

# Request for new information on the Q6 Gatwick price control consultation process

## Response by British Airways

25<sup>th</sup> November 2013

### Introduction

On 18<sup>th</sup> November, Tim Griffiths sent an email to Gatwick airlines, and to Gatwick Airport, seeking additional views on relevant developments since the publication of the CAA's final proposals in October 2013.

British Airways has contributed to and supports the ACC response to this request, so we will not repeat the points made there. The ACC paper addresses:

- New information relevant to traffic forecasts;
- The latest ACC position on Commitments (commenting on the version provided by GAL in its 4<sup>th</sup> November response to the CAA);
- A brief response to GAL's new arguments on pension allowances made in its 4<sup>th</sup> November submission;
- Some high level comments on WACC drawing attention to new information; and
- The latest status of discussions with GAL on remaining service quality and capex consultation arrangements.

### New information

With only one week to respond, it has not been possible to fully coordinate efforts with the ACC on all topics.

British Airways has restricted our additional comments in this note to either new developments (for example the Competition Commission's latest publication on the NI Energy Case), or information that is new to us (for example information in GAL's response which is new to us). We have restricted our response to those areas which seem most material. We have not attempted to counter all of GAL's arguments where we disagree. For the avoidance of doubt, the position of British Airways on all other matters related to Q6 at Gatwick, remains as set out in our response to the CAA's Final Proposals.

This paper by British Airways addresses:

1. the Compass Lexecon report provided as Annex 10 to GAL's response on the impact on passengers of higher or lower airport charges at LGW;
2. an assessment by CEPA on new information relevant to the calculation of WACC; and
3. one aspect of GAL's proposed Commitments not covered by the ACC report.

## **1. Compass Lexecon report on the impact on passengers of higher or lower airport charges (Annex 10 to GAL's response)**

British Airways considers that the report commissioned by GAL as a response to the SLG Economics report is flawed and highly misleading. The main conclusion, that passengers are relatively unaffected by such changes, is therefore unsound. British Airways has already provided information to the CAA in earlier response and to support the CAA's market power assessment (for example on pricing considerations and switching) that is relevant to this question. However, we decided to commission RBB Economics to review the Compass Lexecon report directly. RBB found that there would be direct and immediate impacts on passengers from higher airport charges, especially on the level and availability of low off-peak fares, as well as longer term effects caused by the need for airlines to respond to lower profits or losses (or conversely, the possibility of operating new services profitably if costs are lower). The RBB paper is attached to this paper as Appendix 1.

## **2. CEPA assessment of new information relevant to the calculation of WACC**

British Airways asked CEPA to consider the implications of new information from regulatory bodies since the final proposals were published and to see if there were any new arguments made by GAL than we had not considered before. The most important development is a provisional determination by the Competition Commission that has implications for the CAA judgement on total market return and on selecting a point estimate from the range. They estimate that the adjustments necessary as a result of the CC report reduce WACC from the CAA's estimate of 5.95% to 5.09% (without making other adjustments that we consider are needed for the cost of debt as explained in our 4<sup>th</sup> November response). Two papers by CEPA are attached to this response, the first addressing new information and the second dealing very briefly with GAL's arguments in its 4<sup>th</sup> November response, most of which have been raised with and dealt with before. The two papers are:

- “CEPA response on new information relevant to Q6 GAL” (Appendix 2); and
- “CEPA additional points in response to GAL” (Appendix 3)

Note that the first paper includes very similar information to the CEPA paper submitted with BA's LHR paper, but they are not the same as the implications for each airport are different.

## **3. One aspect of GAL's proposed Commitments not covered by the ACC report**

The concern raised by British Airways about the absence of capex commitments has not yet been addressed in any way. We explained the significance of this in our earlier submission and are disappointed to hear that GAL is opposed to implementing any sort of trigger mechanism or to offer an alternative solution. We continue to see this as a major disadvantage of the commitments approach and a clear example of why the Commitments price should be significantly below a RAB based or "fair price".



# Why increases in airport charges adversely affect airline passengers: a response to Compass Lexecon

RBB Economics, 22 November 2013

## 1. Introduction

In its paper, *Comments on the SLG report on the distribution of rents*, Compass Lexecon argue that changes in airport charges do not affect airline passengers but merely involve a change in the distribution of rents between the airport owner and airlines. This short paper explains why that argument is fundamentally incorrect, contradicting as it does standard economics and the reality of the airline industry. In practice, airlines will respond to changes in airport charges in one or more of the following ways:

- altering passenger fares;
- altering schedules by changing the number of weekly flights per route;
- changing the number of destinations;
- adjusting the size of aircraft operating; and/or

- changing the frequency of introducing new aircraft (ie introducing new aircraft either more or less quickly).

