

YOUR LONDON AIRPORT

Gatwick

20 AUGUST 2013

Andrew Haines
Chief Executive
Civil Aviation Authority
CAA House
45-59 Kingsway
London
WC2B 6TE

Our reference: LGW-BQ5-299

Dear Andrew

London Gatwick's final Contracts and Commitments proposal

Thank you for the CAA's letter to Kyran Hanks of 8 August 2013 and for your time in meeting with us on 14 August. You ask for a revised set of Commitments to be submitted to the CAA by 20 August, such revision to be the final submission on Commitments by Gatwick Airport Ltd prior to the CAA's final proposals to be published on 3 October 2013. In response to the CAA's request, and further dialogue with our airlines, and having considered carefully the points made at our meeting, please find attached to this letter our revised Commitments.

Before I turn to the further changes we have made to the Contracts and Commitments framework, I would like to summarise why Gatwick continues to believe that this framework represents the best way forward for London Gatwick, for our airlines and most importantly for our passengers. We believe that this framework will deliver -

- Greater flexibility to anticipate and react to the changing demands of a rapidly evolving aviation sector, as both airlines and airports seek to differentiate their offerings through service innovations and price, whilst improving efficiency and reducing costs;
- Improved ability to serve the increasingly varied requirements of different airlines through tailored agreements that address more precisely their specific needs;
- More certainty for the airlines over an extended timeframe of 7 rather than 5 years, with Gatwick accepting more risk whilst having greater incentives to grow traffic, develop non-aeronautical revenues and drive efficiency improvements;
- Closer alignment of interests on capital expenditure with stronger incentives to manage it more efficiently, while providing more flexibility to adjust to changing requirements compared with the current system which predetermines capital expenditure over too long a period in too much detail; and

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- Reduced regulatory costs and less bureaucracy and, above all, better alignment of incentives for Gatwick and its airline customers to work together on a partnership basis to deliver better service and improved choice for passengers.

The change in ownership of London's airports is now complete following the intervention of the competition authorities. We continue to urge the CAA to put in place changes to the regulatory landscape that reflect this fundamental change and promote competition and the interests of passengers. Our Contracts and Commitments proposal provides an extra level of comfort for all stakeholders that goes beyond the benefits of the new competitive environment.

Our best and final Commitments proposal coupled with improvements we have already made incorporates several critical benefits in relation to terms and conditions, enforceability and price. We are only able to offer these benefits under the specific Contracts and Commitments framework that we are proposing. In particular, the level of pricing that is possible in our final Commitments proposal is unachievable in a traditional RAB-based regulatory framework - with its enormous hidden costs in terms of lack of flexibility, bureaucracy and difficulties in responding quickly and commercially to changes in what is now a dynamic and competitive market.

I now turn to the changes we have made.

Service quality

First, we propose that the service quality regime is adjusted so that the bonus element of the Commitments regime is eliminated. This is a significant change as it removes the opportunity for Gatwick to earn a proportion of aeronautical revenue as reward for out-performance. In a RAB-based world, this would represent the foregoing of around £4m a year of possible upside. In offering this concession, we are responding to the continued opposition from our airlines to the ability of Gatwick to earn bonuses.

We are able to report also that all the metrics of the proposed service quality regime have now been agreed with our airlines, and we believe that we are now in full agreement on all aspects of the service quality regime. Finally, and solely within the Commitments framework, we have already proposed that there would be an increase in the penalties that would apply in the unlikely event that there were protracted failures in service failure. As a package, we believe that these changes respond directly to the airlines' concerns that the service quality proposals were not sufficiently stringent.

Pricing

Second, we propose that the average prices that will be achieved by Gatwick are adjusted from our most recent set of proposed Commitments. We note the airlines' comments on the current proposed gross price of RPI+2.5 over 7 years, with a delivered net price of RPI+1.5, as being too high. We note the "fair price" previously proposed by the CAA of RPI+0 over 7 years (although we remain of the view that this price should rise in the light of the feedback that we have given to the CAA). We have made a further, final and substantial reduction and commit to set the gross level of

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the Commitments price at **RPI+1.5**, with the net level of prices achieved by Gatwick set at **RPI+0.5**. At this level, we believe that our proposed price levels are very close to the CAA's initial proposals and provide (more than) adequate protection against any risk of Gatwick excessively pricing. We believe that this is a compelling proposition especially given the concession on service.

Runway development costs

Third, we have considered the subject of runway development costs. Our most recent proposal was that these costs, once demonstrated to be efficiently occurred, should be passed through to our airlines, but only if Government support for the construction of extra runway capacity at Gatwick was forthcoming. In our recent meeting, the CAA indicated that the recovery of costs associated with runway development could be the subject of a regulatory policy statement, since the same issue arises at all three currently regulated airports. The way in which the CAA would propose to allow airports to recover runway development costs is a matter of critical importance to the chances of any new capacity being delivered. In a regulated scenario, we can agree that this subject is best addressed by way of a regulatory policy statement. In the absence of a licence, our proposed Commitment on runway costs would stand although we would have regard to any regulatory policy statement issued by the CAA, and have amended the Commitments accordingly.

Changes to the Commitments regime

Fourth, there have been comments that the ability to change the Commitments regime with the agreement of only 51% (by passenger numbers) of our airlines is an insufficiently high hurdle. In that light, we have altered this hurdle rate to 67%.

Other changes that we have made to the term sheet are indicated by way of a mark-up.

We trust that the inherent merits of the Contracts and Commitments regime, coupled with our responsiveness to the airlines and CAA and a suite of significant improvements, will allow the CAA to support the Contracts and Commitments framework in your final proposals document. We believe the following elements will be critical to the success of the framework –

- The removal of a direct link between capital expenditure and aeronautical charges should encourage more efficient and focused capital expenditure and a more collaborative approach to the provision of facilities and services;
- The streamlined and improved consultation framework should focus everyone's attention on the main strategic projects that are being proposed by Gatwick, rather than the detailed intrusive consultation that has evolved under Annex G; and
- The greater challenge implied by the revised and final proposals we have submitted, and the foregoing of service quality upside, makes the incentive properties of the seven year duration of the Commitments period even more important than previously. That duration provides the space for Gatwick both to improve the efficiency of the airport to the benefit of passengers, and to conclude contractual arrangements with our airlines, in a way consistent with the more competitive airports market that now exists.

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Should the CAA wish to change these key attributes of the Contracts and Commitments framework, this would, in our view, undermine the benefits of the Contracts and Commitments framework and the achievability of the outcomes we propose.

Further, the CAA has now received Gatwick's response on the CAA's proposed licence terms consistent with the Contracts and Commitments framework. While we do not repeat that response here, we do not believe that the Contracts and Commitments framework will be able to function effectively if the CAA persists with licence provisions that allow the CAA to implement a price freeze and temporary price control, since this would undermine the certainty that the contractual nature of the new framework seeks to create. The elements of the Contracts and Commitments framework are all important and inter-dependent.

Finally, as you are aware, we continue to believe that Gatwick does not meet the market power test. The Commitments we have proposed would, as we have previously stated, provide sufficient protection against the potential abuse of excessive pricing and service failure identified by the CAA without the requirement for a licence, and all comments in this letter are without prejudice to our views on the CAA's market power analysis.

We believe that this final version of Contracts and Commitments should permit the CAA to adopt this framework as the appropriate future for Gatwick in a more competitive airports market.

As with Tim Griffiths' letter to us, I have copied this letter to the ACC.

Yours sincerely



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CC: Jason Holt, ACC

Attachment: Heads of Terms