CAA final Q6 proposals for Gatwick Airport

Response by British Airways, November 2013

FOREWORD BY PETER SIMPSON

British Airways is the second largest airline at Gatwick, providing a predominantly point to point short-haul and long-haul scheduled operation, with regular flights to 4 continents. At Gatwick we compete with full service, charter and no frills airlines. Competition has driven convergence between business models and has ensured that all airlines develop a close understanding of passenger needs. If British Airways fails to respond to meet our customers' expectations, they go elsewhere.

Gatwick passengers put a high priority on prices. This has driven BA to pursue major efficiency improvements, enabling us to deliver low fares, while at the same time offering a high quality service. In competitive markets prices must reduce while quality increases.

Sadly, that is not a reality that Gatwick – or, it seems, the CAA – has yet come to terms with. The CAA's "fair price" would allow prices to rise above inflation, despite compelling evidence of significant scope for operating cost efficiencies. In addition, the cost of capital has reduced, traffic and commercial revenues are growing and there is far less need for new capital investment. There is ample scope for significant price reductions that would deliver in the passengers' interest, while at the same time continuing to improve the airport.

The Gatwick airlines know that this is what passengers want; that is why the ACC has made strong representations on the price in the Q6 review process. Now is not the time for a grand regulatory experiment. Gatwick has significant market power and needs to be regulated effectively in the interests of passengers. That, in our view, is relatively simple to achieve if an efficient price control is put in place.

Having adjusted our own cost base, operation and commercial offering, BA is growing our Gatwick operation again. The pre-requisite for our future growth, with new routes and services, is an efficient airport, focused on reducing charges and providing what our customers need.

Peter Simpson
Director, British Airways Gatwick

Summary

British Airways understands the CAA's desire to introduce a more targeted form of price control, but considers that an approach based on GAL's Commitments is not in the interests of passengers and does not provide adequate constraints on GAL's market power. A significant weakness in the approach is that the CAA has left itself unable to amend the terms, even where it recognises there is a strong case for change. The CAA's proposal to accept the Commitments before the outstanding issues – including the price – were resolved, has undermined any hope that GAL would agree to make further changes.

We consider that the CAA has made an erroneous price comparison between a Commitments and RAB-based approach, concluding wrongly that prices under the two approaches were similar. There is also little or no evidence to support the supposed wider benefits, which could equally materialise under a longer RAB based approach and reform of the CAA's capex consultation requirements. We therefore conclude that the decision to propose Commitments is flawed and detrimental to passenger interests. We recommend instead that the CAA adopts more efficient price controls directly into the licence.

This response also considers the CAA's "fair price" calculations. In most areas, we provide only an overview, as we have contributed to the ACC paper and support that assessment. However, British Airways has examined the WACC calculations in some detail, with the help of specialist advisers. We conclude that the CAA's calculations are undermined by technical errors and the misinterpretation of market evidence. Much of the analysis applies to Heathrow as well as to Gatwick and some of the papers are common to both responses.

The analysis of the fair price confirms our earlier submissions that there is considerably greater scope for efficiencies and price reductions than the CAA's "fair price" identifies. In particular, we have found clear errors in:

- The cost of capital assessment;
- Traffic forecasts (and therefore also the commercial revenues); and
- Pension calculations.

We also disagree with three key CAA proposals:

- To include Pier 6 south costs based on speculative additional costs in Q7 despite clear evidence that it is not required in Q6, and that the business case is poor;
- GAL is only required to make opex reductions at the bottom end of the range; and
- To add £104m to the RAB to allow all pensions risk for employees remaining in the BAA scheme to be removed for GAL's shareholders at the expense of passengers.

Introduction

This response builds on comments made in earlier submissions to the price control review and the market power assessments where we have set out the role and importance of Gatwick airport as an operating base for British Airways' services, explaining the price sensitive nature of competition.

British Airways has worked closely with the ACC to develop a joint response to the CAA's final proposals, which we support.

This response needs to be read jointly with our earlier submissions and the ACC submission. At this stage of the process, we will focus on key points, issues that remain open and areas where we consider the CAA has made errors in formulating its final proposals.