Changes in airport costs will affect passengers both directly and indirectly. Direct effects arise from changes in per-passenger costs. As standard economics informs us, such changes in variable cost will directly affect pricing decisions. In particular, increases in per-passenger airport charges will tend to lead to increases in passenger fares.

Indirect effects arise when airport charges (including per-aircraft costs) affect the profitability of operating an aircraft on a given route. Increases in those costs can lead to changes (i.e. decreases) in capacity operated on a given route. As standard economics again informs us, a decrease in available capacity on a route will, all else equal, have the effect of increasing passenger fares on that route.

In addition to arguing that increases in airport charges merely shift rents from airlines to airports, and somewhat in contradiction to that claim, Compass Lexecon also argues that increases in airport charges would result in airlines switching airports and, implicitly, that such switching possibilities rule out the scope for Gatwick to exercise significant market power in relation to airport charges.<sup>1</sup> That unsubstantiated argument should be rejected for a number of reasons. First, many airlines have made significant sunk investments in establishing bases at London Gatwick. Only very significant increases in airport charges would likely induce such airlines to switch airports.

Second, we note that Compass Lexecon appears to confuse the ease with which airlines can re-deploy assets across routes operated from the same airport with the significant obstacles that would be associated with moving whole-scale operations from one airport to another. Clearly, switching from operating one route at an airport to another operated from the same airport is fundamentally different from switching all operations from one airport to another.

Furthermore, the fact that airlines might indeed switch in response to excessive increases in airport charges cannot provide the basis for arguing that airports be granted total freedom in pricing. It is well-known that monopolists will price up to the point that *further price increases* become unprofitable. But that does not imply that allowing a monopolist to exercise significant market power raises no concerns of economic efficiency; quite the opposite.

Finally, we address Compass Lexecon's argument that slot trading does not result in an efficient allocation of resources as airlines are strategic when considering whom to sell slots to. The available evidence indicates that slot trading is efficient.

The remainder of this paper is organised as follows.

- In section 2, we explain why a change in airport charges is likely to be passed on to passengers.

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<sup>1</sup> If airlines could fully pass on increases in airport charges as Compass Lexecon suggest, then there would be no need for airlines to switch airports.

- In section 3, we explain why airline switching in response to an increase in airport charges would not be sufficient to prevent Gatwick exercising significant market power in relation to airport charges.
- Finally, in section 4, we explain why allowing airports complete freedom to set airport charges would result in inefficient outcomes.

## 2. A change in airport charges is likely to be passed on to passengers

### 2.1. Airlines do not face a fixed vertical supply curve

Compass Lexecon argues that airlines likely face a fixed vertical supply curve and therefore any increase in airport charges will have no impact on passengers.

Compass Lexecon makes two arguments to substantiate this claim. First, Compass Lexecon states that easyJet, as the largest airline at London Gatwick and with a load factor of 90%, should be used as benchmark for London Gatwick rather than BA which has a much smaller share at London Gatwick and a lower load factor. Secondly, Compass Lexecon argues that the average load factor is calculated from a mix of peak flights, which are essentially sold out, and off-peak flights, for which there is insufficient demand. Compass Lexecon concludes that on many flights, airlines are therefore in fact capacity constrained. Compass Lexecon also notes that once an airline has decided to fly a route the marginal cost of carrying an extra passenger is low, which allows airlines to maximise revenues by pricing depending on demand conditions.

We agree that in the short run, it is not straightforward to increase average load factors if an airline's peak flights operate at close to 100 per cent load factor since only load factors on off-peak flights can be increased with existing deployed assets. We note also that even if easyJet operates at full capacity at peak times, this does not imply that all other airlines operating at Gatwick face a vertical supply curve. For those airlines, changes in airport charges will affect pricing decisions. Moreover, in any event, even in the short-run, there is clearly scope for a decrease in airport charges to benefit passengers by leading to lower prices for off-peak flights.

