

**Economic Regulation of BAA London Airports
(Heathrow, Gatwick and Stansted)**

2003 - 2008

CAA Decision

February 2003

Civil Aviation Authority

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Executive Summary

The CAA has decided to implement price caps, as required under the Airports Act 1986, from 1 April 2003 to 31 March 2008 ('Q4') for BAA's Heathrow, Gatwick and Stansted airports that will allow prices to rise at Heathrow by 6.5% per annum in addition to inflation, while prices at the other two airports can be maintained in real terms. The CAA considers that its decision will enable BAA to implement its £7.4 billion ten year investment programme which is aimed at improving services to customers in growing markets. The CAA decision also contains the conditions to remedy three public interest findings by the Competition Commission on service quality at Heathrow and Gatwick, and on taxi information desks at Heathrow. The decision is the result of careful consideration of responses to the CAA's November 2002 proposals which were produced following analysis of the report and recommendations of the Competition Commission.¹

While BAA broadly accepted the CAA proposals, Heathrow users responded with strong objections to the proposed increase in Heathrow prices. The key arguments were that the increases were excessive given the difficult commercial conditions faced by airlines, that the revenue advancement from future periods to Q4 was not acceptable, that there should not be any pre-funding of Terminal 5, that the costs of the terminal had not been properly tested or otherwise did not represent value for money, and that a 7.75% cost of capital was excessive.

The CAA understands the current commercial difficulties facing some Heathrow airlines but notes that there is broad agreement that demand for each airport will grow over Q4 and beyond, if capacity is available. BAA's investment programme is designed to meet that growth and deliver desired service quality. The Competition Commission recommended a cap at Heathrow that was similar to the one recommended by the CAA to the Competition Commission in February 2002 under different regulatory policies. Both bodies have come independently to the view that prices need to be able to rise at Heathrow to fund the investment programme. Given that and following consideration of submissions, the CAA has decided to implement price caps consistent with the broad thrust of the CAA's proposals. The CAA believes its judgements on the cost of capital, revenue profiling, treatment of assets in the course of construction and the projections on which the price caps are based are consistent with the views of the Competition Commission and are soundly based for the purposes of setting the price caps. The caps reflect the imperative of BAA implementing its investment programme, including Terminal 5.

¹ CAA (November 2002), Heathrow, Gatwick and Stansted Airports: CAA Proposals for Consultation; Competition Commission (October 2002), BAA plc. A report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd). Both are available at the CAA's website www.caa.co.uk

On the key issue of the smoothing of the price increases through the profiling of returns, the CAA concurs with the Competition Commission that to impose a cap at Heathrow which merely maintains current real prices in the next five years would require much larger increases subsequently: on current information the annual increases in the period 1 April 2008 to 31 March 2013 ('Q5') would be RPI+20%. The price cap in Q5 could be even higher depending on BAA's response to the outcome of the planned Government Air Transport White Paper. The CAA agrees with the Commission and BAA that the risks associated with implementing such a large increase in the price caps in five years time could cause serious financing difficulties over Q4. It would therefore undermine BAA's incentives to deliver the investment as scheduled, linked to risks to its ability to finance its programme. The CAA also notes that the full impact of the price increases of 40%, widely cited by some users, will not take effect until 2007/8 by which time the commercial environment for airlines may be very different, airlines having had further time to adjust.

The CAA agrees that BAA's disclosure of information to, and consultation with, users should be improved. This should be addressed under the agreed framework for improved information disclosure and consultation by BAA.

Given that capacity is scarce at Heathrow, and that the permitted price increases will be small in relation to typical air fares for flights operating from Heathrow, the CAA does not expect its decision to materially affect air fares. Charges will continue to be well below the levels indicated by market fundamentals i.e. user values indicated by slot prices and the costs of new capacity.

