund a Reporter.

Fixed price approach

Under the current arrangements, it is actual capex that is rolled forward in to the RAB subject to the twin tests of adequate consultation and best practice project management. In essence, this means that capex is treated largely as a pass-through item with limited incentives for HAL to deliver projects efficiently. We consider that the regime needs to be adapted to strengthen the incentive on HAL to deliver projects more efficiently than was assumed at the time the price cap is set.

In practice this means that once the capex baseline has been set, it should still be possible for HAL to outperform the project and deliver below the anticipated cost. Efficiency should be rewarded in this context, and if HAL can outperform an efficient settlement, then it is appropriate that it should be rewarded for doing so.

As noted in principle 3 above, our preference is to have projects delivered to agreed scope, time and to cost. We are concerned that excessive incentives to outperform on cost may lead to thrifting behaviour or other forms of scope reduction which, in turn, could result in longer term costs or indeed a reduction in the quality of the product sought (e.g. T5 - TTS). Consequently, we believe that the incentives to deliver to time and cost should be stronger than those to outperform on cost.

In order to achieve this we consider that the framework described in the airline community presentation will give HAL appropriate incentives to spend capital efficiently whilst allowing it to achieve a higher return than agreed at the quinquennial review if it performs ahead of expectation.

In summary, this approach is based upon the concept of splitting capex into a "core" category of well-defined and airline supported projects that would be incorporated into the price cap and subject to triggers, as now, and the less defined or "development" capex that could be remunerated as and when it is spent, subject to agreement with airlines nearer the time.

'Core Capital' projects would be included in the price cap on a fixed price basis costed using HAL's P50 cost probability approach. 'Development

Capital' projects would be identified in the price cap settlement at both the P80 and P50 costs levels. HAL would earn a return for the duration of the Q at the P80 level. The 'target' for delivering any project, to scope and on time, will be at the P50 level. The airport operator will be able to 'call off' up to an amount set aside within the project for the 'risk provision' (difference between P80 and P50), but this will need to be justified through the defined change control process.

The proposal also suggests that overspends that are caused by 'Force Majeure' (e.g. earthquake) or that could not have been reasonably foreseen when the project was signed off (e.g. WWII Bomb underground) would be treated as an allowable overspend and allowed to enter the RAB subject to the change control process.

Modification of the trigger regime

Another important element to consider in relation to the incentive framework around capital expenditure is the use of capital triggers. The genesis of the trigger regime stems from the recognition that any slippage in the investment programme is likely to result in airlines paying higher charges than necessary to finance that investment, and delay in receiving the benefit of the investment, with adverse operational and financial consequences to them.

In response to this, the trigger regime requires airports to pay rebates to airlines if certain pre-defined investment milestones are not met. We continue to support the use of triggers and consider that they form a crucial role in ensuring that HAL delivers investment in a timely manner. However, in light of the number of trigger disputes that have arisen during Q5 and as noted above, the over-arching incentive on HAL to re-profile the plan, we consider that the application of triggers under a 'core' and 'development' capex framework needs to be modified.

Our calculations show that HAL received a significant cash and profit benefit within Q5 of circa £180m as a result of re-profiling the capital plan. This is money which has been generated at a direct cost to our passengers with no benefit being delivered. In order to address this for Q6, the airline community

proposal is that HAL should not make cash flow gains by delaying projects within Q or across Qs. In other words, HAL should be inter-temporally indifferent as to when it carries out its capex – it should not, as it currently is, be incentivised to delay.

In making these comments it is important to note that we do not seek to punish HAL or make gains at their expense from project delays. Rather the intention is simply to remove the incentive to delay capex, to ensure that projects are delivered for the benefit of our passengers when they should be.

Of course we recognise there may be times when projects are reasonably delayed, and we would expect the new governance procedures to allow this. Where the delays are reasonable and agreed by the airlines we do not believe that HAL should repay the cashflow benefits it receives.

The treatment of inefficiency

Principle 4 in the airline community paper suggests that airports should not be rewarded for inefficient capex. We consider that there should be a clear up-front expectation that inefficient capex will not be rewarded ex post. Once this principle is established, it should reinforce behaviour within HAL to facilitate the efficient delivery of capex.