But more importantly, Compass Lexecon fails to recognise that the CAA price review is a long-term review (for the time period 2014-2019). It is therefore critically important to assess how airlines would likely respond to higher airport charges over this timeframe and not, as Compass Lexecon do, only assess the static very short run responses of airlines to changes in airport charges. As noted in the introduction, airlines will likely respond to changes in airport charges by altering the size of aircraft operated; adjusting schedules; altering which routes are flown and/or changing the timing of the introduction of new aircraft.

The first three responses will directly affect available capacity operated on a route. To the extent that the responses of airlines to higher airport charges would lead to less capacity being deployed on a route, for a given level of demand, we should expect passenger fares to increase to the clear detriment of passengers.<sup>23</sup> In other words, even if airlines were totally supply constrained in the short run, this is unlikely to be the case in the medium and long term. The potential adverse impact of increases in airport charges on the capacity decisions of airlines and hence on the likely level of passenger fares in the future must therefore be taken into consideration.

## **2.2. A reduction in airport charges is likely to affect fares**

In its report, SLG Economics suggested that a large part of an exogenous price reduction in airport charges would be passed on to passengers as there is competition in the airline sector, and an airline that does not pass on cost reductions will lose out to other airlines that do pass on those reductions.

Compass Lexecon responded that this only applies to variable cost reductions (i.e. per-passenger charges such as security and baggage handling), and that some of the airport charges are fixed by flight (landing, take-off, parking), which would not be passed through.

First, we note that the pass-through of a decrease in airport charges would occur even if there were no competition on a route. Even a monopolist will pass through part of a cost decrease as this will serve to maximise profits by continuing to equate marginal revenue to marginal cost. For example, in the case of a linear demand curve, a monopolist would pass on exactly half of the change in marginal costs.

Secondly, as Compass Lexecon agree, standard economics states that fares will respond to changes in marginal cost. We note that the short run marginal costs associated with selling an additional seat (assuming that capacity constraints do not bind; i.e. there are unsold seats on flights judged by the passenger to be suitable) consist of the cost of additional fuel required, catering costs and a number of other cost items. In addition, short run marginal cost includes airport charges and taxes that are levied on a per-passenger basis. Since demand is not completely inelastic, any change in airport charges would inevitably be directly passed on to passengers on flights (see above).

Thirdly, we note that per-passenger charges account for a substantial part of total airport charges, which implies that Compass Lexecon at least implicitly accepts that a large part of any potential airport charge reductions would be passed on to passengers. Table 1 below shows that depending on the season, typical per-passenger charges represent between 55 per cent in the summer to 96 per cent in the winter of total airport charges.

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<sup>2</sup> Withdrawing from a route altogether represents the most significant capacity decision an airline can make on a given route.  
<sup>3</sup> Passengers are adversely affected by the fourth response in terms of receiving a lower quality product.

**Table 1: Passenger charges as a percentage of total airport charges at LGW in 2013/2014, in GBP**

	Summer peak	Summer off-peak	Winter
<b>Charge per international departing passenger</b>	12.27	12.27	12.27
<b>Passengers per aircraft</b>	159	145	139
<b>Total Passenger charges</b>	1950.93	1779.15	1705.53
<b>1 hour Parking charge</b>	63.36	63.36	63.36
<b>Landing fee</b>	752.68	247.05	0
<b>Take off fee</b>	752.68	247.05	0
<b>Total costs</b>	3519.25	2336.61	1768.89
<b>Proportion of per-passenger charges in total costs</b>	<b>55.4%</b>	<b>76.1%</b>	<b>96.4%</b>

*Note: Charges and passenger numbers for typical Airbus A319 flight (75 tonnes) to an international destination, assuming 1 hour parking and average loads.*

It should be noted that the per-passenger charges listed in the table above include only regulated airport charges. Other per-passenger charges that BA faces in addition to those included in Table 1 include the £12.27 Passenger Service Charge levied by the airport, the Air Passenger Duty of £13.00 levied by the Government, as well as costs for passenger fuel, catering, GDS fees, credit card commissions, PRM and check-in, which for a typical short-haul flight total around £10 to £11 per passenger. Hence, the total short run marginal costs of transporting a passenger are in the region of £35 to £37. This is very close to the lowest fares of BA (£39.00) and other airlines active at Gatwick. A change in any of these costs, including the Passenger Service Charge levied by the airport, would likely lead to a direct increase in these lower fare classes, either by increasing the price of the lowest fare available and/or by reducing the number of seats available at that fare.<sup>4</sup>

As noted above, in addition to considering the impact of changes in short run marginal cost on passenger fares, account must also be given to the impact of changes in airport charges on capacity decisions of airlines which also affect passenger fares. Many costs that might be fixed over the course of a season are variable when considered over a longer timeframe. One should therefore expect that those airport charges based on a per-flight basis will also be passed through to passengers.

