



# **Airports price control review**

## **Economic regulation of Heathrow and Gatwick Airports, 2008-2013 CAA decision**

**CAA briefing  
11 March 2008**



# Context for these decisions

## Today's decisions come after a three year review

- May 2005 – CAA sets agenda for constructive engagement between BAA and its airlines, to inform regulatory review
- December 2005 – CAA policy consultation
- December 2006 – CAA initial proposals
- March 2007 – CAA reference to Competition Commission
- September 2007 - Competition Commission reports to CAA
- November 2007 – CAA proposals, for final round of consultation
- January 2008 – oral hearings with BAA and airline representatives

## Today's decisions only for **Heathrow** and **Gatwick**

- **Stansted** current price cap now extended by 12 months, as for **Manchester Airport**, to run to March 2009
- **Manchester Airport** de-designated by Government – price controls end March 2009
- **Stansted Airport** remains designated – CAA currently consulting on options for price control, in advance of making reference to Competition Commission in April

# CAA's statutory function



- to set maximum limits on airport charges at airports designated by the Secretary of State
  - Heathrow and Gatwick for 5 years from April 2008
- within a clear statutory framework:
  - Government designates airports for price control
  - Competition Commission reference - mandatory
  - CC recommendations – CAA must 'have regard' to CC price control recommendations, must impose conditions to remedy any CC public interest findings
- to set price controls in the manner best calculated by the CAA to:
  - further **reasonable interests of users** of airports within the UK;
  - promote the **efficient, economic and profitable operation of such airports**;
  - **encourage investment in new facilities in time** to satisfy anticipated demands by the users of such airports; and
  - impose the **minimum of restrictions** consistent with the performance by the CAA of its functions;

in doing so, to take into account UK international obligations, notified by DfT

## Key themes

### **Delivering decently modern airports with consistently good service**

- **Passengers and airlines deserve better than they have experienced in recent years**
- **Stronger financial incentives on each airport to delivery timely investment and better service performance**
- **Substantial investment required at both airports**
- **Cost of capital pitched to reflect risks of investment and to attract sufficient capital for next phase of airports' development**
- **Beyond this, BAA rewarded for improving service performance further and for out-performing on commercial revenues and operating costs**

### **The CAA's package of price caps and incentives will enable and encourage BAA:**

- **to deliver genuine service quality improvements**
- **to invest to raise the level of facilities and service that can be delivered to passengers and airlines**

# CAA price control decisions for Q5 (2008-2013)

## Heathrow

- £12.80 per passenger in 2008/09
- 23.5 per cent increase in real terms from 2007/08 price cap (like-for-like basis)
- equivalent to an extra £2.44 per passenger
- allowed charges subsequently increasing in each of the following four years by no more than retail price index (RPI) inflation plus 7.5 per cent each year

## Gatwick

- £6.79 per passenger in 2008/09
- 21.0 per cent increase in real terms from 2007/08 price cap (like-for-like basis)
- equivalent to an extra £1.18 per passenger
- allowed charges subsequently increasing in each of the following four years by no more than RPI inflation plus 2.0 per cent

At both airports, the difference from the CAA's November 2007 proposals is in the first year increase:

- £0.83 per passenger or 7 percentage points greater at **Heathrow**
- £0.72 per passenger or 12 percentage points greater at **Gatwick**