At Stansted, the CAA does not accept the views of users that a tighter price cap based on existing 'net yields' should be adopted. The CAA's view is that the Stansted cap is cost reflective but, as in previous periods, it is unlikely to be profitable for BAA to exercise its full discretion to increase actual charges to users to the cap and that prices at Stansted will continue to be set to reflect market conditions and facilitate the rapid growth of the airport. The CAA's proposal for Gatwick raised little controversy with the price cap remaining constant in real terms over the five years, and is confirmed.

The price caps for Q4 will therefore be:

Caps on revenue yield per passenger at the BAA airports¹

	2003/4	2004/5	2005/6	2006/7	2007/8
Heathrow	£6.48	+6.5%	+6.5%	+6.5%	+6.5%
Gatwick	£4.32	0.0%	0.0%	0.0%	0.0%
Stansted	£4.89	0.0%	0.0%	0.0%	0.0%

¹ The caps in 2003/4 are fixed amounts with no further correction factor reflecting performance over 2002/3. The figures presented for 2003/4 are in nominal terms (i.e. for Heathrow and Gatwick they are the Competition Commission's recommended caps adjusted for inflation) and are the actual caps on revenue yields for 2003/4. For the remaining years the figures given are the X factor under an RPI+X formula. The figures are for the basic price caps, and make no allowance for any variation resulting from the 'S' factor, the capital expenditure triggers at Heathrow and Gatwick, or the ATM incentive at Heathrow.

The CAA also confirms its previous proposals in the following areas:

- the caps for Q4 are consistent with a single till framework;
- the price caps for each airport are set in relation to that airport's own market, assets and costs, without reference to the costs, assets or performance of the other BAA London airports, and this should continue to be the case at future reviews;
- there will be rebates to users if certain service quality standards are not met at Heathrow or Gatwick;
- the advanced revenue allowed in 1997/8 to 2002/3 ('Q3') and part of the capital expenditure underspend in Q3 has offset Heathrow revenue requirements for charge setting purposes in Q4;
- the framework agreed between BAA and the CAA for enhanced information disclosure and consultation with users will be implemented;
- the cap includes an additional incentive for BAA at Heathrow to increase its runway capacity above a benchmark level in peak periods, although this will not come into effect until an aerodrome congestion term has been introduced as part of the service quality term;
- the pass through for the costs of additional security requirements will be set at a rate of 75% above a threshold level;
- the price caps are set on a revenue yield basis, compliance will be determined against published prices (not allowing for unpublished discounts), the cap at Heathrow allows for recovery of transfer baggage infrastructure costs (although not the baggage tunnel between Terminal 1 and Terminal 4), and a separate cap is specified for non-passenger flights at each airport.

The CAA believes that the price caps for Q4 resulting from this set of policies is best calculated to meet its statutory objectives given the recommendations of the Competition Commission and the CAA's consideration of the responses to its proposals. It provides for an environment conducive to long-term investment in new capacity which, particularly at Heathrow, is critical to best meeting the interests of users. BAA must now deliver its plan, working closely with its customers. Regulatory policy places clear accountability with BAA for delivery and dealing with the risks, operational and financial. The policy recognises the strategic inter-dependence of airlines and the airports and encourages greater engagement, including greater reliance on commercial arrangements between parties. The agreement with BAA for enhanced information disclosure and consultation should serve to facilitate this.

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1. Introduction

1.1 On 28 February 2002 the Civil Aviation Authority (CAA) made statutory references to the Competition Commission in respect of Heathrow, Gatwick and Stansted Airports under section 40(9) of the Airports Act 1986 ('the Act'). In the references the CAA asked the Competition Commission to investigate and report on:

- (a) what are the maximum amounts that should be capable of being levied by each airport by way of airport charges during the period of five years beginning on 1 April 2003;
- (b) whether any of the airport operators had at any time during the period between 10 December 1996 (the date of the previous reference) and 28 February 2002 pursued:
 - (i) in relation to any airport charges levied by it at the airport, or
 - (ii) in relation to any operational activities carried on by it in respect of the airport, or
 - (iii) in relation to the granting of a right by virtue of which any operational activities relating to the airport may be carried on by any other person or persons,

a course of conduct, which has operated or might be expected to operate against the public interest;

