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25th November 2013

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25th November 2013

Request for additional points on the Q6 airport price control consultation process - Heathrow

Dear Peter

British Airways is grateful for the opportunity to respond to your open letter on this subject. As requested in your letter, we have restricted our response to either new developments (for example the Competition Commission's latest publication on the NI Energy Case), and information that is new to us (for example the CAA's publication of the responses to its Final Proposals). Given the short period of time you have to digest our comments before making your final decision, we have restricted our response to those areas which seem most material to us. For the avoidance of doubt, British Airways position on all other matters related to Q6 at Heathrow, remains as laid out in our response to the CAA's Final Proposals.

We restrict our response here to four areas: the WACC; opex; traffic forecasts; and the licence. We deal with each in turn. We also attach two short Annexes providing more detail on the WACC points discussed and providing some input on service quality issues.

WACC

The CEPA annex focuses upon new information since the Final Proposals - both from regulatory bodies and from HAL in their response to the Final Proposals. On the former, new information has been provided by the Competition Commission, the Office of Rail Regulation, Ofgem and Ofwat. This unequivocally points to the CAA having over-estimated the cost of capital, and in particular the cost of equity. This difference is over 110bps on the cost of equity when using the CC parameters on the risk free rate and equity risk premium for HAL and GAL. The CEPA note also highlights factual errors made by HAL in their response, both in terms of data analysis and their understanding of financial theory. These errors should lead to great caution when looking at the arguments put forward by HAL.

OPEX

HAL contends at pages 41-42 that the CAA's draft licence condition formula for the business rate revaluation factor does not give effect to the CAA's proposals. BA agrees that the only pass-through should be in relation to the impact of the revaluation and, for that reason, agrees that HAL's definition of "Ut" in the formula is preferable to the CAA's, which looks at the actual figure paid for business rates regardless of what has caused any variation from the expected figures. At the same time, though, BA is strongly opposed to the qualification in HAL's draft condition that the formula should only apply if "BRt >0" and that otherwise "BRt=0" since this would mean that there is no pass-through in favour of airlines and passengers if the revaluation results in less than a 9% increase in business rates, which we consider highly likely. There is no justification for asymmetric treatment and we did not understand this to be the intention in the CAA's proposal.

Traffic Forecasts

In our response to the CAA's Final Proposals, we noted that current traffic figures at Heathrow were not forecast by the CAA to be attained until somewhere between year 3 and year 4 of Q6. We argued that unless the CAA could show that traffic volumes would fall significantly between now and April 1 2014, which it could not reasonably do, that the CAA traffic forecast significantly understated likely volumes.

Since our response, HAL have published new traffic figures for October 2013, show strong growth over October 2012 (4.6%). This confirms the pattern observed in our response. Taking these new figures into account, and uprating each year only by the absolute increase currently forecast by the CAA, would generate a forecast 10m passengers higher for Q6 than the CAA's current forecast.

This is significant error. We believe that in reaching its final decision, that the CAA has a duty to put forward a passenger forecast that properly reflects expected volumes at Heathrow.

We note that in HAL's response they argue that Q6 prices are higher because Q4 and Q5 traffic volumes were lower than forecast. We fail to see how this can be the case. In addition, Heathrow is in the position that it bears, and is compensated for bearing, both the upside and downside traffic risk. It is unfortunate that forecasts have not been accurate, but this is what the higher WACC compensates them for. We also question whether, if volumes had exceeded forecasts, that HAL would have put forward such an argument. We suspect that HAL would not be complaining if actual volumes had exceeded forecasts. HAL's shareholders have made very healthy returns despite the shortfall in volumes. This has been discussed in our previous responses and shows just how generous previous settlements have been.

Licence

In Section 7 of its response to the CAA's Final Proposals, HAL contends that there are certain inconsistencies between the CAA's draft licence and its proposals. There is no real substance to this complaint. To briefly address the three points made by HAL:

- HAL suggests that the CAA proposed to include 'sunset' provisions in the licence but did not actually do so. In fact, there is only one reference to 'sunset' provisions in the whole of the Final Proposals and it is in an introductory paragraph in the Executive Summary where it is clear that the CAA is only indicating that it would consider introducing 'sunset' provisions where appropriate. It does not say that it is intending to introduce any on this occasion.