All £ figures in 2007/08 prices

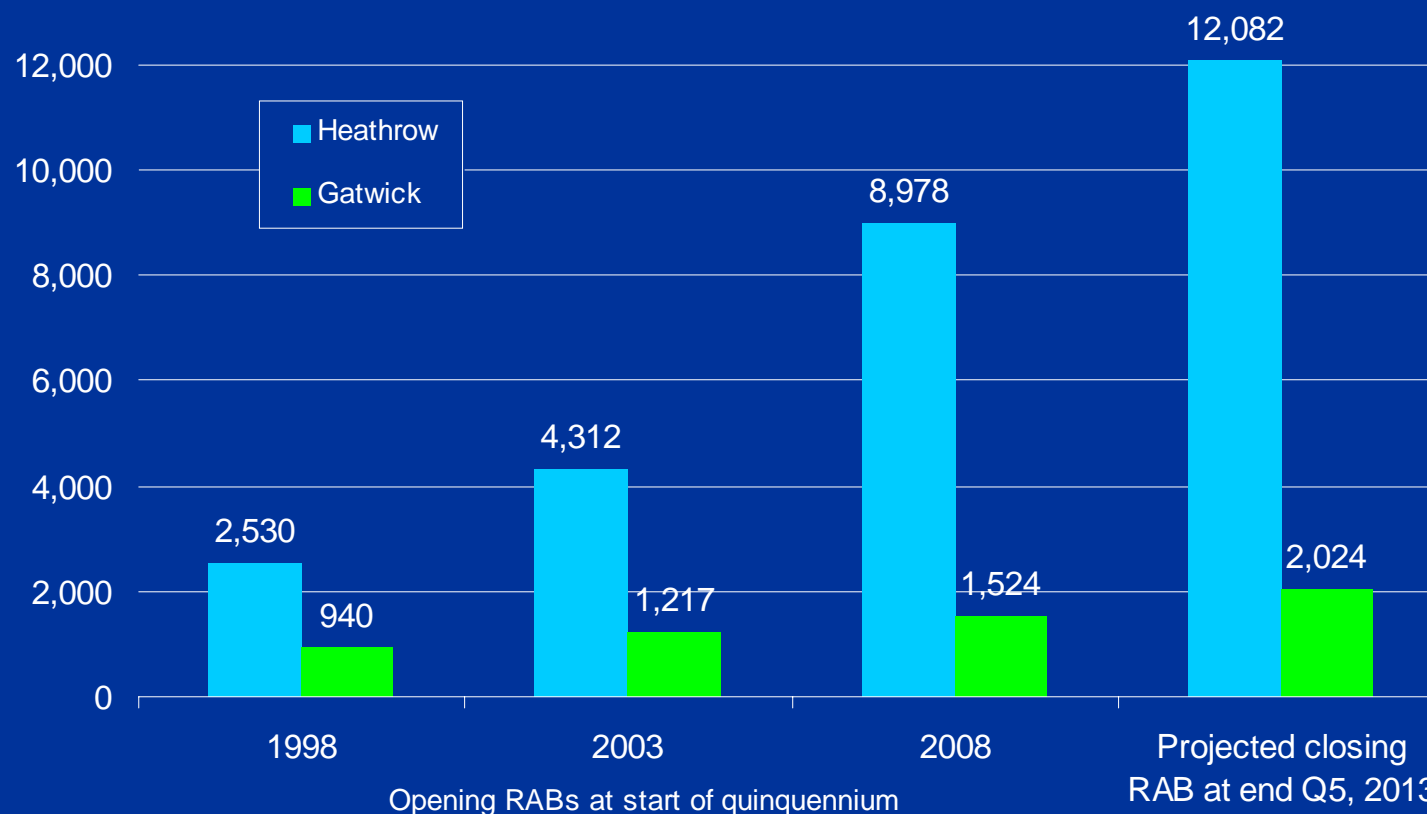
# Investment at both airports growing significantly

Greater investment per passenger in prospect:

**Heathrow** regulatory asset base per pax £128 at start Q5, rising to £154 by end Q5 (+21%)

**Gatwick**: £42, rising to £54 (+26%)

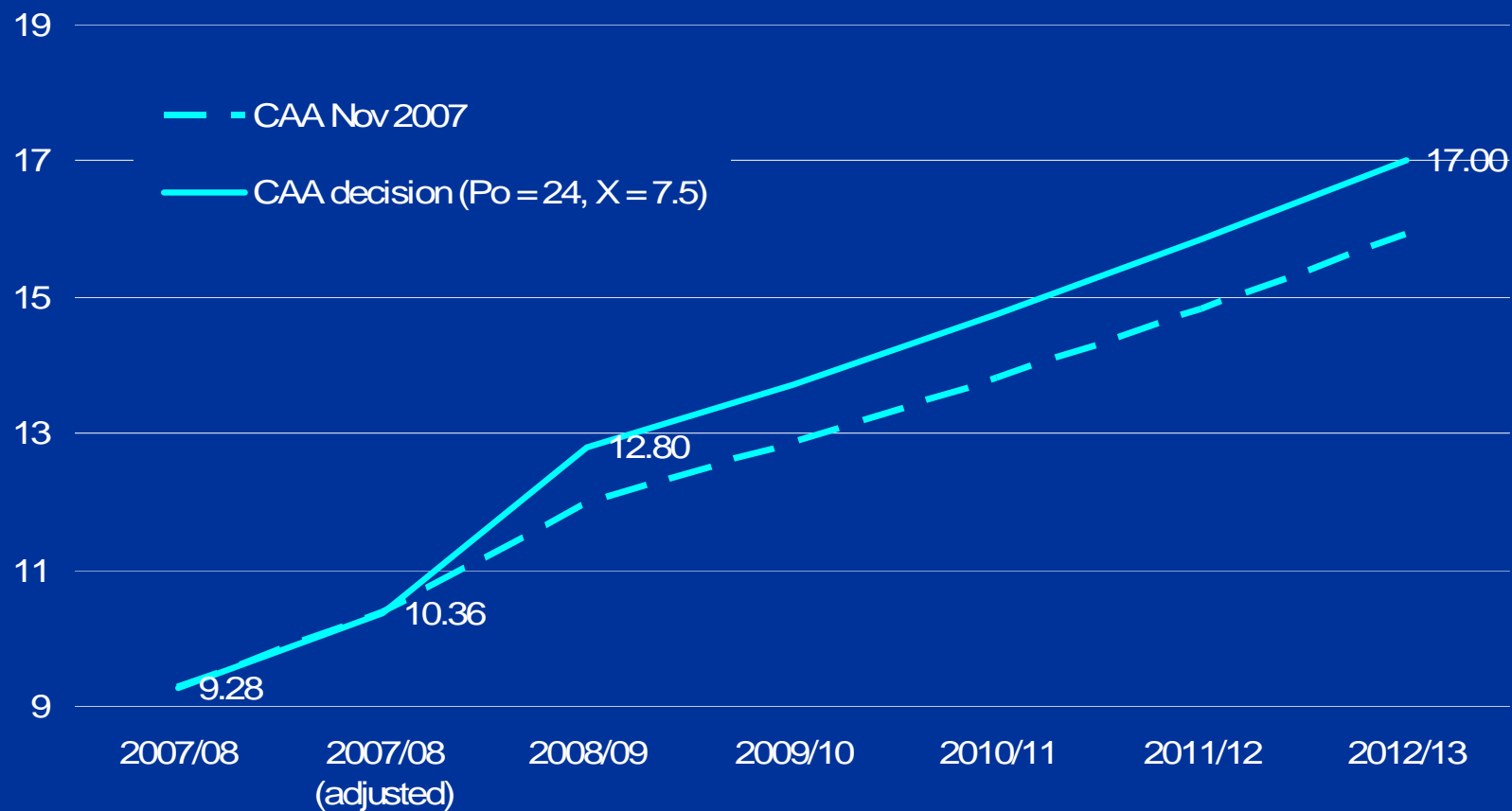
£m, 2007/08 prices



# Heathrow price cap



£ per passenger,  
2007/08 prices



# Gatwick price cap



£ per passenger,  
2007/08 prices



# Key changes since CAA November 2007 proposals



Differences in Q5 totals: March 2008 decision less November 2007 proposals

Q5 total £ million 2007/08 prices	Heathrow		Gatwick	
	Difference	% of Nov 2007	Difference	% of Nov 2007
Opening RAB	105	1.2%	20	1.3%
Capital Expenditure	1,043	27.9%*	27	3.0%
Closing RAB	1,077	9.8%*	27	3.0%
*including estimated spend during Q5 on Heathrow expansion via third runway and mixed mode				
Operating costs	111	2.7%	100	7.8%
Total revenue requirement	354	4.0%	139	6.2%
Commercial revenues	-2	-0.1%	-2	-0.2%
Non-regulated charges	-19	-2.2%	7	3.9%
Net revenue requirement	376	7.3%	134	11.5%
Passengers (millions)	0.8	0.2%	-1	-0.5%

