

Airport Consultative Committee – Gatwick Airport (ACC)

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Dear Tim

AIRLINE CONSULTATIVE COMMITTEE's ADDITIONAL REMARKS

Thank you for giving us the opportunity to comment further on Gatwick Airport's (GAL) response relating to your Final Proposals. We met with GAL on Wednesday 13 November 2013 to try to reach agreement on some of our outstanding points. It was at this meeting that we had first sight of their letter to you dated 4 November 2013.

Rather than reiterate our position regarding the Final Proposals, we have added only additional comments within this response in relation to points regarding GAL's Commitments and the Conditions of Use document. We have included new evidence in response to GAL's comments on the CAA's Final Proposal document, specifically around Fair Price.

This response includes comments on: 1) Traffic, 2) WACC, 3) Pensions, 4) Service, 5) Consultation, 6) Conditions of Use.

1. Traffic

Since the ACC submitted its response to the Civil Aviation Authority's (CAA) Final Proposals, GAL have published their traffic numbers for October 2013 which are 4.3 per cent higher than the same month last year. These numbers continue to show strong year-on-year growth that significantly outperforms the forecasts in the CAA's final decision.

As the ACC's response shows, and the CAA's document confirms, the base year of the forecast (2013/14) has a significant impact on the overall level of traffic over the regulatory period. Taking the higher base year into account (with no change in the CAA's projected growth rates) leads to an increase in the traffic projections for Q6 of 2.7m passengers. The latest figures from GAL continue to prove that this type of adjustment is necessary.

The Airline Community continues to believe that in order to reach a fair settlement this growth needs to be captured in the base of the CAA's assessment. Failing to do so would mean the Q6 proposals start from an incorrect base and would therefore be a clear error of fact by the CAA in reaching its final decision.

Since the ACC's previous submission, more information has also come to light about the introduction

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of 21 additional slots from summer 2014 announced by GAL. This information includes which airlines are taking up the new 8 peak-time slots within the 21 overall slots. The ACC made a very cautious estimate in its previous submission that the additional 21 slots would add 1.9m passengers per year to the CAA's forecast. The latest information confirms the robustness of this modest assumption and we believe there is a good chance this could be exceeded.

2. WACC

The CAA's letter of 18th November noted the Competition Commission's provisional determination of the WACC for Northern Ireland Electricity Limited. The CC has set out a cost of capital for NIE of 4.1%. This is significantly lower than the cost of capital the CAA set out for Heathrow and Gatwick. This difference is driven by two factors: (1) a significantly lower estimate of total market returns and (2) the CC adopting estimates from the middle of proposed ranges.

(1) The Competition Commission calculated a total market return (i.e. risk free rate plus equity risk premium) of 5.75% based on market information and future forecasts. This is significantly lower than the CAA's estimate of 6.75%, mainly it seems because the CC does not believe that future returns will revert to the high levels seen in the last decade.

(2) The CC also made clear that it was not credible to select a point at an extreme of the range stating "*we 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.*" The CC favoured selecting a midpoint of the range. This again adds considerable weight to the point already made by the ACC in previous responses that the CAA should not arbitrarily choose a point at the top end of the range. The CAA has continued to justify this on the basis that it mitigates the risk of lower investment. However, this is inconsistent with the CAA's proposed acceptance of Commitments, with their corresponding lower level of CAPEX which means that clearly the CAA does not believe the exact amount of investment needs regulating. Further, the CAA has not set out any evidence or modeling to support its assertion that using the mid-point of the range carries any risk for passengers.

The CAA needs to reflect on the CC's estimate of NIE's WACC, and the implications this has for Gatwick. It is clear that the CAA's proposals are inconsistent with the CC's judgement. We believe that CAA has no choice but to lower its estimates of GAL's cost of capital.

We do not accept GAL's assertions that their relative risk has increased and a greater differential should be provided with LHR. The ACC has submitted evidence to demonstrate that GAL's risks are lower rather than higher. We see nothing in GAL's response to cause us to change the position set out in our response.