- HAL suggests that there is an inconsistency between Paragraph 5.19 of the Final Proposals and Condition F.1.2 of the draft licence on the timing for agreeing a governance protocol. In fact, there is no inconsistency. The Condition merely states the latest date by which a protocol or protocols (arguably broader than discussed in Paragraph 5.19) must be published to avoid licence breach. The Licence plainly could not require HAL to do anything before the Licence was itself in force. It is still, though, open to the CAA to press HAL to agree a governance protocol before April 2014 and we consider that it is right to do so.

- HAL suggests that there is an inconsistency between Conditions F1.1 and D1 on what changes can be made in consultation with airlines. In reality, it is clear that changes to the "the service quality regime in Condition D1" does not mean changes to Condition D1 but changes to the service quality regime, which is given effect by Condition D1 (but the substance of which is in a Schedule incorporated through Condition D1). As such, there is no inconsistency.

HAL also complains about conditions imposing obligations "to agree" matters since HAL cannot unilaterally secure compliance with such conditions. In reality, though, the only such obligation is in Condition F.1.2 (the only example HAL refers to) and it is not actually problematic because Condition F.1.7 allows HAL to refer the issue to the CAA if there is no agreement. As such, a failure to agree cannot be a licence breach.

HAL makes more substantive criticisms about the proposed condition(s) on delivery of capital spend, i.e. to prevent HAL implementing the "capex strike" that it has sought to use as a form of blackmail to secure a higher WACC. The criticisms made by HAL are without substance for the following reasons:

- The proposed condition is not inconsistent with incentive-based regulation. It is appropriate even in incentive-based regulation to have minimum requirements. Besides, the Act does not limit the CAA to incentive-based regulation. No-one is suggesting that HAL should be required to make unnecessary and inefficient capex investments.

- The other measures referred to by HAL (e.g. capital triggers) cannot achieve the same objective pursued by the proposed condition on delivery of capital spend. They ensure, or should ensure, that HAL cannot earn a return where it does not invest or invests unwisely but they cannot operate to require HAL to invest. It is for this reason, in the light of HAL's RBP, that additional measures are required and are not disproportionate.

- HAL's case on "legitimate expectations" is misconceived. It is HAL that has sought to back away from previous commitments, not the CAA.

British Airways does agree with HAL in one respect. It would certainly be better to impose the proposed condition on capital spend at the same time as the rest of the licence conditions rather than later. The terms of the price control should properly take account of whether or not there is a capital spend condition of the type proposed. It would not be appropriate to maintain a WACC developed on the basis of a £3bn capex investment in circumstances where the licensee actually only invests £2bn.

I hope that you find this helpful, and am of course happy to discuss any of these points further.

Yours sincerely,

David Hart
British Airways

ANNEX A

A response based upon new information since the CAA Final Proposals

Note prepared for British Airways[1]

November 2013

This note is in response to the letter from the CAA on 18 November 2013 in request of any additional points to consider on the Q6 process[2]. This request included comments on information that has arisen since the CAA Q6 Final Proposals consultation, such as the provisional determination by the Competition Commission (CC) on the Northern Ireland Electricity (NIE) case, or information provided in response to the consultation.

As such, this note is split into two sections; relevant material from regulators since the consultation and a subsequent section on aspects of the Heathrow Airport (HAL) response where we perceive factual errors. We have previously discussed the setting of an appropriate cost of capital in detail, thus do not intend to cover the same areas again and only focus upon new information[3].

Regulatory decisions since the CAA Final Proposals

CC provisional determination on the NIE case

This section focusses upon the economy-wide parameters of the cost of capital in the provisional determination as the most directly applicable to the Q6 determination. This leads us to focus on the total market cost of equity[4].

The CC note in their approach to the NIE case that the appropriate way to arrive at a cost of equity is to examine long-dated index linked gilt yields and forward data in establishing a risk free rate, then calculating an equity risk premium (ERP) based on the deduction of the risk free rate from a total equity market return (TMR). The table below shows the total equity market return range and point estimates from the CC in the NIE case and from the CAA in their Q6 Final Proposals.