# Service quality incentives

Passengers and airlines expect and deserve more

- BAA recognises need to improve performance
- Competition Commission mandates improvements in security processing, and recommends improvements elsewhere

Four dimensions to CAA decision (building on BAA/airline consultation):

- Broader scope of service quality incentives (e.g. transfer passenger security processing)
- Raising service quality standards (e.g. security queue no more than 5 minutes 95% of time)
- Strengthening financial incentives – increasing rebates
- Incentives for improving passenger service – bonuses for above-target service

## Overall financial impact

Maximum service quality:	% of airport charges	Maximum payments in 2008/09 (2007/08 prices)	
		Heathrow	Gatwick
rebates	7%	£63m	£17m
bonuses	2¼%	£20m	£5m

# Service quality – improving passenger experience



## What can passengers expect from BAA?

- **Shorter security queues:**
  - Departing: less than 5 minutes (95% of time, whole day), with maximum queues of 10 mins at **Heathrow** (99% of time), 15 mins at **Gatwick** (98% of time)
  - Transfer passengers: new target, rising over Q5, to <10 mins queue (95% of time, whole day)
- **More reliable equipment:**
  - Lifts, escalators and travelators all available for 99% of time (aside from planned maintenance), with more financial incentives on key equipment
- **Cleaner terminals**
- **More comfortable terminals: better seating**
- **More easily understood terminals: better way-finding and flight info**
  - (Target for all – average passenger perception to be ‘good’ on survey measure)
- **More information (in terminals and on website) about each airport’s performance**

## Bonus potential for BAA for service above standard

- encourage BAA to aim higher, raise aspirations, align incentives for staff
- inform decisions for Q6 that could raise minimum standards higher

# Investment

## Investment remains a strong theme for next price control period

- **Heathrow**: bringing terminal facilities up to competitive equivalent standard across the airport
  - completion of T5 and new Heathrow East Terminal by 2012 (together taking 63% of passengers), refurbishment of T3 and T4, airlines relocated
- **Gatwick**: renewal of ageing infrastructure and improved terminal capacity and service standards
  - new North Terminal pier, better passenger space in South Terminal check-in and access, new South terminal baggage system

## CAA decision

- all investment in current period allowed into the Regulatory Asset Bases
- decision based on BAA's full capital investment programmes: **Heathrow** £4.11bn, **Gatwick** £0.92bn, including construction price inflation
- stronger protection for users from any slippage in required investment
- at **Heathrow**, contingent funding of return on capital for initial expenditure of up to £640m on airport expansion (e.g. blight costs, design and planning work) – pending Government decision on expansion

