

Gatwick response to ACC, BA and Virgin's responses to Gatwick's response to the CAA's final proposals

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This document sets out Gatwick's comments on the various CAA solicited responses to Gatwick's responses to the CAA's initial proposals, as well as further comments by the ACC upon Gatwick's response to the responses to the CAA's initial proposals. We have largely limited our responses in this document to pointing out inaccuracies in the responses and material presented by others. We expect the CAA to take these comments into account and note that the ACC has provided further comments upon response.

Gatwick notes the highly irregular nature of the process the CAA has adopted following on from the CAA's Final Proposals consultation. We are concerned that this iteration has taken place at such a late time within the CAA's process and that material has been published without any notification or warning to Gatwick. We consider that the late publication of these items could be prejudicial to Gatwick's position, depending on how the CAA treats the material in its Licence decision. In particular we would be concerned if changes are made without proper consultation. We furthermore consider it unsatisfactory as this continual reiteration leaves everyone unclear about where the process ends.

Annexed to this document is also comment by Oxera on the notes prepared by CEPA on cost of capital, and we intend to provide a note commenting on the note by RBB shortly.

Relevance of Commitments to test B and C

The ACC notes our view that the existence of the Commitments affects the CAA's assessment of Tests B and C of the market power test. However, the ACC disagrees, noting that "the Commitments are not a commercially agreed contract and the airlines do not accept the current terms". As we have previously stated our view is the Commitments, as accepted by the CAA as being fair and reasonable, must be relevant to the CAA's consideration of tests B and C. The Commitments fully address any risk of abuse of any market power by GAL, as they are applicable to 100 per cent of traffic and airlines operating from Gatwick. Moreover, the Commitments mean that any residual benefit to be gained from licence-based regulation of GAL must be minimal at best, set against the distortive effects of GAL being issued a licence. These arguments are even stronger in light of the progress that has been made, and is continuing to be made, in reaching commercial bilateral agreements with airlines.

Traffic:

The ACC argues that based on the traffic numbers until October 2013 the base year projections needed to be adjusted. They argue that the impact is 2.7m passengers over "Q6". In addition, the ACC argued that the additional 21 slots would add 1.9m passengers per year to the CAA's forecast.

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In its latest response to Gatwick's response to the Airlines responses to the CAA's final proposals the ACC argued that Gatwick has not justified why traffic has simply been pulled forward and that growth will be slower in future periods.

Gatwick response:

These statements are misleading and Gatwick provided an extensive discussion about traffic, including why we considered that the increase represented demand being pulled forward on pages 1-6 of our response to the ACC's response to the CAA's final proposals. We further note that the ACC's response to Gatwick's response to the final proposals The ACC's further response to our response ignores these and merely asserts that no justification is provided. We furthermore note that the ACC's response does not address the inconsistencies we outlined in relation to the airlines assessment that new slots would have an impact of 1.9m.

Cost of capital:

ACC considers that the CC NIE provisional determination needed to be taken into account and the cost of capital adjusted based on two factors:

- The use of lower estimate for market returns
- Using the middle of the proposed ranges.

The ACC furthermore continued to argue the relative risk of Gatwick compare to Heathrow was lower, rather than higher.

Gatwick response:

In its further response the ACC argue that Gatwick "has simply dismissed" the CC's provisional findings regarding NIE and that this is not reasonable as it would mean not reflecting the latest evidence on the cost of capital. Gatwick continues to disagree with this assertion. In particular we noted the provisional nature of the CC's findings, the fact that the impact was not one sided (which the ACC suggests) and that it would not be appropriate to adopt the CC's findings without a comprehensive consideration of why they are 'better' than the results of the CAA's own consultation.

We also attach a separate paper by Oxera providing further comment upon the CEPA paper commissioned by BA.

Pensions:

The ACC raised various counter-points to the responses Gatwick made on pensions; including:

- Gatwick should not expect its customers to manage pension risks or the cost of paying for the long term sunseting of the close pension scheme.
- Gatwick should be benchmarked against other aviation industry companies and this would highlight the need for reform.
- Comparison with Heathrow's allowance is not relevant as the Heathrow allowance should be lower.
- GAD's suggested pension allowance of 20% was too high as it did not take account of the CAA's conclusion that pay was too high.
- Gatwick's pension deficit reduction is not appropriate as the interim assessment had been rushed in October 2013, GAL has an incentive to exaggerate the size of any deficit, pay assumptions are unlikely to reflect the CAA's allowance and the deficit had probably arisen largely as a result of GAL failing to bring pay in line with market rates.

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Gatwick response:

The ACC fails to recognise that GAL has already taken responsibility for managing its future service cost risk. GAL has demonstrated effective risk management by closing the scheme to new joiners and making the commutation payment to BAA. Both of these actions reduced substantially the payments that had to be made by the new defined benefit scheme established by the Airport on the date of sale and its future risks.