3. Pensions

This section comments on the elements of GAL's response on pensions which is new information to the ACC only evident since the disclosure of the 4 November 2013 letter. The ACC believes this contains a number of errors of fact and regulatory precedent and these are set out below.

FUTURE SERVICE COSTS

- a. GAL Objection Number 1: *The CAA fails to recognise that the scheme is closed to new entrants and will sunset over the longer term.*

ACC response: GAL fails to realise that shareholders and employees, rather than customers, must take responsibility for managing these risks. Future service costs need to be tackled, not just future joiners. Long term inefficient costs need to be cut.

- b. GAL objection 2: *The benchmarking is not against comparable companies and is out of date.*

ACC response: GAL has known that its benefits were well above industry averages since at least the CC report of 2007 twinned with the CAA Regulatory Policy Statement that flagged the need for efficiency and gave the airport time to reform over Q5.

If GAL were benchmarked against other UK aviation sector companies, it would be clear that greater reform of benefits and pay is needed¹. Other companies are also continuing to reduce their pension risks. The National Association of Pension Funds in its last annual report found that “a third (29%) of those pensions closed to new joiners but still open to future contributions from existing staff said they would make changes in the coming years, including closing the scheme or making it less generous.”² Presumably, the companies that are most serious about managing risks.

The ACC also believes the CAA misinterpreted the ONS data in stating that employer contribution was around 20%. That was the total contribution rate, including employee contribution. The employer contribution was around 14 to 15%.

- c. GAL Objection 3: *The CAA proposals are not based on GAL’s own plan of action.*

ACC response: This objection betrays a misunderstanding of the purpose of regulation and the CAA’s duties to further the interests of passengers.

GAL could have addressed this area of inefficiency, and has had ample time to do so taking account of the CC report and the CAA RPS. The long terms risks were known. After the 2010 valuation, GAL could have increased the build-up rate and extended the retirement age, as well as reforming its generous DC scheme. Following the 2013 valuation, GAL could then have made further changes, such as reducing build up rate further, capping pensionable pay and increasing employee contributions if necessary to keep pace with reforms made by other companies. In any case, GAL can at least make the benefit reductions necessary at the start of Q6.

- d. GAL Objection 4: *the CAA has allowed more for LHR*

¹ Eg British Airways, privatised at a similar time and with the same industrial relations issues. BA closed its DB scheme to new staff in 2003 and in 2007 increased retirement age to 65 and the build up rate to 60ths. In 2010 the standard build up rate was reduced to 75ths with employees paying 8% and pension increases were reduced from RPI to CPI. For the DC scheme, the maximum employer contribution for most staff is 7% but could be less depending on the size of the employee contribution. Pensionable pay increases are capped at RPI. Thus BA dealt with its structural problems over 3 valuation cycles. TUI has also taken a progressive approach to reform and in 2011 capped pensionable pay increases to 2.5%.

²http://www.napf.co.uk/PressCentre/Press_releases/0280_Final_salary_pensions_shut_at_record_rate_in_private_sector.aspx

ACC response: The allowance for LHR should be reduced. Even if not, GAD stated that this is due to different assumptions that, over time, would even out.

- e. GAL objection 5: *if average benefit structures are used, average funding assumptions should be applied including lower discount rates and longer life expectation.*

ACC response: GAD used GAL's own valuation assumptions because they found "no significant concerns". The assumption on benefits is intended to address a clear inefficiency in GAL's pension provision.

As explained in our response, GAD's suggested pension allowance of 20% did not take account of the CAA's conclusions that pay levels were well above market rates and should be reduced. The contribution rate should therefore be lower than 20%.

PAST SERVICE DEFICIT

- f. GAL objection 6: *the CAA should recover from airlines an amount based on a new higher interim assessment rushed out in October 2013.*

ACC response: Despite wishing to impose this on airlines without consultation, GAL redacts the relevant numbers for no good reason. GAL has every incentive to exaggerate the size of the deficit in its choice of assumptions and to avoid proper scrutiny. For example it seems unlikely that GAL's assumptions on pay reflect the CAA's allowance. This is not a proper basis of information to justify the CAA changing its position. Further, GAL has not provided any information to confirm that they have contributed the level of funds to the pension scheme allowed in the Q5 determination, so this would also need to be ascertained.