Table 1.1: Cost of equity estimates

	CC (NIE)		CAA (Q6)	
	Range	Point estimate	Range	Point estimate
Risk free rate	1.0-1.5%	1.25%	0.5-1.0%	1.0%
ERP	4.0-5.0%	4.5%	5.25-5.75%	5.75%

[1] This note has been commissioned by British Airways. However, the views expressed are those of CEPA alone. CEPA accepts no liability for use of this note or any information contained therein by any third party.
[2] As published on the CAA website: http://www.caa.co.uk/docs/78/request%20additonal%20points%20Q6%20heathrow.pdf
[3] Consequently, failure to discuss an aspect does not mean that we agree with the interpretation put forward by HAL, but do not disagree with the factual data upon which this interpretation is made.
[4] The cost of debt approach taken by the CAA and their consultants, PwC, look at the cost of debt at the all-in cost of debt level, rather than necessarily using a risk-free rate and debt premium calculated separately. As such, any change to the risk free rate should not change the cost of debt.

	CC (NIE)		CAA (Q6)	
	Range	Point estimate	Range	Point estimate
TMR	5.0-6.5%	5.75%	6.25-6.75%	6.75%

Source: CC, CAA

This shows that the TMR estimated by the CC is an entire 100bps below the CAA point estimate, and the effect of using the CC parameters with the CAA equity betas would lead to a cost of equity which is over 110bps lower. We discuss some of the commentary around the CC determination.

On the risk free rate, the CC '*see little justification for the upper end of the range of the risk free rate to be above 1.5 per cent.*'[5] They suggest that long-term factors may be at play and quote Dimson, Marsh and Staunton (DMS), who state that it is difficult to observe whether long bond yields are artificially low, but suggest there is evidence that these 'distortions' will not disappear. DMS also suggest that forward data should accurately reflect available information.

Whilst HAL had proposed a 7.0% TMR for Q6, the CC find that '*a forward-looking expectation of a return on the market of 7 per cent does not appear credible (to us), given economic conditions observed since the credit crunch and lowered expectations of return.*'[6] The CC instead propose a TMR of 5.0-6.5%.

In terms of selecting a point estimate from this range, the CC favour use of the mid-point. This is supported by their statement, in which they '*consider it unlikely that the cost of capital lies at the very top or very bottom of the estimated range as this would involve the lower or upper estimates for each parameter coinciding.*'[7]

This analysis should suggest further scrutiny of work presented by HAL, given that the HAL response alone speaks of '*prediction of a plausible range for the RFR of at least 2%,*'[8] and discards the use of market evidence when predicting a rise in the risk free rate '*in a way which that is not adequately captured by observations from the forward market.*'[9] This leads to HAL being 125bps above the CC NIE estimate for a TMR and this is before considering the questionable equity beta assumptions put forward by HAL.

The impact on the cost of equity for HAL by using the CC parameters for the risk free rate and equity risk premium is 1.4% on a pre-tax basis. This leads to a fall in the pre-tax WACC of 57bps, to 5.03%. The use of the mid-point of the equity beta range would further reduce the pre-tax WACC by 17bps to 4.86% for HAL.

Further regulatory information

HAL refer to insufficient information being provided to show as a comparison to UK regulated companies. They state that '*the CAA proposes a WACC 25bps below that set by Ofwat for water and sewerage companies.*'[10] For PR14, the Chief Regulation Officer from Ofwat, Sonia Brown, has discussed a vanilla WACC of 4.1% publically as a mid-point of analyst estimates.[11] The Ofwat chairman, Johnson Cox, has also pointed out the falling cost of capital since the PR09 decision.[12] Therefore we think that comparing to the 5.1% vanilla WACC from the PR09 determination is potentially misleading. The CC also lowered the vanilla WACC given to Bristol Water by Ofwat at PR09 by 50bps[13].