The benchmarking analysis conducted by GAD refers to the ONS Occupational Pension Schemes Annual Report 2011. Again, like the IDS/Hymans benchmarking analysis, this comparator set includes a significant number of pension schemes of various sizes and from various industries, not all of which are reasonable comparators for Gatwick, thereby distorting the relative positioning of Gatwick's benefits. In addition, the data is significantly out-of-date. Gatwick highlighted both of these concerns in its response to the CAA's initial proposals, final proposals and its consultants' reports.

Passenger and airline interests are best served by a well-managed Airport, providing the services its customers expect in a resilient way, operating efficiently, and staffed by motivated employees. We consider that caution should be applied so that passenger and airline interests are not damaged by engaging in a 'slash and burn' approach to employee remuneration. The Airport continues to manage its pension costs actively within the parameters of ensuring operational resilience of a key national infrastructure asset. Achieving efficiency savings in pension costs is not just a simple actuarial calculation. The potential to reduce the contribution rates, as proposed by the ACC, is predicated on "...hypothetical benefit changes..." rather than a cost reduction strategy grounded in commercial and HR realities. Management operates the Airport as an efficient asset, on a strategic basis, for the benefit of passengers and airlines, rather than cherry-picking cost reduction initiatives based on pure mathematical calculations. If the ACC have issues with the level of Heathrow's allowance for future service costs, then they should be directed to HAL. However, the defined benefit pension scheme arrangements at Heathrow are effectively identical to the Gatwick scheme because both schemes originated from the former BAA defined benefit scheme. As a result, Gatwick is confounded by how Heathrow is afforded a contribution rate of 24% by the CAA for future service pension costs, but the allowance for Gatwick is only 20%. This is differential, amounting to a 20% greater allowance for Heathrow, is not explained in either the CAA's final proposals or by GAD's reports.

GAD reached a view on what an 'efficient' pension cost might look like, by assuming that a more 'average' benefit structure is adopted (i.e. NRA increased to age 65 and the accrual rate based on 1/60ths instead of 1/54ths) and applying the GAPP funding assumptions. GAL did not disagree with GAD employing an 'average' benefit structure, but this should also be supplemented with a view on 'average' assumptions. Adopting the above 'average' benefit structure and 'average' funding assumptions would increase the CAA's assumptions about future Gatwick contributions over and above their current level.

Furthermore, current pay levels are somewhat irrelevant in calculating future service pension costs. The cost of pension provision is based on long term salary growth assumptions.

In October 2013, the scheme's actuary performed a high level assessment of the scheme deficit as at 30 September 2013 (i.e. the next full actuarial valuation date) based on existing scheme funding principles and allowing for changes in market conditions to that date. These calculations indicate a deficit of [redacted] to

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[redacted] in the scheme as at 30 September 2013. This was not a valuation that was ‘rushed out’, but one performed by a reputable actuarial firm.

Since 2010, GAL has funded the pension scheme in line with the last full actuarial valuation. The cash contribution rate [redacted] of the allowance (25%) provided under the Q5 determination. The significant negative movements, from a pension funding perspective, in both corporate bond yields and inflation during 2012 and 2013 have given rise to the deficit in the scheme, not the current level of employee salaries. It is also important to note that these movements, which increased the cost of providing DB pensions, are outside the control of management and are reflected similarly in the economics of other DB schemes

Commutation 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.”

Gatwick response:

GAL has previously set out its view in relation to the commutation payment and the regulatory and commercial rationale for including this in the RAB. Both the CAA and GAD have agreed with GAL’s position.

Pier Service Levels:

The ACC argued that as 95% pier service levels are currently achieved despite significant construction at both terminals it would be inappropriate to adjust the pier service target.