In principle, the ACC considers that this deficit, even if real, arises largely as a result of GAL's failure to reform its scheme and failure to bring pay into line with market rates, despite being fully aware of the funding risks and having been given six years grace by the CAA to facilitate change. The ACC remains of the view, as stated previously, that we see no case for remunerating a deficit.

COMMUTATION PAYMENT

- g. GAL Objection 7: *GAL's commutation payment should be increase by inflation to £112.5m; and*
- h. GAL objection 8: *the amount should be recovered over 10 years rather than 15 and the CAA should take no account of the size of the payment*

ACC response: The ACC has explained why this sum should not be recovered from airlines and pointed out that the amount is well in excess of the actual deficit. Further it is not clear that the CAA's approach of adding the sum to the RAB is consistent with GAD's recommendations, given that the outstanding sum will attract not just interest and depreciation but a full return at the WACC rate. GAL's new proposals therefore compound the problem and we reject them as being wholly unreasonable and disproportionate and quite clearly contrary to the interests of passengers.

4. Service

The ACC are having on going discussions regarding 2 of the service levels.

- a. Outbound Baggage Performance. The overall level of money at risk through the outbound baggage metric and also the monthly measure are already agreed between the ACC and GAL. Since our last update the ACC and GAL have also agreed that a daily measure will be included. At this time there is ongoing discussion on the level of the daily measure and how the money at risk would be attributed. The ACC is working with GAL using historic data to ensure that the service level target reflects the point at which passengers are impacted by failure to deliver bags through the GAL baggage system.
- b. Pier Service Levels. The ACC is in agreement with GAL that the default pier service level should remain at 95% within in each terminal. However as each terminal is achieving over 95% whilst significant construction projects are being undertaken the ACC sees no reason to reduce the pier service level targets from its current levels. However the ACC are happy to come to an agreement where-by when projects are undertaken that impact on the ability to deliver pier service levels that the target levels may be adjusted. Where we differ is that alteration needs to be consulted and agreed. In the event that we are unable to agree on a level then the CAA should arbitrate or allow the use of an arbitrator as allowed for within the commitments.

5. Consultation

On 20 November 2013 the ACC were given a presentation by GAL on the way that they see the future of consultation. The ACC have asked GAL if we could postpone a response until January 2014 to consider and consult comprehensively with all the airlines fully before we respond.

6. Conditions of Use

Since we responded to the CAA on 4 November 2013, we have seen a new Conditions of Use document from GAL. Please see Appendix I for our comments.

Thank-you once again for allowing the ACC another opportunity to respond to GAL's view of your Final Proposals and their subsequent letter dated 4 November 2013.

Yours sincerely

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Chairman
Gatwick Airline Consultative Committee

APPENDIX I

GAL's Commitments framework

GAL's response of 4/11/13 to CAA final proposals

ACC comments to GAL & the CAA on outstanding matters

This paper covers:

- Changes to the Commitments (Ch 1 & App 1&2 of GAL response)
- Comments on the License (Ch 3 & App 8 of GAL response)

While this paper deliberately focuses on the drafting of the proposed Commitments rather than the price proposed within them, this should not be taken as ACC acceptance of the overall Commitments regime nor the price at which it is offered.

The ACC's views on the Commitments price remain unchanged from its submission on 4th November. That submission set out evidence on why:

- 1) The proposed Commitments price remains too high. Our view is that the CAA should have challenged GAL's Commitments price further, rather than simply adopting the proposals.
- 2) We also consider that the CAA has wrongly concluded that the Commitments price is comparable to the 'fair' or RAB price based price and has relied on this when proposing Commitments over alternative approaches.
- 3) The proposed Fair Price is too high.