BA's response is structured around the three key issues on which the CAA has asked for views in the consultation paper:

A. the fair price;
B. the appropriate form of price regulation and the CAA's evaluation of the various options;
C. the appropriate licence conditions that would implement GAL's Commitments

We include as appendices:

- Appendix A: an analysis of errors in the cost of debt
- Appendix B: a paper by CEPA on use of spot market data corroborating the analysis in Appendix A
- Appendix C: a technical analysis by CEPA of inflation adjustments and consequences for choosing a point in the range
- Appendix D: BA's interim submission of 23rd October addressing the capex deficiencies under GAL's Commitments

Only Appendix D is included in this paper. The others are attached separately to accompany this response.

A) FAIR PRICE

British Airways supports the CAA's methodology for calculating the fair price based on the standard RAB-based price formula used in previous control periods, rather than using an alternative approach such as allowing market clearing prices, as proposed by GAL. Market clearing prices would allow GAL to exploit its market power and would transfer value from passengers to GAL's shareholders.

As explained in section B below, British Airways is unable to support the CAA's proposed Commitments approach. We therefore consider that the CAA should introduce price controls directly into the licence, based on an updated assessment of the RAB-based fair price. This should take account of the points identified in this section, and more fully in the ACC response.

British Airways has worked closely with the ACC to establish common airline views on the key elements that establish a "fair price". In this paper, we do not repeat the ACC arguments. In summary, BA's views on the price control building blocks are as follows:

Calculation of the fair price

- **Traffic forecasts** – CAA forecasts do not take proper account of a higher base year and newly created slot capacity (see additional comments below on traffic);
- **Capex** – Pier 6S should be excluded as it is not needed in Q6 and provides poor value. It is not certain that this project will be needed by Q7 or that the costs of delay (on which there has been no proper consultation) would be as large as GAL asserts.
- **Capex efficiency** – negative construction price inflation should not be taken into account, consistent with the CAA's approach in Q5 and the Regulatory Policy Statement. The fact that there is uncertainty is not a reason to ignore this issue, as there is uncertainty in any forecast.
- **Opex** – the CAA proposal to reduce costs at low end of range found by consultants would not be in the interests of passengers or be consistent with the CAA's duty to promote efficiency. Pension cost allowances should be reduced to market levels and policy in future reviews set out more clearly to give GAL an incentive to reform its scheme.
- **Commercial and other revenues** – the scope for greater traffic growth will increase retail revenues. In addition, the CAA has not placed due weight on Javelin's assessment of the scope for improvement in unit retail revenues. We also consider the CAA does not have a proper basis for its reduction in non-commercial revenues on the basis of the information provided in the consultation and by GAL in the charging consultation for 2014/15
- **RAB** –the pension commutation payment should be excluded or at least reduced so that it covers only the amount required to repair the deficit. Passengers should not be required to underwrite deficit risks as this is unfair and removes all incentive for GAL to manage risks as other companies must do.
- **Weighted Average Cost of Capital** – see detailed comments below.

Traffic increase

British Airways considers that the timing of GAL's announcement of 21 new slots, which came the day before the CAA published its final proposals, misled the CAA about the scope for and likelihood of traffic growth. GAL's timing was also extremely poor for airline scheduling teams, coming without notice a few days before the IATA scheduling conference submission deadline when airlines were well advanced in planning their submissions. It is unprecedented to release such a large amount of peak hour capacity with so little notice or discussion with airline schedule planners. The scale is also much larger that previous peak capacity increases. The table below compares the especially valuable new peak hour departure slots[1] created in Summer 2014 with previous seasons:

Season	New departure slots in 0500-0800 hours
S14	+8
S13	+1
S12	+1
S11	+1
S10	+5
S09	+2
S08	+1
S07	0

Source: ACL start of season reports available from www.acl-uk.org

The timing of the LGW announcement raised great concern among schedulers at BA and other airlines that GAL was releasing new slots that could reduce the resilience of the airport and that once released, they could not be withdrawn. Email correspondence with NATS provided reassurance that:

- The increase in capacity was made possible by the benefits delivered to date by the ACDM55 programme (which commenced in January 2013); and
- NATS expected further benefits to be delivered by the close of the ACDM programme, that have not yet been "banked in the modelling nor the declaration". These would come from introducing pre-departure sequencing (DMAN) in Winter 2013/14 and, if a trial is successful, reducing departure separations on some SID splits.