Airlines determine, in the medium term, whether to add a flight to a schedule based on the incremental profits made from such a flight. This means that airlines would find that adding more flights would be profitable if costs are lower (i.e. if airport charges - both on a per-passenger basis or on a per-flight basis - are reduced). Such additional flights would increase

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<sup>4</sup> Similarly, airlines have low profit margins, which would not allow them to absorb any price increases. For example, easyJet's profit per passenger has fluctuated around £1 to £5 per passenger. Such a level of margin is incompatible with an ability to absorb an increase in airport costs. Rather, a significant part of any increase must necessarily be passed on to passengers at least in the medium to long term.

capacity on a route, which would tend to imply, all else equal, lower fares for passengers . In addition, passengers might also benefit from higher frequencies and/or a choice of more destinations.

It might be argued that the above mechanism whereby passengers benefit from decreases in airport charges cannot arise at airports that are capacity constrained. But that would be to ignore alternative mechanisms for increasing capacity; namely, flying larger aircraft. Lower airport charges may make operations using larger planes profitable. Such a response would also result in an increase in available capacity and, as above, tend to lead to lower fares.

Additionally, outside the peak times, there is in fact significant spare slot capacity available at London Gatwick. This means that outside of peak times, i.e. during the majority of the time, airlines are able to increase capacity both by increasing the number of flights and by increasing the size of the aeroplanes used.

### 3. Airlines switching in response to an increase in charges would be insufficient to prevent Gatwick from exercising significant market power

#### 3.1. An increase in airport charges will lead to insufficient switching

Compass Lexecon argues that increases in airport charges would lead airlines to switch airports and, implicitly, that such switching possibilities rule out the scope for Gatwick to exercise significant market power in relation to airport charges. There are a number of points that can be made in response.

First, the impact of a change in airport charges on the airlines' profitability depends of course on the extent to which cost increases will be passed through to the passengers. If they are passed on to a large extent (which they would be in many cases as we detail above), the impact on profitability will be much less significant than suggested by Compass Lexecon and therefore the incentive for airlines to switch is reduced. This implies that there is an inherent tension in the Compass Lexecon paper between the alleged ease of airport switching and the claim that airport charges are fully passed onto passengers.

Secondly, the fact that *some airlines* are able to switch does not prevent the operator of Gatwick airport from exercising significant market power. In order to prevent firms from exercising market power, it is important that a *sufficient proportion* of consumers are able to switch to render the putative price increase unprofitable. Compass Lexecon does not address this fundamental issue. We note that Compass Lexecon provides no evidence on the expected level of switching in response to the proposed increase in airport charges at Gatwick and is therefore unable to substantiate its assertion.

In any case, standard economics informs us that even a monopolist airport operator will price to a level up to the point where airlines will eventually start to switch away in sufficient numbers to render *further price increases unprofitable*. But that does not, and cannot, imply the absence of

any competition concerns. The issue in assessing whether the owner of London Gatwick is able to exercise significant market power is not whether there is a level of prices that even a monopolist finds that it unprofitable to increase prices further but rather whether the owner of London Gatwick is able to profitably increase prices above normal competitive levels.<sup>5</sup>

### **3.2. The scope for switching routes does not prevent the exercise of significant market power at Gatwick**

Compass Lexecon states that the evidence shows that many routes are opened or closed all the time and, therefore, infers that sunk costs are low.

However, Compass Lexecon confuses the case of switching an airplane from one London Gatwick route (e.g. LGW-FRA) to another London Gatwick route (e.g. LGW-MAD) with the switching of the airplane to fly a completely different route not involving London Gatwick (e.g. LHR-FRA instead of LGW-FRA).

The mere switching of routes operated at Gatwick provides no competitive constraint on the level of airport charges at Gatwick and will therefore not prevent the operator of Gatwick airport from exercising significant market power. Furthermore, the ability to switch routes readily provides no insights into the magnitude of sunk costs associated with switching airports. The former only involves minimal sunk cost (i.e. marketing cost when starting up the route), whilst the latter involves more significant investments. This is especially the case if an attempt were to be made to move several routes from Gatwick to other London airports. Even if capacity were available at other London airports to accommodate such a wholesale switch (which is unlikely), such a move would entail significant costs relating to staff and facilities established over many years at Gatwick.