# Capital expenditure



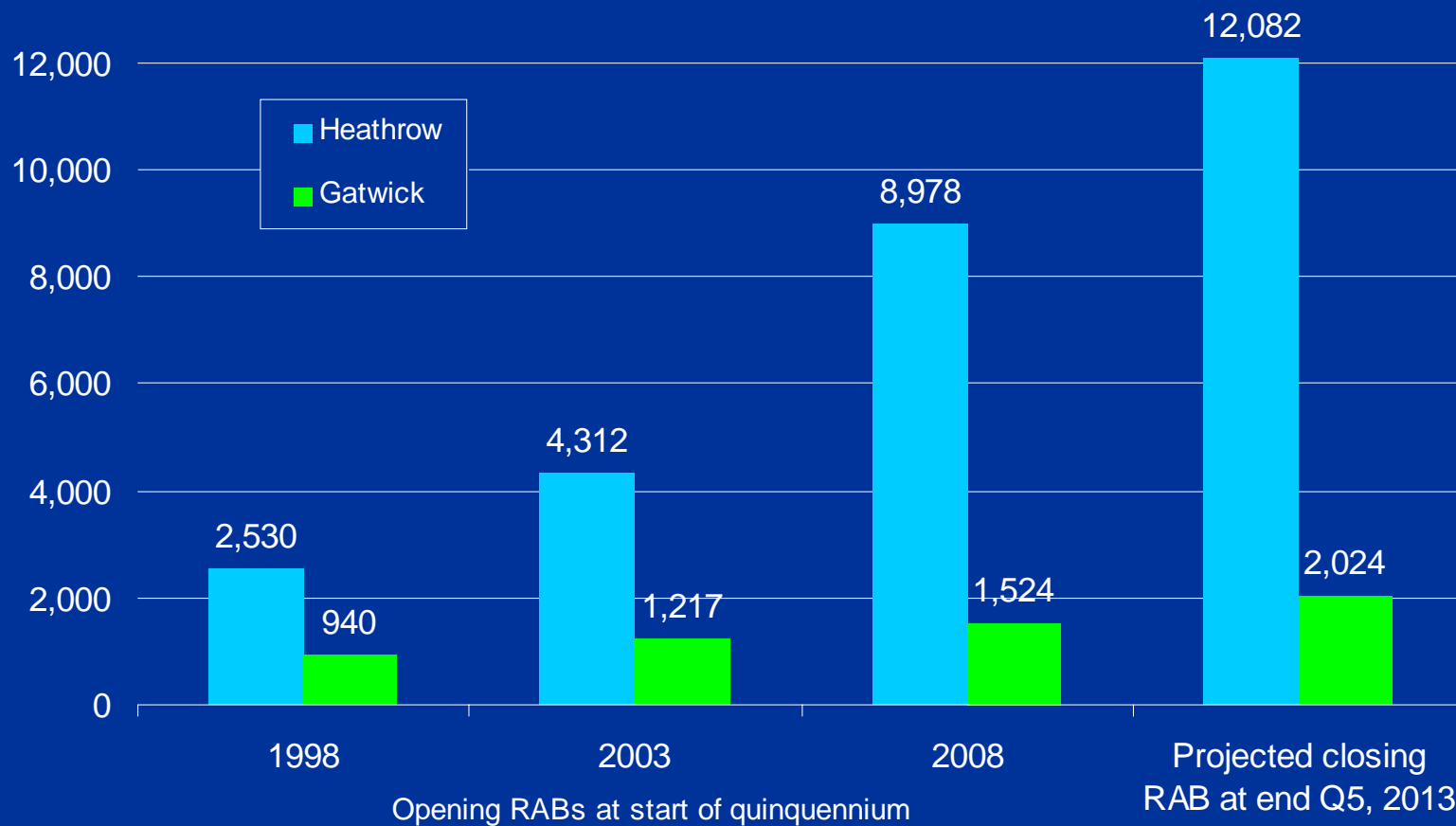
£m, 2007/08 prices



# Regulated asset bases



£m, 2007/08 prices



## Investment incentives

- greater proportion of the investment programme at each airport subject to 'triggers' - penalty payments each month for late delivery of specified projects
- CAA's decision: triggers covering some 60 per cent of each of **Heathrow's** and **Gatwick's** respective capital programme for Q5
- Puts at risk for **Heathrow** some 5 per cent (£277m), and for **Gatwick** 4.3 per cent (£56m) of total Q5 airport charge revenue, in the event that the specified projects were not delivered at all

# Cost of capital

- Pre-tax real weighted average cost of capital **6.2 per cent at Heathrow** and **6.5 per cent at Gatwick** (as per CAA November 2007 proposals and Competition Commission recommendations)
- Financeability: the CAA concludes that there is no basis on which to adjust the proposed price controls at either **Heathrow** or **Gatwick** airports in Q5 for reasons of financeability

Parameter	Heathrow		Gatwick	
	Low	High	Low	High
Gearing	60%		60%	
Pre-tax cost of debt	3.55%		3.55%	
Risk free rate	2.50%		2.50%	
Equity risk premium	2.50	4.50	2.50	4.50
Equity beta	0.90	1.15	1.00	1.30
Post-tax cost of equity	7.3%		7.9%	
Taxation	28%		28%	
Pre-tax cost of equity	10.2%		10.9%	
<b>Pre-tax, real WACC</b>	<b>6.2%</b>		<b>6.5%</b>	



# **Civil Aviation Authority** **the UK's specialist aviation regulator**