GAL has therefore been planning to increase peak capacity for some time in order to facilitate significant levels of capacity growth next Summer. Further additional peak hour slot capacity will also be created shortly in the following seasons.

[1] Slots available at this time each allow a based airline to operate at least 3 rotations per day, because capacity is not constrained later. Each set of daily rotations is a "line of flying". So 8 new early morning departure slots facilitates the growth of 24 daily return flights, whereas 1 new slot would facilitate 3 new daily return flights.

Cost of Capital

British Airways considers that the CAA has made significant errors in its calculation of WACC and that the proposed cost of capital, at 5.95% is excessive, not based on the evidence, and contrary to passenger interests. It is our view that:

- The cost of debt is based on a wrong interpretation of the facts and technical errors;
- The CAA has selected a figure for the overall WACC that is at or above the top end of the range proposed by PwC (rather than at the 75th percentile as stated) because of errors in the treatment of inflation; and
- The evidence on equity beta does not support the beta assessment, especially given the (unjustified) reduction in gearing relative to Q5.

Cost of debt

There are two papers discussing the cost of debt, attached as Appendix A and Appendix B. Appendix A "GAL cost of debt" examines and interprets market evidence on embedded and new debt.

The CAA assesses GAL's overall cost of debt as 3.2%, whereas BA considers that a proper interpretation of the evidence, and a correction of errors would result in an overall cost of debt of 2.5%. This is explained more fully in Appendix A. In summary:

- The CAA's adjustment to increase GAL's cost of embedded debt from 2.9% to 3.1% results from an artificial correction to what was wrongly perceived as anomalies with Heathrow and wider market data. A correct interpretation of the data shows that there are no such anomalies and therefore there is no case for adjustment;
- The CAA has included GAL's longest tenor debt, of 25-30 years, which skews the embedded debt results because it attracts higher debt rates. The appropriate CAA policy is to ignore particular airport financing decisions and to base calculations on a notionally efficient airport, using actual data as a cross check. Adjusting the debt yield to a more appropriate debt tenor leads to embedded debt costs falling by 20bps to 2.7%.
- New debt should be reduced from 2.7% to 2.53% after correcting for a number of technical errors, as detailed in Appendix A. Applying a yield differential based on evidence from traded bond yields rather than the theoretical adjustment made by PWC, then gives a real cost of new debt of 1.5%.

The errors and misjudgements in the estimation of GAL's cost of debt are, to a large extent, by-products of the mistakes in the analysis of HAL's debt. A direct analysis of GAL's comparatively straightforward financing structure produced counter intuitive results when compared to a similar investigation of HAL's financing arrangements. The perceived anomalies are proved entirely rational. Attempts by PwC and the CAA to establish cogent arguments for inflating GAL's cost of debt to bring them in line with expectations relative to HAL are misplaced. (A difference between the airports would be achieved by deflating HAL rather than inflating GAL, given the evidence put forward by BA and CEPA (see response to CAA Q6 proposals for Heathrow). Making the required amendments to the cost of GAL's debt produces a considerably more reliable estimate.

Adjusted proposals for BA's estimate of GAL's cost of debt are shown below.

	GAL CAA	BA
Embedded Debt	3.20	2.70
New and Floating Debt	2.70	1.50
Cost of Debt ex Fees	3.05	2.34
Fees	0.15	0.15
Total Cost of Debt	3.20	2.50[2]

In Appendix B, "A response on the choice of cut-off date for the CAA Final Proposals", CEPA reviews market data on the cost of new debt against iBoxx indices with appropriate credit rating and maturity. They conclude that the CAA has selected a cost of new debt that is 85bps above the benchmark. The paper explains that under the PWC/CAA analysis:

- too great a reliance has been placed on a particular spot rate; and
- the date chosen corresponds to the highest possible data point since Initial Proposals for the benchmark cost of debt indices and forward estimates, leading to an overestimation of the cost of new debt.

CEPA suggests that average figures for the last 6 months (April-October 2013) are a more appropriate methodological approach than that used by PWC. This would result in 1.82% for the cost of new debt and 2.28% for overall cost of debt.