- (c) whether any associated company of Heathrow Airport had at any time between 10 December 1996 and 28 February 2002 pursued:
 - (i) in relation to any operational activities carried on by it and relating to the airport, or
 - (ii) in relation to the granting of a right by virtue of which any operational activities relating to the airport may be carried on by any other person or persons,

a course of conduct which has operated or might be expected to operate against the public interest; and

- (d) if so, whether the effects adverse to the public interest which the course of conduct that falls within (b) or (c) above has had, or might be expected to have, could be remedied or prevented by the imposition of any conditions in relation to the airport or by the modification of any conditions already in force.

- 1.2 The CAA published the references² on its website on 6 March 2002 together with the information and recommendations³ that it submitted to the Competition Commission with the references.
- 1.3 The references asked the Competition Commission to report within six months, by 28 August 2002. On 5 July 2002 the Competition Commission applied to the CAA in accordance with section 44(3) of the Act seeking an extension until the end of December 2002. Having considered the Competition Commission's request the CAA agreed to an extension until 31 October 2002. The Competition Commission duly reported to the CAA on 31 October 2002 and the CAA published the report on 29 November 2002⁴ after making the excisions directed by the Secretary of State under section 45(7) of the Act. The Competition Commission's report is available on the CAA's website⁵. For ease of reference a summary of the Competition Commission's main recommendations is in Annex 1 but this should be read in the context of the Competition Commission's report as a whole.
- 1.4 Under section 46(1) of the Act the CAA must impose charges conditions upon each of the airports and, under section 46(2), impose such conditions as it considers appropriate to remedy the adverse effects found by the Competition Commission under that subsection. In imposing charges conditions the CAA must have regard to the Competition Commission's recommendations and in imposing conditions relating to public interest findings must have regard to the remedies the Competition Commission has suggested. The CAA has to publish notice of the conditions (or modifications to existing conditions) it intends to impose and where these differ from the Competition Commission's recommendations, give the reasons for such differences.
- 1.5 On 29 November 2002 the CAA published proposals in accordance with Regulation 12 of the Civil Aviation Authority (Economic Regulation of Airports) Regulations 1986.⁶ The CAA set out and explained its proposals for conditions in respect of airport charges at Heathrow, Gatwick and Stansted for Q4 and in respect of the three public interest findings made by the Competition

² www.caa.co.uk/erg/erg_airport/default.asp?page=67

³ CAA (March 2002), Heathrow, Gatwick and Stansted Airports' Price Caps, 2003-2008: CAA recommendations to the Competition Commission. While the reference was made in February the CAA's recommendations were not published until early March

⁴ Competition Commission (2002), BAA plc: A report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd)

⁵ www.caa.co.uk/erg/default.asp?page=1322

⁶ CAA (November 2002), Heathrow, Gatwick and Stansted Airports' Price Caps: CAA Proposals for Consultation

Commission. It also addressed a number of other issues raised by the Competition Commission in its report.

1.6 The CAA invited written representations on its proposals by 10 January 2003. It received written representations from those named in Annex 2 and these were published on the CAA's website⁷, subject to certain deletions on commercial confidentiality grounds. The CAA also considered further representations on specific issues made after 10 January 2003. In addition the CAA heard oral representations between 22 January 2003 and 31 January 2003 from those marked by an asterisk in Annex 2. Transcripts of these hearings are also being published on the CAA's website⁸, again subject to confidentiality constraints. The CAA has carefully considered all the representations that were made to it. Under section 39 of the Act the CAA is required to establish price caps best calculated:

- to further the reasonable interests of users of airports within the United Kingdom;
- to promote the efficient, economic and profitable operation of such airports;
- to encourage investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports; and
- to impose the minimum restrictions that are consistent with the performance by the CAA of its functions.