Apart from the Ofwat statement referenced above, two regulatory determinations have been released over the last month. The Office of Rail Regulation have released their Final Determination for CP5 in which a 4.31% vanilla

[5] CC (2013) 13.121
[6] CC (2013) 13.144
[7] CC (2013) 13.174
[8] HAL (2013) p26
[9] HAL (2013) p26
[10] HAL (2013) p12
[11] Utility Week (2013) http://www.utilityweek.co.uk/news/a-message-for-water-companies-from-ofwat%E2%80%99s-sonia-brown/938592
[12] Ofwat (2013) http://www.ofwat.gov.uk/mediacentre/speeches/prs_spe20130305jcrae.pdf
[13] CC (2010) Bristol Water determination, Annex N

WACC has been agreed upon, or 4.93% in pre-tax terms (the same as the draft determination from 12 June 2013)[14]. This price control runs over the same time period as Q6 and this compares to a 5.6% pre-tax WACC for HAL and 5.95% pre-tax WACC for GAL. This was released prior to the CC provisional determination for NIE. In addition, Ofgem released its decision on fast tracking the electricity distribution companies. Three relevant items are covered here:

1) The central reference cost of equity for assessing business plans was 6.3%[15];

2) The accepted cost of equity for WPD (the only fast-tracked company) was 6.7%, but this was accepted as part of a package including greater than anticipated efficiency targets[16]; and

3) A consultation is proposed on the impact of the recent CC NIE provision determination as this would reduce the allowed cost of equity to closer to 6%.

Again, this evidence points to the CAA final determination and HAL's response both embodying excessive cost of equity values.

HAL response to Final Proposals

In this section we consider elements of the HAL response to Final Proposals in which we perceive there has been a factual error on the cost of capital (or statement made which implies a factual error).

There are two items in particular which we would like to highlight as part of our analysis (in addition we attach at Appendix A a short summary of our responses to HAL's comments).

The first of these is on the choice of cut-off date and is covered more extensively in a CEPA note included as an annex to the British Airways (BA) response to the CAA Q6 Final Proposals[17]. PwC relied on a spot estimate in their report for the CAA, using data from 27 June for the Final Proposals.

HAL agree that the PwC approach is not appropriate and suggest a three month average is preferable (with a data cut-off of 7 October). CEPA, in the aforementioned note, present a six month average with a data cut-off of 30 October[18]. The quote in the HAL response is that *'if rates were updated to now (7th October), or if an average of rates over the last 3 months were taken, the cost of new debt would be higher by around 7bps, adding 1bps to the WACC.'*[19]

Our analysis would suggest that this summary is incorrect. The table below shows the real cost of debt based upon our benchmark, the 10-15 year iBoxx non-financial corporates A and BBB rated bonds. We show the spot rate (PwC favoured approach), three month average (as noted in the HAL response) and six month average, as noted in the CEPA response for BA. The dates correspond to the cut-off for the PwC report, the cut-off for the HAL response and the cut-off for the CEPA note for BA.

Table 1.2: Real cost of debt (historical)

Estimate as of….	Spot rate	3 month average	6 month average
27 June 2013	1.55%	0.80%	0.86%
7 October 2013	1.24%	1.31%	1.10%
30 October 2013	0.96%	1.29%	1.17%

Source: iBoxx, Bank of England, CEPA analysis

[14] ORR (2013) http://www.rail-reg.gov.uk/pr13/PDF/pr13-final-determination.pdf
[15] Ofgem (2013) https://www.ofgem.gov.uk/sites/default/files/docs/2013/11/assessment_of_the_riio-ed1_business_plans_0.pdf, p18.
[16] This 6.7% cost of equity should be seen in the broader context of a 4.1% real vanilla WACC, implying a significantly lower cost of debt (from the indexation model) than has been allowed by the CAA.
[17] CEPA (2013) A response on the cut-off date for the CAA Final Proposals
[18] This included forward rate estimates over the averaging period rather than simply historic rates.
[19] HAL (2013) p26

The figure chosen by PwC was the equivalent figure of 1.55% using their favoured benchmark indices[20]. If the data was updated to the 7th October using spot rates i.e. the same methodology adopted by PwC, the cost of new debt would have fallen by 31bps, not risen by 7bps as stated by HAL. If the evidence were to be updated further to 30th October, the cost of new debt would have fallen a further 28bps (i.e. 59bps in total). Using averages rather than spot rates, both the three month and six month averages would be at least 24bps lower than the 1.55% figure arrived at by using the PwC spot rate approach. Both methodologies would lead to a notably lower cost of new debt rather than a higher cost of new debt, as HAL seem to suggest.