We note that even a transfer between different bases would be difficult, say from London Gatwick to London Heathrow in the case of BA: First, the capacity at London Heathrow is already fully utilised, so it would not be possible to move the base of a plane from London Gatwick to London Heathrow without removing a plane at London Heathrow. Secondly, the configuration of BA's planes based at London Gatwick is different to the configuration used for planes based at London Heathrow. In fact, no transfer of planes between London Gatwick and London Heathrow has occurred since 2010.

The above implies that many airlines, including BA, cannot realistically discipline Gatwick Airport in response to an increase in airport charges by switching services to a different London airport.

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<sup>5</sup> This economic issue is similar to the *cellophane fallacy*, so-called after a case in the cellophane industry in 1956 (United States vs DuPont).

#### 4. Allowing airports freedom of pricing will not deliver efficient outcomes

In response to the claim that slot trading would result in an efficient allocation of resources, Compass Lexecon argue that in practice this does not hold as airlines are strategic when determining to whom to sell slots. Compass Lexecon suggest that in consequence airports should be allowed to set a market clearing price.

Compass Lexecon's arguments rely on a number of critical implicit assumptions. Allowing congested airports to set charges without regulation would without doubt result in significant increases in airport charges and hence in passenger fares, for the reasons set out in the previous sections. Such increases in airport charges could, in theory, result in additional airports (or additional capacity at existing airports) being built, and these new airports would compete to attract airlines by lowering airport charges.

The problem is that in the real world these additional airports can neither be built due to government restrictions nor quickly enough to ensure that the competitive pressures on pricing are brought to bear in a timely manner. We note that competition authorities are normally concerned that any competitive responses are made within two years, a far shorter period than required for airport expansions.

It is for this reason that economic regulation of airport charges is required to prevent airlines and their passengers from excessive pricing.

We also note that Compass Lexecon's argument regarding the alleged inefficiency of slot trading is flawed. Once a slot is sold, it is sold. Onward trading of the slot would mean that a slot would likely end up in the hands of the airline that valued that slot most, even if the initial seller does not sell to this airline directly.

In any case, it is well established that slot trading works in an efficient manner at airports such as London Gatwick or London Heathrow. In the European Commission's Study on the Impact of Secondary Trading at EU Airports (November 2006),<sup>6</sup> secondary trading was found to have resulted in a number of efficiencies. The Commission found that secondary trading (which has taken place since 2011):

- Has led to "*a liquid and flexible market in slots.*"
- Has been "*effective in fostering new entry.*"
- Is "*supported by the industry, and has proved to be an active market.*"

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<sup>6</sup> *Study on the Impact of the Introduction of Secondary Trading at Community Airports*, Volume I - Report (November 2006), produced by Mott MacDonald and commissioned by the European Commission: [http://ec.europa.eu/transport/air/studies/air\\_en.htm](http://ec.europa.eu/transport/air/studies/air_en.htm)

- Has seen “*direct competitors prepared to trade slots with each other freely.*”<sup>7</sup>

This is further supported by a statement of Jacques Barrot in his capacity as Transport Commissioner (30 April 2008): *“At crowded airports, we need to make sure that slots are used as efficiently as possible and that airlines have a fair chance to develop their operations. Slots at airports must be distributed in a fair and non-discriminatory way. Today we are recognising for the first time that secondary trading is an acceptable way of allowing slots to be swapped among airlines. We will keep a close eye on the situation across Europe and ensure that secondary trading works to the advantage of consumers, but this system has already shown its value in London, where it has allowed a range of airlines to take advantage of the opportunities provided by the EU-US aviation agreement and to create new levels of competition.”*<sup>8</sup>

We also draw the attention of the reader to a study conducted by the European Commission in 2011,<sup>9</sup> which with respect to Gatwick and Heathrow conclude that

*“The analysis also shows that secondary trading at the London airports has been successful in improving capacity utilisation, increasing the mobility of slots between airlines and allowing new entry on some (particularly long haul) routes.”*

In the same study, the European Commission notes that “[in 2010,] 39% of slots at Gatwick are operated by a different airline to that which operated the slots in 2007”, indicating a very liquid and active secondary slot trading market. Furthermore, the Commission notes that “Of the most congested EU airports, only Gatwick airport has seen significant changes in slot holdings in the last few years, other than changes caused by the takeover of one airline by another.”.