CEPA's analysis supports the findings on the cost of debt in Appendix A. In particular, CEPA confirm that GAL's embedded debt cost demonstrate higher yields that the iBoxx benchmark indices and as such further inflating of the GAL cost of debt for the HAL differential is not justified. . Appendix A suggests that total cost of debt should be 2.5% for GAL and Appendix B suggests it should be a little above the benchmark of 2.28%. This compares with 3.2% estimated by the CAA.

<u>Errors in inflation assumptions and selection of the wrong point in the range</u>

In Appendix C: "Issues arising in relation to the CAA's estimation of the cost of capital", CEPA explains that the CAA's cost of capital point estimate has not taken into account the differences between their own inflation assumptions and the assumption used by their advisers, PWC. As a result, the CAA has overstated the real WACC value by a minimum of 20 bps and has pushed the proposed WACC above the range recommended by PWC. To summarise:

1. PWC converts their overall range of WACC values from nominal to real values by assuming 2.8% RPI. The CAA acknowledges that 2.8% is not supported by current

[2] Rounded up from 2.49

evidence, but simply picks a point estimate from PWC's range, without adjusting downwards for higher inflation. Compared to the PWC range, there is an upwards adjustment made for a higher proportion of embedded debt.

2. If PWC and the CAA had adjusted for inflation using the Fisher method used by other regulators, it would be seen that the CAA's proposed WACC value is above the top of the range recommended by PWC. Even if a simpler, less accurate adjustment is made, the CAA's WACC value is above the 90th percentile in the range, rather than the 75th percentile which was its stated intention.

3. While the CAA states they have made adjustments for inflation differences with PWC in the cost of debt calculations, it is clear that the adjustment is too small at 5-10bps rather than the 20-30bps consistent with the CAA modelling assumption (which would be higher if using the top end of the CAA inflation range).

4. The CAA's choice of RPI estimate will make a significant difference to the value of WACC. While the CAA's range of 3.0-3.4% is plausible, RPI has averaged 4% over 2010-2013 and the OBR expects RPI to exceed CPI by 1.2% from 2010 onwards.

CEPA also set out flaws in the CAA's logic for preferring the 75th percentile in the range, for its WACC value, rather than the 50th percentile. The selection of a particular point in the range should not be, as claimed by the CAA, primarily a matter of judgement, when there is evidence which should be taken into account. Factors pointing to a lower point in the range include:

- The use of a Fisher equation to adjust for inflation, as should have been done, would further reduce the range (or if the Fisher method is not used, a lower point should be selected in the range);
- Based on the CAA's plausible inflation range, there is a good chance that inflation during Q6 will be above the CAA's modelling assumption (which should have led to a reduced WACC);
- The capex programme is much smaller as a proportion of RAB than in Q5 and the projects are far less strategic.

This is explained more fully in Appendix C.

In addition, the CAA stated that rather than reducing the WACC to allow for reinvestment returns, as it did in Q5, it would take this into account in selecting a point estimate in the range. BA cannot see how the CAA has taken this into account.

<u>Lack of evidence to support the beta and reduced gearing</u>

CEPA have addressed the appropriate equity beta in the February 2013 Cost of Capital report and in BA's response to the Initial Proposals. The evidence available clearly points to a lower asset beta than was used at Q5. Given the change in the notional gearing for Gatwick, the same asset beta will correspond to a lower equity beta.

Evidence on relative changes in beta estimates for comparator airports showed that asset betas had fallen by around 0.1 since Q5. PwC in their analysis agreed in finding that the estimates have remained relatively stable or declined.

Given the change in gearing assumption for GAL between Q5 and Q6, the equity beta has in effect risen by 0.05. This corresponds to a 0.3% rise in the post tax cost of equity, which is not justified by the evidence.

Table 1: Equity beta decisions

Measure	Equity beta range	Equity beta spot rate
Q5 Final Proposals (HAL)	0.90-1.15	1.08
Q5 Final Proposals (GAL)	1.00-1.30	1.19 (equivalent to 1.06 at 55% gearing)
Q6 Final Proposals (HAL)	0.90-1.15	1.10
Q6 Final Proposals (GAL)	0.90-1.17	1.12

Source: Markit, Bloomberg, Bank of England, CEPA analysis

Note: implied equity beta for Q5 using a 2.5% risk free rate and 4.5% equity risk premium. Q6 figures from CAA technical annex on the cost of capital, p81.