We understand that the current system for striking capex from the RAB is difficult to operate, and to our knowledge, the CAA has only struck capex from the RAB on one occasion. This is not the case in other regulated industries, and we are keen to explore approaches that allow the CAA to more readily audit capex. We are especially keen to explore Ofgem's approach to ex post scrutiny of capex (the three pots) and how this can be applied to the regulated airport system.

We understand that in its treatment of gas distribution Ofgem use three pots for the ex post evaluation of capex.

- Pot 1 – defined as 'wasteful and unnecessary' (although we would prefer the term 'Inefficient Spend') – expenditure here is outside the RAB, and not rewarded;

- Pot 2 – defined as ‘efficient overspend’ – no allowances are given for depreciation or returns. After 5 years, the depreciated asset is placed in the RAB and earns returns as normal;
- Pot 3 – ‘re-opener’ (although we would prefer the term ‘Efficient Spend’) – capex included in the RAB, all allowances paid (including for under-recovery).

In summary, we support the airline community view that the reforms described above would significantly improve regulation of capex and that it would provide a strong incentive on HAL to delivery capex more efficiently than it has in the past. Much of the detail around this model remains to be worked through and we look forward to working with HAL through the capital efficiency group to develop these proposals further.

Benchmarking

Through the capital efficiency group, HAL has provided the airlines with additional information on how it plans to cost the projects that will eventually form part of the Q6 CIP. One thing that has become apparent from this exercise is that HAL’s approach to costing the base level of capex for any given project involves limited assessment against external reference points. This is consistent with the findings of the CAA’s consultants who noted, as part of the mid-Q5 review, that they had observed some evidence of the use of external benchmarking against other industries and competitor airports but not enough data was provided to verify the external benchmarks for accuracy.

In the short term, we consider that this issue is best addressed by using expert reporters to review and challenge HAL’s approach to capital costing. However, over the medium to longer term we would like to see much greater use of external benchmarking to inform the efficient assessment of capital costing.

In previous airport reviews, the CAA has made extensive use of benchmarking to inform its assessment of the efficient level of operating costs, however, very little benchmarking has been done to inform the assessment of capital efficiency. This is in contrast to the approach in other

regulated sectors (e.g. Ofwat, Ofgem and ORR) where regulators have placed significant emphasis on the use of benchmarking to inform the assessment of capital efficiency. In the case of Ofgem and Ofwat, the existence of ready-made intra-industry comparators means that the availability of data is much greater than in the airports case.

In the case of the ORR, it has invested significant time and resource in recent years in developing its capability to benchmark aspects of Network Rail's cost base against relevant comparators. This includes:

- **international benchmarking:** ORR undertakes top-down benchmarking analysis of Network Rail's maintenance and renewals costs against overseas rail infrastructure managers; benchmarking its approach to asset management versus international best practice; and benchmarking of signalling and possessions efficiency relative to its international peers.
- **national inter-industry benchmarking.** Some of Network Rail's unit costs, for example costs relating to civil structures, are benchmarked against costs in other industries.
- **intra-company benchmarking:** ORR also makes use of intra-company benchmarks which reveal information about how efficiently different regions within the overall network incur capital and operating expenditure.

To the extent that capex efficiency has a more prominent role in Q6, British Airways considers that the approach to benchmarking should be developed through constructive engagement in collaboration with the CAA and with airlines. We consider that benchmarking of capital costs should become an enduring theme of airport regulation (as it is in other sectors) rather than a static piece of analysis that is conducted every five years as part of the quinquennial price review.