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<sup>7</sup> *Competition Issues Associated with the Trading of Airport Slots*: A paper prepared for DG TREN by the UK Office of Fair Trading and Civil Aviation Authority, paragraph 2.14.

<sup>8</sup> <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/672&format=HTML&aged=0&language=en&guiLanguage=en>

<sup>9</sup> European Commission, DG MOVE, Impact assessment of revisions to Regulation 95/93, Final report (sections 1-12), March 2011.



## A response based upon new information since the CAA Final Proposals

Note prepared for British Airways<sup>1</sup>

November 2013

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

This note covers relevant material from regulators since the consultation and addressing further some points raised in the Gatwick Airport (GAL) response. We have previously discussed the setting of an appropriate cost of capital in detail, thus do not intend to cover the same areas again and only focus upon new information.

### Regulatory decisions since the CAA Final Proposals

#### CC provisional determination on the NIE case

This section focusses upon the economy-wide parameters of the cost of capital in the provisional determination as the most directly applicable to the Q6 determination. This leads us to focus on the total market cost of equity<sup>3</sup>.

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

Table 1.1: Cost of equity estimates

	CC (NIE)		CAA (Q6)	
	Range	Point estimate	Range	Point estimate
Risk free rate	1.0-1.5%	1.25%	0.5-1.0%	1.0%
ERP	4.0-5.0%	4.5%	5.25-5.75%	5.75%
TMR	5.0-6.5%	5.75%	6.25-6.75%	6.75%

Source: CC, CAA

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<sup>2</sup> As published on the CAA website:

<http://www.caa.co.uk/docs/78/request%20additonal%20points%20Q6%20heathrow.pdf>

<sup>3</sup> The cost of debt approach taken by the CAA and their consultants, PwC, look at the cost of debt at the all-in cost of debt level, rather than necessarily using a risk-free rate and debt premium calculated separately. As such, any change to the risk free rate should not change the cost of debt.

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

On the risk free rate, the CC ‘*see little justification for the upper end of the range of the risk free rate to be above 1.5 per cent.*’<sup>4</sup> They suggest that long-term factors may be at play and quote Dimson, Marsh and Staunton (DMS), who state that it is difficult to observe whether long bond yields are artificially low, but suggest there is evidence that these ‘distortions’ will not disappear. DMS also suggest that forward data should accurately reflect available information.

Whilst GAL had proposed a 7.0% TMR for Q6, the CC find that ‘*a forward-looking expectation of a return on the market of 7 per cent does not appear credible (to us), given economic conditions observed since the credit crunch and lowered expectations of return.*’<sup>5</sup> The CC instead propose a TMR of 5.0-6.5%.

In terms of selecting a point estimate from this range, the CC favour use of the mid-point. This is supported by their statement, in which they ‘*consider it unlikely that the cost of capital lies at the very top or very bottom of the estimated range as this would involve the lower or upper estimates for each parameter coinciding.*’<sup>6</sup>

The impact on the cost of equity for GAL by using the CC parameters for the risk free rate and equity risk premium is 1.5% on a pre-tax basis. This leads to a fall in the pre-tax WACC of 64bps, to 5.31%. The use of the mid-point of the equity beta range would further reduce the pre-tax WACC by 22bps to 5.09% for GAL.

### **Further regulatory information**

Two regulatory determinations have been released during the last month in addition to the provisional determination of the CC. The Office of Rail Regulation (ORR) have released their Final Determination for CP5, in which a 4.31% vanilla WACC has been agreed upon, or 4.93% in pre-tax terms (the same as the draft determination from 12 June 2013)<sup>7</sup>. This price control runs over the same time period as Q6 and this compares to a 5.6% pre-tax WACC for HAL and 5.95% pre-tax WACC for GAL. This was released prior to the CC provisional determination on NIE. In addition, Ofgem released its decision on fast tracking the electricity distribution companies. Three relevant items are covered here:

- 1) The central reference cost of equity for assessing business plans was 6.3%;<sup>8</sup>
- 2) The accepted cost of equity for WPD (the only fast-tracked company) was 6.7%, but this was accepted as part of a package including greater than anticipated efficiency targets<sup>9</sup>; and
- 3) A consultation is proposed on the impact of the recent CC NIE provision determination as this would reduce the allowed cost of equity to closer to 6%.