BA have pointed out that the five investor tests show an equity beta of less than 1.0, with HAL also demonstrating lower volatility of earnings and less uncertainty than the FTSE100. BA also supplied evidence that traffic volatility, which was strongly affected by a one off adjustmet in US flights, did not translate into earnings volatility at Gatwick.

The discussion in the PwC and CAA analysis on comparator airports could be interpreted in four different ways, depending on whether you look at the absolute number or relative change, asset beta or raw equity beta.

The CAA has seemingly relied on the absolute asset betas from comparator airports in justifying an effective rise in the equity beta. The same evidence though shows a decrease in the relative value in the asset beta compared to the Q5 decision (and Q6 Initial Proposals). Both the absolute and relative estimates on the equity beta would not support a rise in the equity beta. The CAA should revisit the evidence presented, given that they have interpreted empirical evidence in a different fashion to PwC and BA/CEPA, and proposed equity beta values that are not supported by the evidence. If the CAA wishes to argue for taking a high relative position in the equity beta range, this would be inconsistent with taking the 79th percentile position on the overall WACC range as it would constitute a double counting of risk.

Value of "x"

British Airways has seen no evidence to make us change our view that a price settlement of RPI-10% is appropriate and achievable for Q6. The strengthening economy, combined with a large number of newly created slot capacity and Easyjet's purchase of Flybe slots, should result in much stronger traffic forecasts and commercial revenues. It is clear from our work on WACC that GAL will be able to finance its activities and make a reasonable return on investment provided that it invests wisely, pursues the scope for efficiencies as companies operating in competitive markets must do and meets the needs of its customers.

B) FORM OF REGULATION

British Airways considers that the CAA's proposal to accept GAL's Commitments rather than making its own RAB based price determination is based on serious errors both in the comparison of price outcomes under the two approaches and in the assessment of benefits of a Commitments based approach. Further, because the CAA has significantly underestimated the scope for price efficiencies in its assessment of a "fair price" (as explained in the previous section and more fully in the ACC response), the price outcomes under the two approaches are, in fact, much more divergent than they appear in the CAA proposals.

A fundamental structural weakness of the CAA's proposed approach is that the regulator is unable to change the price or any of the other terms of the Commitments because it is GAL alone who determines these. The CAA only gives itself the option to accept the Commitments in full or reject them in full. Despite acknowledging that the CAA and most airline stakeholders have concerns over the terms, and despite itself recognising unresolved flaws, the CAA's proposal is to accept GAL's Commitments. This has made it highly unlikely that GAL will agree to further changes however strong the case for doing so and however widespread the concerns. This approach has also strengthened GAL's already strong bargaining power over airlines when attempting to secure the available discounts under bilateral contracts.

The flawed price comparison

Part of the CAA's assessment involves a comparison between the price commitment offered by GAL under the commitments and what it calls the "fair price" calculated under a RAB-based approach. As the commitments are for seven years but RAB-based controls are typically for five years, the CAA comparison is with "fair prices" for 5 year and 7 year periods. The CAA concludes:

> *"…the commitments blended price is below the CAA's five year RAB-based price but marginally above the seven year fair price…"*[3]

The CAA also considers that it should put more weight on the five year fair price because the seven year price has to be considered less certain given that it was developed from the five year price rather than from a separate bottom-up analysis and because there may be greater traffic risk over 7 years.

We have three serious issues with the comparison that the CAA has made:

a. The first, and most significant, is that the commitments only commit to a minimum spend of £100m on capex per year compared to the £160m per year used to calculate the RAB-based framework. The CAA acknowledges this lower capex commitment as a drawback of the commitments[4] but does not adjust the prices it

[3] Paragraph 10.89.
[4] Paragraph 10.98.

uses in its comparison to reflect it. The CAA seems to suggest that it could, after the start of the price control, look to introduce additional licence conditions to address its concerns over the "flexibility" in the capex plan[5] but it does not follow that it could actually require GAL to invest more (or reduce prices to reflect the lower investment) without re-opening the whole price control process. It is clear that GAL's price is based on only a minimum commitment of £100m per year and it would undoubtedly want more money if it had to invest more. The lack of any capex commitment should have been dealt with either by making the acceptance of the commitments contingent on GAL making meaningful capex commitments – we set out in our interim response[6] how this could be done – or by adjusting its RAB-based "fair price" comparator so that it was calculated on the basis of the same capex commitment. Our approximate calculations suggest that a RAB-based approach based on only £100m per year of new capex could reduce the value of "X" in the price formula by up to almost 2%, depending on timing.