Incentives to undertake operating expenditure

Current Arrangements

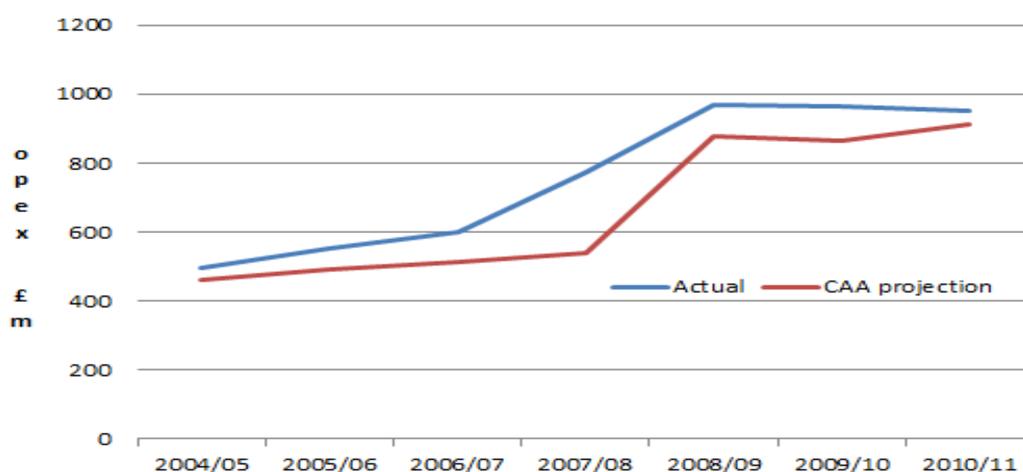
In our view, the current regulatory arrangements for opex provide a fairly blunt incentive on HAL to reduce the costs of running the airport. The CAA's uses the standard RPI-X framework under which the regulator makes a forward-looking assessment of the level of efficient costs required to operate the airport. If HAL is able to run the airport for less than the CAA assumed then it retains the difference as additional profits, conversely if it spends more than the CAA assumes this will lead to lower profits⁶.

The theory behind this approach is that by providing a powerful financial incentive to reduce costs, the airport will benefit in the short term by reducing its cost base and earning higher returns. In exchange the regulator will capture this revealed lower cost base in future charges.

Recent airport performance

The chart below shows how HAL's operating costs have grown between 2004/05 and 2010/11 relative to the assumptions made by the CAA at the time of setting the price cap.

HAL's operating costs v CAA projection 2004/05 – 2010/11 (nominal prices)



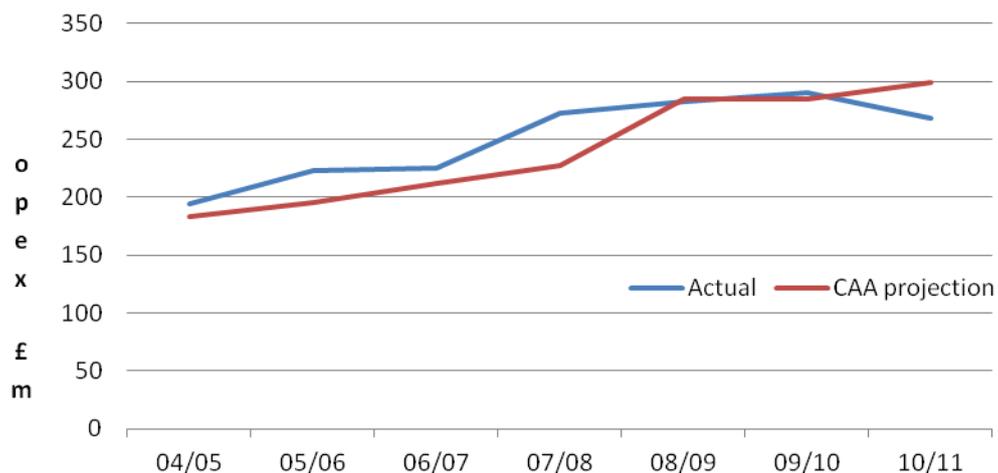
Source: HAL regulatory accounts

⁶ NB an important counter-weight to this incentive is provided by the service quality regime which ensures that HAL does not cut costs at the expense of the level of service received by passengers.

Notably, HAL's annual opex has grown from £497m in 04/05 to £951m in 10/11 an increase in nominal terms of 91%. This compares to economy wide cost increases, as measured by the retail prices index, of 20% over the same period.

Also of concern is the fact that in each of the previous seven years, HAL has spent more to operate the airport than the CAA assumed would be required at the time of setting price caps. Over the seven year period set out in the chart, HAL's operating costs have on average been 15% higher than the level the CAA assumed when setting price caps. This might tend to suggest that the existing regulatory incentives to bear down on operating costs have not been effective during this period

The chart below sets out a similar analysis for Gatwick.