Changes to Commitments

On 4th November, GAL issued a revised version of its proposed Commitments in a new COU document, with an accompanying revised Heads of Terms and a covering letter providing their rationale.

GAL's changes were intended to respond to airline interim comments, but not all points were addressed. In some cases, this may be the result of drafting or timing issues and in other cases; we understand that GAL may be willing to make further changes.

GAL and the ACC met on 13/11/13 to review.

This document sets out the outstanding issues along with our understanding of GAL's position and the ACC's recommendations for action.

Issue	Ref in COU	GAL position (as understood by airlines from 4/11 letter & 13/11 meeting)	ACC Position	Action
Lack of mutual waiver/ indemnity	2.1.9-2.1.11	No change yet. Not a “point of principle” – so deal with in consultation as a commercial negotiation.	This is one-sided, for the benefit of GAL only. This is inappropriate now that Commitments place obligations on GAL as well as airlines. This cannot be dealt with as a “commercial negotiation” outside the CAA-led process because of GAL’s market power.	Mutual waiver and indemnity should be included. See ACC response App 1: 2.3
Dispute resolution inflexible & short limitation period	2.1.12-2.1.21	No change yet. Not a “point of principle” – so deal with in consultation as a commercial negotiation. GAL sees merit in forcing people to use DR.	Need an effective remedy process if GAL breach Commitments. While there is merit in DR, this approach is likely to be unworkable (too slow, too costly or timed out) in some circumstances. It is a point of principle because it is part of the enforceability framework.	The possibility of simultaneous or alternative recourse to the court is needed (as is normal). The limitation period of 90 days from the expert’s decision should be deleted so the statutory period applies. See ACC response App 1: 2.4
Consultation on operational resilience is vague	7.4	No change. GAL does not disagree but considers it unnecessary to spell out what is meant by consultation.	The document is not only relevant in case of a legal dispute. It will be read mostly by non-lawyers and the nature of the consultation commitments need to be set out clearly. We propose an appendix on consultation setting out the standards adopted, including the stage at which it consults and the information to be provided. This can be in plain language, drawn from the precedents.	An appendix added about what the standard of consultation is. See ACC comment 2.14
At least two consultations meetings/yr needed on op resilience	7.5	No change. GAL considers this is unnecessary.	Need at least one wash up at end of season and one to agree changes.	Substitute two for one. Under discussion with GAL.

<p>Airlines required to take actions allocated by GAL during disruption</p>	<p>7.6</p>	<p>No change. GAL does not deal with the point but only refers to CAA material (that does not require airlines to obey in all cases.)</p>	<p>Far too prescriptive and therefore unacceptable. GAL could require airlines to take unreasonable actions in order to protect its own commercial interests. The second part of the Para must be deleted, so that airlines are required only to use reasonable endeavours to cooperate with GAL.</p>	<p>Delete "...take the actions allocated to them in the plan(s) during periods of disruption".</p>
<p>Unclear definitions of core service & premium charges which would allow GAL to levy additional or higher charges for core services.</p>	<p>Sched 2 1.4, 9-10</p>	<p>GAL believes it has addressed this by defining Core services & core service charges and by committing to provide core services.</p>	<p>The ACC welcomes GAL's intent, but seeks two drafting changes to ensure this works as intended.</p> <p>1) the definition is unclear if a service was provided, but no <i>separate</i> consideration was paid in Apr 13 (eg central search which is covered by the PSC).</p> <p>2) Second, the reference to services provided at a certain date may not cover infrastructure/services unserviceable then, or the area has since been refurbished?</p>	<p>Can be addressed by adding to the definition of Core Services in 1.4: "A service that was provided at 1 April 2013 shall not fall outside the definition of Core Services merely because there was no charge directly referable to it at that date. Further, a service shall not cease to be a Core Service merely because substantially the same output is achieved through a different process (e.g. provision from a different location at the airport)."</p>