b. The comparison the CAA makes is between the RAB-based price and the "average" or "blended" price commitment under the commitments. As such, it includes any lower prices offered to airlines under bilateral agreements. The price commitment for published prices is 1% per year higher. We do not consider this to be an appropriate comparison as the lower prices under bilateral agreements will not be automatically available to airlines and will only be made available in return for reciprocal commitments going beyond anything that would apply under a RAB-based approach. For example, discounts offered in exchange for passenger growth commitments would generate increased revenues and/or reduce traffic risks. Discounts might be also be offered in exchange for opportunities by GAL to increase commercial revenues. Any discounts would therefore be wholly, or at least partly, self funding.

c. As already noted, the CAA has compared a 7 year commitments price with a 5 year RAB-based price. We do not consider this to be an appropriate comparison. While we accept that there are uncertainties in calculating a 7 year RAB based "fair price", GAL would have a greater incentive to make larger operating cost reductions than the CAA has assumed, to develop larger commercial revenues and to offer incentives to airlines, so it Is likely that GAL would be better able to manage these risks.

d. The CAA has not taken account of the many opportunities available to GAL to increase prices under the Commitments that would not be available under a RAB based approach. The CAA has recently suggested licence based controls to limit the scope for premium charges and the costs of a second runway, but there is still provision to increase prices in a number of ways (discussed further below).

When compared more appropriately, we believe it is clear that the commitments price is significantly higher than the equivalent RAB-based price.

However, as we have explained in our comments on the "Fair Price", the CAA's assessment of a RAB-based "fair price" is itself more generous than it should have been because of errors and misjudgements in the calculations, especially in its estimate of WACC, traffic forecasts, operating expenditure and a failure to adjust for negative construction price inflation.

The CAA identifies three "*issues pointing towards accepting a commitments price above the fair price*" , acknowledging that the commitments price is above the 7 year RAB-based

[5] Paragraph 10.109.
[6] BA's Interim response of 23 October is attached as Appendix D

price). In BA's view, any such benefits are weak and are insufficient to overcome what we consider to be a significant price difference under the two approaches.

"*the greater period of certainty to airlines and consequently the greater risks to GAL*"

In BA's view there is less price certainty under Commitments because GAL is able to demand additional payments for premium charges, for the second runway, for security costs and for developing particular capex projects. Prices in any one year can also change by the cumulative revenue difference mechanism and capex projects can be delayed without triggering rebates. There is significantly less certainty over the major 'ancillary charges' such as staff car parking. It is also far from clear that any benefits of a longer period accrue (only) to the airlines and, similarly, that the risks only accrue to GAL. GAL would have a much longer period in which to exploit the potential for outperformance, especially on opex and commercial revenues, without the opportunity for airlines to pass these benefits to consumers. The fact of the matter is that it was GAL that proposed a 7 year period of its own volition, suggesting that it considered 7 years more favourable for itself than 5 years. While it is possible that both sides could benefit, we see no basis for concluding that the longer period works in favour of airlines (and therefore passengers).

"*the commitments would lock in the forecast reductions in prices in the subsequent control period, which often have a tendency of not transpiring, with new cost pressures emerging so the actual price ends up higher*";

As there are explicit conditions allowing for prices to increase within the Commitments period to pay for additional capex projects, higher security costs etc, this comment presumably applies to opex. The CAA's view is highly speculative. In any case no price reductions are proposed. Under Commitments, prices will increase by more than the rate of inflation for a longer period. The CAA has itself identified the scope for large operating cost reductions, which it considers will take time to achieve because pay and pensions take time to reform. In addition, advances in technology have driven productivity improvements across most businesses and we would expect there to be opportunities at airports as well. We would therefore expect opex efficiency to increase.

"*the risk that GAL could walk away from the commitments if the CAA sets the price, removing the other benefits from the commitments in terms of flexibility and greater tailoring to individual airline needs*".