Source: GAL regulatory accounts

Looking ahead to Q6, this upward trend in opex, if action is not taken, looks set to continue at both Heathrow and Gatwick. Under the projections set out in HAL's strategic options plan, opex in the first year of Q6 is forecast to be some £296m (31%) higher in nominal terms than it was in 2010/11. This is partly explained by general inflation of course.

We consider that increases in costs of this magnitude are entirely unsustainable and it will be imperative for the regulatory regime to improve the incentives on airports both to put forward reasonable and well justified 'ex ante' projections and also to improve efficiency and reduce costs on an on-going basis. We set out below some options for how this might be developed in practice.

However, regardless of the approach to opex efficiency that is adopted it seems imperative to us that the CAA imposes strict opex limits for Q6 based on limits for an efficient business. It does not seem right to us that our passengers are faced with ever rising opex bills.

Efficiency benefit sharing

We are attracted to the suggestion that there might be ways of better aligning the interests of the parties during the Q6 review by strengthening the incentives on airlines to help drive efficiency improvements. We helped to develop, and continue to support, the gain-sharing arrangements which take place with respect to certain non-regulated charges.

In the case of non-regulated charges the airport and the airlines share between them any cost savings that they can identify during discussions about the level of those charges. The key advantage of such an arrangement is that the airport is better off if it takes seriously the negotiations with airlines and ultimately reaches agreement on cost reductions. In theory, we consider that this could be extended to operating costs and may lead to more productive engagement between airports and the airlines so that opportunities to reduce costs are more evident than under the existing arrangements. This would have the effect of lowering the cost base in the long term below the level that a conventional regulatory approach might achieve.

There are parallels to this idea in other regulated sectors, most notably the ORR's efficiency benefit sharing mechanism (EBSM) which was introduced at the most recent periodic review of prices in 2009. In summary, the EBSM was designed to encourage train operators to work with Network Rail to reduce its

costs and incentivise greater efficiency by allowing operators to share in any outperformance achieved by Network Rail.

The EBSM covers operating, maintenance, and renewals expenditure as well as certain revenue items. As part of its annual assessment of Network Rail's efficiency the ORR measures the extent to which Network Rail has outperformed its efficiency target relative to the regulatory baseline. Network Rail shares 25% of any outperformance with train operators. Before they can receive payments, train operators are required to demonstrate that they have engaged positively with Network Rail to help drive efficiency improvements.

Extending the period over which savings are retained

An alternative and / or complementary approach to efficiency benefit sharing could be to strengthen the incentive on airports to reveal operating cost efficiencies. One way to achieve this could be done through a rolling incentive mechanism. An opex rolling incentive might operate in the following way:

- historical out-performance would be identified for each year of the control period just ending by comparing out-turn opex with the allowances made at the previous review (in a consistent price base);
- any out-performance from prior years that is not sustained up to year 4 is disregarded;
- the airport would be entitled to keep the benefit of the remaining 'sustained' out-performance for five more years in addition to the year in which the saving is made;
- where that entitlement falls within the current control period, the airport is considered to have collected its reward via the profit it made from the difference between its actual costs and the opex allowance factored into the price control; however
- where that entitlement falls into the next control period, the regulator would recognise that the resetting of prices leaves the company with no benefit from its out-performance unless it takes

compensating action. It therefore adds the sum of the rolled forward out-performance entitlements for that year to allowed revenue in that year.

The regulator would also have the option of strengthening the incentive further e.g. by applying a multiplier e.g. 1.25x or 1.5x to the level of out-performance (as has been done for top performing companies in the water sector). Alternatively, the regulator could permit the airport to benefit from the out-performance for longer than 5 years e.g. 7-10 years.

Given the experience in previous quinquenniums, the case for strengthening incentives in this way is far from clear. Additionally, rolling incentive mechanisms can be administratively burdensome and open to gaming. For those reasons we consider that there would need to be a compelling justification for introducing a mechanism of this kind.

Equalising incentives

The CAA's document notes that some regulators have acknowledged that there may be a perception of bias towards capex rather than opex within a RAB-based framework.