Definition of RPI_{t-1}	Sched 2 1.16	No change. GAL categorises as a detailed drafting point.	There are different published RPIs. In the absence of clarification, the current drafting might be read as a reference to the all items index, rather than CHAW, so this creates a measure of ambiguity.	We see no reason why GAL won't agree to our suggested clarification.
Pass through of increased Security costs	Sched 2 1.17	Now symmetrical ie can reduce, but still compares with previous year rather than base year. GAL said they would consider our point.	If GAL makes early savings eg as a result of NT security project, they would be able to recoup any increase even if the total was still within amount assumed when prices set. Need to set reference amount or base year.	Add to the end of 1.17.2 "...provided that security operating costs in year t are higher in real terms than in 2013/14 and..."
"The Gross and Net Commitment prices are too high at 1.5% and 0.5%	Sched 2 1.19- 1.20	No change.	The price is fundamental and this is a major outstanding issue.	See ACC response of 4 th November and supplementary submission of 25 th November to CAA for details.

<p>Amendment of price if at least 67% of airlines agree</p>	<p>Sched 2 6.1.1</p>	<p>No change. GAL consider that 100% is unachievable but will consider increasing above 67%.</p>		<p>ACC consider that changes to Commitments would need to be based on consensus as much as possible, so as not to undermine the intention that airlines can rely on Commitment prices for 7 years.</p>
<p>Planning and development costs of a second runway</p>	<p>Sched 2 6.2</p>	<p>GAL will “follow” rather than “have regard to” any CAA policy guidance in relation to recovery of costs.</p> <p>GAL rejects our proposal of a license change because they are opposed to a licence in principle.</p>	<p>Still not a licence change. Airlines would have a limited ability to challenge GAL’s interpretation of the CAA guidance through dispute resolution/enforcement, but there would be no need for authorisation by CAA and no possibility of an appeal.</p> <p>This is unacceptable given that costs could be as high as £9bn and the CAA’s guidance will not be specific to a particular development and will therefore be open to wide interpretation.</p>	<p>The ACC continues to believe that this should be a re-opener requiring a licence change. See ACC response 2.7(g)</p> <p>If GAL cannot agree our full proposal, including the licence change, they could at least delete 6.2 and deal with this through commercial negotiation and the change provisions in the first part of paragraph 6.</p> <p>It is essential that development costs are not passed through without airline agreement or the possibility of an appeal.</p>

SQR rebates, by default, are available only to airlines operating exclusively under the COU.	Sched 2 6.3 & Sched 3 Para 1	No change. GAL requires airlines to negotiate this if they have a bilateral agreement.	If any airline wants a bilateral, they must negotiate to re-include SQR rebates and smaller airlines may not be aware that this needs to be done. This further strengthens GAL's negotiating power.	The ACC considers that this should be removed so that passengers travelling on all airlines are subject to a default level of protection and that airlines are compensated for failures.
Airline standards	Sched 3 Para 3 & App II	No change	Airlines oppose GAL-imposed airline standards. The current version is anti-competitive because it reduces passenger choice by reducing the scope for price and service competition between airlines. The ACC supports standards only where agreed and necessary to deal with identified problems eg avoiding congestion or capital expenditure. In any case, App II is unclear because it does not state that these are monthly averages or that the reduction percentage is divided over a year. GAL would be able to impose onerous details in the measurement appendix.	Include a revised version of App II and measurement appendix in agreement with airlines.
Pier service standard missing	Sched 3 Appendix I (iv) 17	No change yet but under discussion in SQR group.	Must be 95% as extensive work demonstrates this is achievable in both terminals.	95% needs to be included, with reductions by agreement for major works.
Aerodrome congestion term standard	Sched 3 Appendix I (iv) 19	Now includes a metric which is defined in a separate GAL manual and a standard of "3" deferred movements	This document has been renamed and needs to be attached	This document should then be included.
Daily outbound baggage measure missing	Sched 3 Appendix I (iv) 14	Only includes a monthly measure. In SQR group, GAL has agreed in principle and details are being discussed.	This is almost worthless if it is not an event based measure, given that the impact of outages is likely to be masked by monthly averaging.	Include an event based rebate (under active discussion in SQR group)