The main benefit relied on by the CAA is the belief that bilateral contracts are more likely under commitments than under a RAB-based control.[7] It believes this to be so because:

- a longer period (than 5 years) is needed in order for an early sacrifice of margin to be compensated later;
- commitments for 7 years reduce the risk of inconsistency between bilateral contracts and the regulatory regime. The comment is made that bilateral contracts would typically be for 10 years; and
- commitments would enable a more flexible capital plan which would support differentiated services under bilateral contracts.

It is not obvious that these benefits really exist as they appear to rely on assumptions that the RAB-based control must retain the structure of previous quinquennia when there is no particular reason that it would have to do so. In fact, the main rationale for replacing the

[7] Paragraph 10.77.

Aviation Act with the new framework in the Civil Aviation Act 2012 was to give the CAA more flexibility to tailor regulation to circumstances. The ability to move away from rigid 5 year control periods was a key benefit of the new approach. The CAA could decide to fix a 7 year price control (in line with the commitments), an 8 year price control (in line with the approach adopted by Ofgem) or even a 10 year price control so as to fully match the length of the supposedly typical bilateral contract (we are not sure what the CAA means by a typical contract). Similarly, it could have changed the capex provisions to allow more flexibility.

It is, of course, difficult to know what exactly what would result from a Commitments type arrangement. However, the benefits would need to be large to overcome the likely significant additional costs for passengers that we identified when comparing a RAB price with a Commitments price. In addition, we are not aware that any bilateral contracts have so far been agreed, despite every encouragement from the CAA and many airlines exploring this.

In conclusion, BA considers that the CAA should not adopt GAL's Commitments. The calculation of a "fair price" is the appropriate mechanism to develop a licence-based price control using a RAB framework, whether as a modified version of GAL's Commitments, or as a Heathrow-style price control mechanism. This need not prevent the conclusion of any bilateral contracts as these will be developed where there are incremental benefits to both sides.

C) LICENCE CONDITIONS

The interim response by the ACC on 22nd October sets out the remaining issues with a licence framework to accompany the Commitments. BA also continues to have some concerns that GAL would not share the CAA's formal duties in the way that it implements the Commitments, although we note that the CAA believes this is clearly the case.

The alternative licence framework to include a price control has already been drafted by the CAA for a price control to be implemented directly within the licence.

Appendix D

Interim submission by BA to the CAA for the final Q6 proposals:

Capex commitments

1. Introduction

1.1 This note is an interim submission by British Airways to the CAA's final Q6 proposals for Gatwick Airport. It concerns the absence of any capex commitments under GAL's proposed Commitments.

1.2 BA has previously set out its concerns with the Commitments approach and explained why we believe a RAB based settlement is necessary to constrain GAL's market power and why that would better serve the passenger interest. Nevertheless, and without prejudice to our position, we thought it would be helpful to set out a particular concern that we have with the absence of commitment to capex outputs in the Commitments.

1.3 We have also contributed to an ACC interim position paper, submitted on 22nd October, which covers concerns over particular Commitments terms. Our final response to the CAA consultation will also set out why we consider the Commitments price to be excessive and inefficient.

2. The absence of any Capex Commitments

2.1 The CAA calculations of a "fair price" were based on an assumption that GAL would spend £791m over 5 years, or £1144m over 7 years under the "core" programme. This is equivalent to an average of £158.2m over 5 years or £163.4m over 7 years. This compares with GAL's "Commitment" to spend only £100m a year on average over the 7 year Commitments period.

2.2 This means that under a Commitments regime, GAL could, at its complete discretion, reduce the proposed capex programme by 39% without any loss of income. If this reduction was made under a RAB based settlement, rebates would have to be made either under a core/development approach, or with traditional triggers. Furthermore, under Commitments, future profits would not be related to the company's capital assets, so there would be a strong financial incentive to under-invest, where GAL would not suffer financial disadvantage.

2.3 For example, it is highly likely that GAL would choose not to build P6 because the formal PSL standard is likely to be met. To offset longer term risks, or risks associated with unforeseen circumstances, by careful stand planning they could increase required towing to achieve higher PSL. Handlers might ultimately not be able to achieve these towing levels and as a result tows would be refused. GAL would then point at the conditions of use, which they have unilaterally changed so as not to pay off pier rebates for flights where tows have been refused by our agents. The result is that even if GAL were to fail the PSL, which seems unlikely, they could require airlines to resolve the problem at their own expense. Beyond the 7 year Commitments period, there is no guarantee that the 95% PSL would endure.