In particular, Ofgem's framework of incentives for electricity distribution companies looks quite different from the CAA's incentives package. Under Ofgem's approach these companies are able to retain a fixed percentage of any under- or over-spend against Ofgem's opex and capex allowances. The idea is that this will not only encourage efficiency improving behaviour but also make a company indifferent as to whether, at the margin, it spends a pound of opex or a pound of capex because, at the margin, the rewards/penalties that companies receive will be identical.

Our initial view is that in previous periods, the focus of airports has been on spending capex rather than exploring ways to reduce opex. Therefore, there could be some merit in considering the extent to which the regulatory regime could be modified to address this apparent imbalance. Any change to the current approach needs to be proportionate and in that context it not yet clear to us whether Ofgem's totex approach would be appropriate for airport

regulation. However, we would be interested in exploring these issues further through the process of constructive engagement.

Non-financial incentives

We are particularly interested in the CAA's suggestion that non-financial incentives could play a more prominent role in the future. The CAA's approach to regulation of airports between quinquennial reviews has been very much at the light touch end of the spectrum relative to other economic regulators. Currently, there is very little formal regulatory analysis of airport performance on an on-going basis and publicly available data extends mainly to the regulatory accounts which are prepared at a very high level.

This means that it has been difficult for the CAA and other interested stakeholders such as airlines to hold the airports to account for their performance on a regular basis. This is in contrast to the situation in the water, energy and rail sectors where the respective regulators publish a variety of annual⁷ reports and other data setting out details of how the companies have performed on a number of measures.

In the airport context we note that detailed information has been monitored and published with respect to the service quality regime and that this has led to noticeable performance improvements in recent years. This process clearly increases reputational incentives and greatly assists with the assessment and development of performance in future periods. For that reason we would be keen to explore the extent to which benchmarks or some form of balanced scorecard / traffic light system could be used to examine a much wider range of airport performance metrics.

Chapter 7: Approach to airport risk and financing

Question 7: How should the CAA interpret its new financing duty?

British Airways agrees with the CAAs proposed approach to risk. We do not believe that our passengers should be expected to bear risks that can be best

⁷ In the case of Network Rail, ORR publishes a quarterly review examining many aspects of the company's performance.

borne elsewhere. We also agree with HAL that there would be merit in maintaining RAB based regulation (albeit updated in certain respects) as it brings both consistency and certainty.

We believe that there should be a strong presumption in favour of RAB based regulation, and that this presumption should apply at both Heathrow and Gatwick airports.

British Airways maintains its view that the regulated airports are generously rewarded in terms of their cost of capital allowance as they are only exposed to second order traffic risk. However, we would be open to exploring risk-sharing mechanisms, whether that be on capital or on passenger volumes, where it could be shown that such a proposal would be to the direct benefit of our passengers.

Question 7 – How should the CAA interpret its new financing duty

British Airways fully supports the CAA's interpretation of its new financing duty. We believe that the Government's intent in setting the financing duty has been clearly articulated and that the CAA's position is consistent with that.

Clearly the decision on the appropriate financing structure is the airport operator's alone. However, it seems only reasonable that if an airport chooses to accept a higher level of risk and gearing than a notionally efficient company, in return for higher profits, then it should also be prepared to accept any adverse consequences of such a decision.

More generally, we also do not feel that it is appropriate for our passengers to have to pay for inefficiency on the part of the airport operator (whether that be in terms of opex, capex, or in its financing decisions).

Finally, British Airways supports the establishment of a full financial ring-fence within the licence. This is consistent with practices in other more modern regimes, and we believe would provide a greater degree of protection for our passengers. Furthermore, we understand that the implementation of a ring-

fence on existing financing may create difficulties, and even perhaps warrant a temporary derogation from the ring-fence.

We share the Government's objective of a move to a full ring-fence over time, but feel that the current proposal for the removal of derogations is unnecessarily burdensome, out of keeping with other regulatory regimes (and indeed the rest of proposed airport economic regime) and undermines the authority and independence of the CAA. British Airways believes that the best interests of our passengers would be best served by allowing the CAA to regulate free from Government interference with appropriate checks and balances imposed by the appeals system.

Weighted Average Cost of Capital

In this section, we provide comments on the approach to the WACC in general, as well as specific comments covering:

- split cost of capital;
- skewness of financial returns;
- indexation of the cost of debt;
- risk sharing; and
- indexation of the RAB.