The second error we note is where HAL state that *'it is generally accepted that the cost of capital of large pension funds like USS is lower than the cost of capital of other types of investors*.' The argument that a large pension fund would require a lower cost of capital for the same asset totally goes against financial theory and to argue that this is generally accepted should lead to further questioning of the credibility of arguments put forward by HAL.

As previously stated, there are a range of further areas in which we disagree with the approach taken or interpretation made by HAL, but we have focussed upon new information and arguments in this note.

[20] Indices are the same maturity and credit rating as the CEPA preferred indices, but PwC consider non-gilts rather than our non-financial corporates indices. Whilst we may expect the exact numbers to vary, we would not expect there to be significant variations in time trends across indices.

Appendix A

Table 1.2: Further HAL response points

Item	HAL response (page ref)	Most relevant BA/CEPA response(s)	Comments
Cost of equity			
Equity beta	Analysis from HAL and from advisers points to a 1.35 equity beta. (p34)	CEPA (June 2013) Equity Betas for Heathrow and Gatwick in the Q6 Price Control Review; CEPA (June 2013) An updated estimate of Heathrow and Gatwick's WACC	Equity beta of 0.95 is appropriate. This is consistent with evidence from comparator airports and regulatory precedent. Note that the notional gearing from recent regulatory determinations in GB are higher (e.g. Ofgem RIIO 65%, ORR CP5 62.5%), therefore a similar asset beta would correspond to a lower equity beta estimate for HAL and GAL.
Coskewness	Asset beta of 0.60 equivalent to no adjustment for coskewness. (p29)	CEPA (Feb 2013) Setting the weighted average cost of capital for Heathrow and Gatwick (Appendix 2)	Considered as part of our analysis and an asset beta of 0.60 is completely unreasonable.
Net versus gross debt	Prefer net debt rather than gross debt for gearing estimates in beta calculation. (p33)	CEPA (June 2013) Equity Betas for Heathrow and Gatwick in the Q6 Price Control Review	The CEPA figures use net debt for comparators. This comparator data points to lower figures since Q5.
Taxation	Labour Party at the 2013 conference announced a 21% corporation tax figure rather than 20%. Should use range based on these. (p35)	CEPA (June 2013) An updated estimate of Heathrow and Gatwick's WACC; CEPA (Feb 2013) Setting the weighted average cost of capital for Heathrow and Gatwick	Our favoured approach has to be 20.2%. We think that the best estimate is what is currently set out in legislation.
Cost of debt			
Debt premium	Two year average of HAL spread equal to 177bps excluding swap costs, or 186bps with swap costs included. Adding a 2% risk-free rate gives a cost of new debt of	BA (October 2013) Response to CAA Final Proposals (Appendix B)	BA point to technical errors in the existing calculation and the removal of subordinate debt leads to an

Item	HAL response (page ref)	Most relevant BA/CEPA response(s)	Comments
	3.86%. (p27)		overestimation of the cost of new debt. CEPA, working as a consultant to ORR for CP5, estimate a cost of new debt of 1.75-2.25% for a notional company with a BBB+/A- credit rating. There is no compelling reason why HAL should be above this range.
Forward coefficient	Include a one-for-one relationship between gilt and corporate bond yields, raising the cost of new debt by 20bps. (p19)	CEPA (October 2013) A response on the choice of cut-off date for the CAA Final Proposals	We use the 0.8 coefficient for estimating forward rates. The above details already note an overly generous allowance before any further additions are made.
Fees	New Issue Premium fees for new debt should be 20-25bps. Revolving credit facility fee should be 17-20bps. (p21)	BA (October 2013) Response to CAA Final Proposals (Appendix B)	BA agree with the CAA estimate of 15bps in total fees on the cost of debt.
Non-sterling debt	PwC should have included non-sterling debt and associated currency hedging costs. Estimate that this would add 5bps to the cost of debt. (p24)	BA (October 2013) Response to CAA Final Proposals (Appendix B)	The inclusion of non-sterling debt includes bonds with lower yields (and a shorter average maturity) even after associated costs. BA estimate that HAL trade 60bps below the PwC benchmark indices and that the cost of embedded debt is significantly overestimated by the CAA in the Final Proposals.