2.4 The Commitments approach would also make it likely that GAL would skew any investment towards projects that delivered incremental commercial revenues, which would be uncapped, or towards projects that reduced their own operating costs.

2.5 While the service quality regime would put some pressure on the airport to invest in areas where the service quality standards would otherwise fail, it is clear that the relatively modest cost of failure could be insufficient to support a business case involving significant investment. In any case, many such investments are not related directly to SQR standards.

2.6 We accept that a RAB based approach can over-incentivise capex development in a way that is inefficient and adverse to passenger interests. This is not an intrinsic problem with a RAB based approach, but results from particular regulatory decisions, including a tendancy to allow for almost all capex proposed by the company and by setting a generous cost of capital that exceeds the company's underlying cost of capital, allowing the airport to profit from the difference. Under a RAB approach, neither triggers nor a core/development approach penalise an airport for failing to carry out inefficient investment, as these mechanisms are designed simply to return some of the expenditure the airport has not incurred and/or to allow investment to be redirected to more worthwhile projects. Therefore the CAA already has tools to constrain inefficient investment under a RAB approach, while still providing incentives to invest where GAL themselves otherwise receive no direct benefit. There is a very strong case, for example, for including the P6S project as "development" rather than core, given the large uncertainty surrounding this project, thereby removing it from the price calculation.

2.7 Under Commitments, the significant financial benefits of either delaying or reducing investment (compared with the programme on which the CAA has assessed its fair price) would accrue to GAL's shareholders in its entirety, whereas the costs of delay or reduced outputs/standards would be incurred by airlines and their passengers. It is difficult to see how this would be in the interests of passengers.

2.8 There is a further risk that GAL might be able to compel airlines to pay more because they are not obliged to make any investment or to meet any deadline. They might therefore say that investment X would proceed only if airlines agreed to increase the Commitments price by Y or if particular airlines agreed to pay Z more under bilateral agreements. GAL could therefore exploit its market power by compelling airlines to pay extra for something, even when it has been included within the agreed capex programme.

3. Capex controls under a Commitments regime

3.1 BA considers that the risk of capex underspend is best mitigated by retaining the RAB based approach and adjusting regulatory decisions to reduce incentives to overinvest, especially the cost of capital and the decision to allow all investment into the RAB, even where inefficient. However, if a Commitments based approach is adopted, GAL should include Commitments to deliver projects that are important to customers and to rebate savings made from cancelled, reduced or delayed projects.

3.2 The obvious approach would be to replicate a simplified version of capex triggers in the Commitments, focusing on certain categories of projects, including those:

(a) where there is high risk of cancellation (such as Pier 6 south[8]); and
(b) where there are benefits to users but little or no financial benefit to the airport (eg the Early bag store); and
(c) where GAL would have incentives to delay/reduce projects without being constrained by the SQR regime (eg upgrading of check-in areas).

3.3 Under a simplified triggers approach, the Commitments would include, for each project, at least:
a) the date for beneficial use;
b) key outputs/dimensions (eg 3,000 bag capacity for the Early Bag store); and
c) rebate amounts for cancellation and delay.

3.4 Delay rebates would be based on established Q5 trigger sums. Cancelled projects should return the full costs as per the CAA calculations for a fair price. Projects where outputs are reduced should return a reasonable proportion of the cancellation amount, reflecting the savings made.

3.5 The amendment provision, set out in Paragraph 6 of Schedule 2 to Schedule 1 of the Conditions of Use, could be used to vary the capex commitments with airline agreement. The airport would also have the option to request a licence change using Airports Act provisions. Therefore the capex commitments would provide the necessary flexibility to alter the Commitments where appropriate in the light of changing commercial circumstances.

[8] BA does not support the P6S project. However, if the Commitments/fair price is based on building it, GAL should either commit to deliver it or compensate airlines if they decide not to. Including a capex commitment would require them to negotiate with airlines when they are ready to decide. If GAL is not prepared to commit to the investment, the Commitments price should be reduced accordingly and there would be no commitment.