General comments

British Airways supports an approach to calculating the WACC based on the standard CAPM approach. We also note that to our knowledge no other stakeholders have advocated a departure from this approach. This has also been the position of regulators from other sectors and the CC. However, we would also comment that although a CAPM-based approach is common, it is not without its drawbacks – for example, a lack of listed direct comparator companies – and so cross-checks (such as analysis of Market Asset Ratios) will be important.

British Airways has mixed views on the initial high-level positions being adopted by the regulated airports:

- HAL considers there is “value in retaining RAB-based regulation as it brings both regulatory certainty and policy consistency”. We broadly agree – and add that it is important that the regulatory certainty provided by a RAB-based approach is appropriately reflected in the cost of capital allowance.
- STAL suggests the CAA needs to develop a “differentiated regulatory approach” for Stansted. While we acknowledge that the CAA needs to consider carefully evidence on risk differentials between airports, whether this is part of a fundamentally different approach needs further consideration.

Split cost of capital

British Airways acknowledges the comments made by Professor Cooper concerning the practical application of a split cost of capital/RAB. However, we believe that the principles embodied in the paper by Professor Helm are of critical importance. Most important is, we believe, that the signals for development of the business need to be clear and transparent while ensuring that the risk inherent in existing activities is rewarded appropriately compared to the risk in new activities. Regulation should not lead to windfall gains or losses for the company.

- Existing regulatory determinations have captured the fact that embedded debt should be remunerated at a different rate to new debt – a reflection of the key principle we support. The issue is whether, as we believe appropriate, this is taken to its sensible conclusion with separate treatment of the cost of capital and RAB.
- Further consideration of the issues around a split cost of capital is required as well as evaluation of more partial options like the indexation of the cost of debt.

Skewness of financial returns

British Airways notes that HAL has suggested that the CAA should consider the skewness of financial returns when calculating the WACC. We understand that the basis of HAL's argument to support this is their concept that as the airport is effectively full, they are more likely to experience negative rather than positive shocks.

Before commenting on HAL's proposal, it may be useful to lay out, in stylised manner, what British Airways understands skewness in this context to mean.

- Positive skewness: highest probability of a small loss, small probability of large gains, v. small probability of large losses
- Negative skewness: highest probability of small gains, small probability of large losses, v. small probability of large gains
- No skewness: highest probability of mean returns, equally small probabilities of large gains and losses
- What matters is skewness relative to the market – known as co-skewness

It is true that there are problems with the CAPM approach, particularly when it comes to using it in the context of regulated airports. In brief, we believe that if there are asymmetric risks faced by HAL then they are of second order. It is important when calculating a WACC to distinguish between features which affect the WACC and those which can be treated as insignificant noise. We believe that HAL's skewness argument is at best an argument about non-significant noise. More importantly, and by far the most important issue relating to the CAPM approach is lack of data – and incorporating co-skewness does not address this.

In the context of airports, and across UK regulation, there are few pure listed regulated entities to use as comparators for CAPM analysis. As such, use of credible cross-checks is in our view, more important than detailed theoretical

refinements (even if the principle behind these is reasonable). This is particularly true when these refinements are data-intensive (and therefore it is very difficult to reach meaningful conclusions).

Other theoretical refinements have been discussed and the experience there is instructive. For example, 'Fama-French' or 'three factor' models could be thought of as similar proposals – though have been given little weight due to a lack of compelling evidence. In our view, the weight of academic opinion and specific evidence is even less compelling in relation to skewness of returns – although we would welcome sight of the evidence gathered by BAA. We also note that skewness of returns is not a new issue in UK regulation – it has also been discussed in the past and has not gained traction.

There are a number of reasons why the theoretical principle of skewness is likely to be much less applicable than the Cooper report suggests. In this context, British Airways notes:

- While it may be valid to note that volume-based upside potential is limited, equally downside risk is not as it would be for an unregulated company. There is some read-across here from the split RAB discussion. Arguably, the RAB is, and is considered by many to be, a low-risk asset. It is equally clear then that there is a significant backstop against downside risk. Is it really credible that there is a significant probability of highly negative returns (as negative co-skewness suggests)?
- While it makes reasonable points regarding theoretical principles, it, deliberately does not address computational issues. These are far from straightforward:
 - It would not be correct simply to add a premium to an unadjusted CAPM-derived cost of equity, since if a co-skewness effect is present then beta estimates may be biased. The two effects must therefore be identified jointly.