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

Statements by Ofwat support this story and for the upcoming price control, PR14, the Chief Regulation Officer from Ofwat, Sonia Brown, has discussed a vanilla WACC of 4.1% publically as a mid-point of analyst estimates.<sup>10</sup> The Ofwat chairman, Johnson Cox, has also pointed out the falling cost of capital since the PR09 decision.<sup>11</sup> Therefore we think that comparing to the 5.1% vanilla WACC from the PR09

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<sup>4</sup> CC (2013) 13.121

<sup>5</sup> CC (2013) 13.144

<sup>6</sup> CC (2013) 13.174

<sup>7</sup> ORR (2013) <http://www.rail-reg.gov.uk/pr13/PDF/pr13-final-determination.pdf>

<sup>8</sup> Ofgem (2013) [https://www.ofgem.gov.uk/sites/default/files/docs/2013/11/assessment\\_of\\_the\\_riio-ed1\\_business\\_plans\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2013/11/assessment_of_the_riio-ed1_business_plans_0.pdf), p18.

<sup>9</sup> This 6.7% cost of equity should be seen in the broader context of a 4.1% real vanilla WACC, implying a significantly lower cost of debt (from the indexation model) than has been allowed by the CAA.

<sup>10</sup> Utility Week (2013) <http://www.utilityweek.co.uk/news/a-message-for-water-companies-from-ofwat%20%99s-sonia-brown/938592>

<sup>11</sup> Ofwat (2013) [http://www.ofwat.gov.uk/mediacentre/speeches/prs\\_spe20130305jcrac.pdf](http://www.ofwat.gov.uk/mediacentre/speeches/prs_spe20130305jcrac.pdf)

determination is potentially misleading when considering regulatory precedent. The CC also lowered the vanilla WACC given to Bristol Water by Ofwat at PR09 by 50bps<sup>12</sup>.

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<sup>12</sup> CC (2010) Bristol Water determination, Annex N

Table 1.1: Further GAL response points

Item	GAL response (Oxera report page ref)	Most relevant response(s)	BA/CEPA	Comments
<b><i>Cost of equity</i></b>				
Equity beta	The asset beta does not reflect the significant increase in GAL's risk. Systematic risk has increased during Q5. (p2)	CEPA (June 2013) Response to the CAA's Initial Proposals on the WACC for Gatwick; CEPA (June 2013) Equity Betas for Heathrow and Gatwick in the Q6 Price Control Review		The equity beta measures relative systematic risk. The evidence supports a lowering of relative risk since Q5 and given the reduction in notional gearing, the asset beta is significantly above a reasonable figure and regulatory precedent in comparator sectors.
<b><i>Cost of debt</i></b>				
Inclusion of junior debt	Junior debt has been included in the HAL embedded debt cost calculation. (p4)	BA (October 2013) Response to CAA Final Proposals for HAL (Appendix B)		The inclusion of junior debt should not be included for HAL, and there is certainly no reason to include this for GAL.
Fees	New Issue Premia of 25bps could be up to 25bps. (p4)	BA (October 2013) Response to CAA Final Proposals for HAL (Appendix B); CEPA (June 2013) Response to the CAA's Initial Proposals on the WACC for Gatwick		Given the generosity of the cost of debt allowance, we think that the amount for fees given by the CAA represents an upper bound, the additional fees above HAL are not justified and any further fee allowance uplift would be unreasonable.
Tax	There is different treatment of taxation in the regulatory and tax accounts. This is different to the difference between effective and statutory tax rates. (p5)	Only previously discussed indirectly		There is no reason why the CAA should not note the difference in effective and statutory rates. This discussion is not a new concept and the approach taken by the CC is consistent with regulatory precedent. The inclusion of notional tax allowances which are above the

Item	GAL response (Oxera report page ref)	Most relevant BA/CEPA response(s)	Comments
			effective rate harms the consumer and no further uplift is justified.
<i>Overall WACC</i>			
Differential with HAL	There should be greater recognition of greater risks faced by GAL compared to HAL.	CEPA (June 2013) Response to the CAA's Initial Proposals on the WACC for Gatwick; CEPA (Feb 2013) Setting the weighted average cost of capital for Heathrow and Gatwick	We have discussed in detail the differences between the airports and no new evidence has been presented to alter our judgement on this.