ANNEX B

Comments on the HAL Response re Service Quality

Service Quality

- We do not agree with HAL that any recognition by CAA or the airlines of any improvement in standards achieved by HAL in Q5, should preclude any further improvements to the service quality regime and standards in Q6. In fact, the improvements to date demonstrate the efficacy and need for such a scheme in incentivising HAL to continue to improve the passenger experience. Heathrow themselves have an agreed aspiration to provide service levels that allow us to compete with other airlines, all of whom will be focussed on continuously improving their service to remain competitive. We would expect HAL as the airport operator to remain committed to similar improvements, as are the airlines, and a Service Quality Scheme that supports this, can only be a welcome means of ensuring this.

- Much of HAL's complaint about the FP seems to revolve around fairness and regulatory duty or burden. In this response, they seem to have fundamentally ignored the fact that the primary duty of the CAA is not to HAL, but to furthering the interests of the passenger. British Airways strongly supports much of the CAA's SQ rebate Scheme final proposal as resolving known issues with the Q5 settlement and/or refocusing attention on new or existing areas where further improvements are required. The SQR has been on a path of modification, and refinement since its inception in Q3, evolving in line with the changing requirements of the airlines, their passengers and HAL's business itself, and we would expect this to continue to be the case in the future. We do not consider refinements to the regime to be undue regulatory burden.

Rebates and Bonuses-

- We note that HAL object to the removal of the two bonus elements from the scheme. Whilst British Airways remains fundamentally opposed to the inclusion of bonus within the scheme, we support the CAA in withdrawing bonus from the two areas where HAL no longer appear to require the incentivisation of a bonus to reach a suitable level of service. We do not agree with HAL that symmetry is a requirement of the scheme with respect to bonus and rebate.

- On the issue of rebates, we continue to strongly support CAA's decision to remove the proposal for sliding scale rebates. We consider the risk of HAL making their own trade offs that lead to uncertain performance levels that the airlines must plan their operation around has too great a potential consequence on the passenger and the operation of the airport to be a viable option moving forward.

- We fundamentally oppose the concept of bonuses being applied to security processes (staff, passenger or control posts).

Security

- We remain strongly in support of the CAA proposal for a 5 minute standard as an interim measure at transfers, in line with that at Directs. HAL have made the suggestion that additional infrastructure is needed in order to meet the final standards, and that therefore this interim standard also cannot be achieved without it. It would appear that their arguments fail to take into account the fact that until automation is introduced, it will not be on a true per passenger basis, and that it does not therefore require the same level of stretch as the final solution.

- We would also point out that yet again, as in their previous responses, that HAL have failed to acknowledge that the real problem in achieving robust security performance is not in infrastructure provision, but in their failure to address and manage steadily decreasing flow rates. Resolution of this issue would address any concern about meeting standards without any further increases in security infrastructure numbers.

- We therefore believe that this standard is a fair and sensible introduction by the CAA which will protect the passenger experience whilst automation is introduced, and which should incentivise HAL to follow the lead of other UK airports in getting processes and flow rates under control. These two aims would seem to be entirely in line with CAA's duties to the passenger, and improving and promoting efficiency.

- Control posts- British Airways agrees with HAL that the current CAA proposal to group control posts is not desirable and that by grouping posts, there may be undesirable consequences of redirection of traffic. We do not however agree with HAL that there should be a single averaged control post measure. British Airways strongly supports the airline community position that each control post should remain independently measured, so as to maintain true independence and flexibility of use and measurement based on actual experiences.

- We would again highlight that whilst HAL have moved to a 15minute standard, the control post technology purchased for Q5, was done so on the understanding that it would lead to increased performance and efficiency, and an improved standard during the period. The move to a 15miunte standard represents the minimum improvement that the airlines would have sought during this period.