Detail of SQR measurement needs to be confirmed	Sched 3 App I final Para & App II	GAL has deleted App II entirely and refers instead to a GAL document annexed to the Commitments that can be amended by agreement between GAL, the AOC and the ACC.	This is an important document which must be agreed and included and not left as an outstanding matter (as GAL would be able to make changes to matters such as measurement of security queues).	Document to be attached in short order.
Consultation on CIP & Master Plan is vague	Sched 4 Para 3 & 4	No change. GAL does not disagree but considers it unnecessary to spell out what is meant by consultation.	Should be a stronger commitment from GAL as to the standard of consultation, the stage at which it consults and the info provided.	See comments against 7.4. The same appendix could be used. [Under discussion with GAL].
Definitions needed for Master Plan and Tollgates	Schedule 4	No change. GAL considers to be drafting points.	Need definitions to add clarity. Should not be controversial.	See 2.19 of ACC response
Capex: reference to CAA final proposals for consultation is unclear	Schedule 4 4.2.5	No change except to substitute "2014" for 2013. GAL considers to be drafting points.	GAL change makes matters worse because the CAA final decision may not include any relevant forecasts. Should not be controversial.	Replace reference and refer instead to Chapter 4 of the CAPI 102 "Economic Regulation at Gatwick from April 2014: final proposals"
GAL only required to consult on capital annually	Sched 4 6.1	No change	Should reflect further discussion and agreement	Update according to latest agreement on capex consultation.

Other issues with GAL's position on Commitments

GAL wants to limit the scope of the CAA's proposed 2016 review. They want this to assess only whether or not GAL has complied with the Commitments (not whether it has worked in pax interests).

GAL commits to publishing a shadow RAB only up until the 2016 review. The ACC does not agree with this. The CAA needs to be sure those Commitments are working in the best interests of passengers as this would be inconsistent with the CAA's duties. and must retain the ability to impose a RAB based price control if necessary. GAL should maintain the shadow RAB throughout the commitments period.

GAL's comments on the Licence

GAL considers that regulation is unnecessary and unjustified and therefore there should be no licence. (Ch 3 & App 8). The ACC disagrees.

GAL considers they do not meet tests B or C of the market power test. GAL believes the existence of the Commitments must affect the CAA's market power assessment and will thereby remove the airport's SMP. In addition, GAL believes the STN current thinking provides a precedent. GAL compares its Commitments with STAL's commercial contracts and asserts that this demonstrates that GAL does not

have SMP either. Commitments are “better” than STAL bilateral contracts in that all airlines are covered. The ACC disagrees. The Commitments are not a commercially agreed contract and the airlines do not accept the current terms. This is quite different from the situation at STN. GAL also disagrees that a licence is needed to ensure enforcement of the Commitments. The ACC continues to believe that incorporation within a licence is necessary for the reasons set out in our previous responses.

The ACC is concerned that GAL is arguing to remove the licence framework that the airlines and CAA consider to be an essential part of the Commitments framework.

Without prejudice to their position that there should be no licence, if there is to be a licence, GAL supports the proposed framework subject to changing certain provisions:

1. exclude the provision that in complying with the commitments, GAL shall do so in a manner designed to further interests of passengers.
2. clarify which part of the COU would be incorporated into the licence reflecting the wording of GAL’s Commitments.
3. remove various other financial resilience conditions (unnecessary in the light of bond covenants).
4. remove the provision that GAL can invest in other business only with CAA consent.

Assessment of GAL’s proposed license changes.

The first point is clearly unacceptable - GAL needs to be required to comply in a manner designed to further the interests of passengers.

On the second point, Condition 3.4 needs to be added as this includes certain protections that were in the commitments and nowhere else and that need to be given force as license conditions.

On the third and fourth points, there is no proper justification for the proposed change. The bonds can potentially change or not be enforced, so they do not give sufficient protection to substitute for a license condition.