- It is not clear from the academic evidence that any co-skewness effect could be estimated precisely (and the beta estimate may at the same time become less precise)
- o It arguably makes stronger assumptions regarding investor behaviour than the unadjusted CAPM.
 - E.g. do regulated infrastructure investors really require a small but significant probability of very high gains (as would be implied if they favour positive co-skewness)?
 - Or are they attracted more by a high probability of small gains (which sounds more typical of favouring negative co-skewness) or by dependable, inflation-protected standard returns?
 - The preponderance of pension funds and insurance firms suggests the latter may be a better characterisation
- o Moves to incorporate additional features into a CAPM approach risk over fitting the data to a model.

Overall, it is British Airways considered view that incorporating skewness would not improve the CAA's estimate of the cost of equity. BAA would have to make a very compelling case in favour of incorporating skewness. In addition, cross-checks (e.g. appetite for transactions) do not suggest that the cost of equity allowed by the CAA has systematically been too low. Consequently we believe that far from making a compelling case in favour of incorporating skewness, the evidence and pragmatic reality of setting a WACC shows that HALs proposal is unnecessary and unfounded.

Indexation of the cost of debt

British Airways is broadly supportive of a pragmatic approach towards cost of debt indexation. We believe that it is unlikely that such an approach would result in companies declining opportunities to minimise debt costs. The

incentive to beat the allowance still remains, and there is no evidence that companies have adopted borrowing which mimics the existing five year fixed deal.

We also believe that the establishment of cost of debt indexation in the energy sector under the new 'RIIO' model sets a useful precedent in introducing such an approach. It has generally been received positively by stakeholders, and is part of the recent transmission fast-track settlement for Scottish Power and SHETL.

Risk sharing

Risk allocation is clearly a key issue, and we agree that risks should be allocated to those best able to manage them. In our view, there are, broadly, three approaches available to the CAA to do this: allow additional returns to cover the risk; create a mechanism to mitigate the risk; or require investors to diversify the risk.

It also seems clear to us that any change in risk allocation between (or within) these options needs to be matched with an appropriate change in the allowed return. We would need to be clear that any change in the risk profile would be consistent with the CAA's new primary duty and in the interests of our passengers.

While traffic volume risk is important, there are two points to bear in mind: that the first priority should be to require investors to seek to diversify risks where possible; and that BAA carries only second-order traffic risk. It is therefore not clear that any reduction in risk faced by investors is warranted – and if any such reduction is made, there should be a clear read-across to a reduced allowance.

Indexation of the RAB

We assume that discussion of RAB indexation is for illustration only and is not an issue under consideration. However, were RAB indexation to emerge as an issue under consideration, the following points would be relevant:

- For NPV neutral approaches (such as those the CAA has set out), intergenerational equity is the main concern
- Back-end loaded returns appear more consistent with that than front-loaded returns – especially as utilisation of assets changes over time.
- Under front-end loaded returns, the link between charges and RPI is lost. Further, computational complexity can arise if a nominal WACC approach is adopted – the New Zealand Commerce Commission approach to gas distribution charging is a good example of this.
- More generally, it is not clear what might be achieved by a change of approach in this area

SUMMARY

British Airways welcomes, and is grateful for the opportunity to respond to this Consultation. Our primary concern in the Q6 process continues to be to engage thoroughly and constructively to try to achieve an outcome that delivers meaningful benefits for our passengers at a price that they are willing to pay.

We are already engaging wholeheartedly with the aviation community and regulated airports at Heathrow and Gatwick, and with the CAA. Consequently, and especially given the constructive dialogue that we are having with the CAA, we hope that the content of our response builds upon these discussions.

We look forward to further constructive dialogue with the CAA, but in the meantime should you wish to discuss or seek further clarification of any of the points in this response, then please contact:

David Hart
Head of Economic Regulation
British Airways

David.hart@ba.com

07789 610175