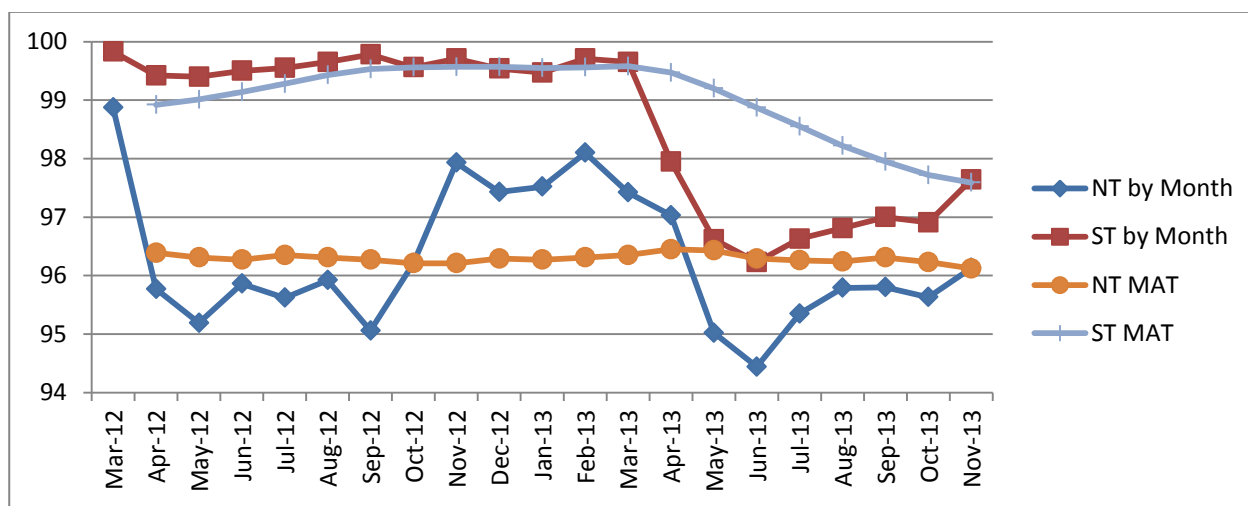
Gatwick response:

We are happy to agree with the ACC that both Terminals are recording pier service performance in excess of 95%, and with the exception of the month of June in NT that has been sustained throughout the summer even though there are the significant construction projects which are being undertaken, namely Pier 5 and ST Baggage/Pier 1. This has been achieved through significant effort and cooperation between the Airport, Airlines and Handling Agents to step change the volume of tows performed. We are pleased to see the ACC agree with us that when projects are undertaken which impact on the ability to deliver pier service levels, that the target levels are adjusted. We also agree with the ACC that these changes would be consulted, and that the change would only be made as per the commitment set out in Schedule 3, Clause 5 in the Conditions of Use – we do not differ on this point.

Where we do have a difference of opinion with some of the ACC members is about the fact that GAL believe the target for North Terminal should be 94% for the duration of the Pier 1 project and for a period afterwards (to allow the moving annual total time to catch up monthly performance) – our proposal being until April 2016. We believe we have enough information to agree this revised target with the AOC/ACC now. As members of these forums are aware, the airfield doesn’t work as two separate entities for each Terminal, but is interdependent. In particular, this interdependency relates to towing, where the resource is combined. In addition the South and North Terminals have different levels of infrastructure associated with

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pier served stands and coaching gates. They also have a geographical difference in terms of access to remote stands and of course a different mix of airlines and therefore different demands for the stands at peak hours. When all of these factors are put together and we assess the impact of the current construction works on the pier service scores it is clear that North Terminal pier service is more volatile and more reactive to a reduction in pier served capacity. The following chart shows the trend of Pier service over the past 21 months since the Pier 5 work started in March 2012. (Pier 1 closed April 2013)



For both Terminals, the relative recovery and then stability in performance during the busier summer months of July to September during 2013 was due to the additional towing being carried out by the Handling Agents paid directly by GAL – the airlines were supportive of this extension to the previous year’s trial.

Since summer 2012, the North Terminal monthly performance reflects the fact that extra towing was being paid for by GAL as a trial for easyJet/Menzies – it also reflects the continued push, by easyJet in particular, to carry out more arrivals tows in the evening in order to position aircraft on piers for the following day and it reflects the lower traffic levels during winter 12/13. In particular the loss of services from the summer season, which lowered the demand for stands in NT during peak hours, which in turn enabled a higher percentage of the passengers to enjoy pier service. All of these factors were important in enabling the MAT to remain stable during that period. As there are higher traffic levels this winter (than last winter) it is not expected that so many passengers in the North Terminal will receive pier service, albeit it will be higher than the summer as some of the pressure in the peak eases. The November 2013 PSL is about 2% lower than the previous year, this and the knock on impact to the MAT PSL for the NT are the first indicators of a reduction in pier service; we predict that this fall in the MAT will stabilise just above 94% next summer. South Terminal pier service has stabilised on a per month basis, (with the expected small uplift for winter where the peaks are lower) so the continued fall in the moving annual total will stop by June 2014 – we are predicting that the MAT PSL will stabilise at this point just above 95%.

These trends, together with the knowledge that the planned extra 8-9 based services will start in the peak hours for summer 2014, means that the demand for stands in the peak will be approximately 2% higher than this past summer. For these reasons the target for NT should remain at 94% and the target for ST

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remain at 95% until April 2016; unless any change is agreed due to further projects impacting pier service in this period.

These targets will be very challenging to meet and will rely upon the Airlines and their Handling Agents carrying out the requested levels of towing throughout all the peak periods. In order to facilitate continued cooperation GAL proposed to introduce a new rebate for each requested tow in respect of enabling pier service for passengers. This initiative has received support from the airlines and will therefore be in place from April 2014.