The CAA must also take into account the UK's international obligations.

1.7 The decision of the CAA was taken by a panel of members comprising Mr D Andrew, Mr J Keohane and Mr C Senior.

1.8 This document constitutes a statement as required by section 46(5) of the Act.

⁷ www.caa.co.uk/erg/default.asp?page=1456

⁸ www.caa.co.uk

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2. CAA's November 2002 price cap proposals

2.1 The CAA's November 2002 proposals⁹ for the price caps at Heathrow, Gatwick and Stansted airports, together with proposals concerning future regulatory policy are summarised in this chapter.

Key regulatory policies

2.2 The CAA's price cap proposals were based on the following policies:

- prices for Q4 should be consistent with the single till framework, whereby the costs, revenues and assets of commercial activities at the airports are taken into account in setting the price caps on airport charges;
- regulation at the BAA airports should be on a 'stand-alone' basis, where the price caps are set with reference to the costs, revenues and assets of each airport individually, without reference to the returns made at the other BAA designated airports;
- incentives to provide appropriate levels of service quality at Heathrow and Gatwick would be achieved through a system of rebates following from the Competition Commission's public interest finding, rather than through a term in the price cap;
- the new security cost 'S' factor, which allows for the pass through of costs arising from new security requirements, should continue to apply, but be modified such that 75% of the additional costs above a de minimis level would be subject to pass through (rather than 95% of all additional costs currently);
- there should be an additional incentive linked to the declared runway capacity at Heathrow, whereby if capacity were increased in peak periods above a benchmark level, BAA would earn an additional £200 for each additional movement permitted, accompanied by CAA oversight of BAA's performance on delays;
- the price cap at Heathrow should be linked to five triggers based on stages of completion of Terminal 5, and the price cap at Gatwick linked to a trigger based on Pier 6;
- the price cap should continue to be based on a revenue yield per passenger approach and compliance with the cap determined by reference to the published charges of the airport (rather than the actual charges paid),

⁹ CAA (November 2002), Heathrow, Gatwick and Stansted Airports: CAA Proposals for Consultation

providing a basis for direct contracting between the airport and users to take place;

- non-passenger flights would be excluded from the core price cap, with charges to non-passenger flights regulated by a separate condition;
- at Heathrow the recovery of costs currently associated with the transfer baggage infrastructure charges at Heathrow should be recovered through the price cap (excluding the baggage tunnel between Terminal 1 and Terminal 4 ('T1 – T4 tunnel') which is governed by a separate contractual arrangement);
- the airports should provide enhanced information disclosure as a basis for improved consultation with its users, under the terms of proposals previously agreed with BAA.

The price caps and the basis for them

2.3 The price caps set by the CAA for the BAA London airports would be based on a financial model developed by the CAA, which has been used consistently throughout the review process. The model and supporting documentation were made available to BAA throughout this process. Key aspects are:

- the CAA model is based upon the same source data as that used by the Competition Commission in its financial modeling;
- the CAA model has been reconciled with the Competition Commission model and generates conclusions which are equivalent to those of the Competition Commission, when calibrated to reflect the policy assumptions adopted by the Competition Commission;
- the regulatory calculations which underpin the CAA's model have been audited by external consultants and consequently the logical integrity of the model has been endorsed.

2.4 The core price cap proposals for Heathrow and Gatwick were those recommended by the Competition Commission. The proposal for Heathrow was for an initial cap on the revenue yield for 2003/4 of £6.48 per passenger, to be increased by RPI+6.5% in each of the four subsequent years of Q4. The proposal for Gatwick was for an initial cap on the revenue yield for 2003/4 of £4.32 per passenger, to be maintained in real terms through an adjustment of RPI+0%. These caps were based on the following:

- the revenue advancement linked to Terminal 5 in Q3, and part of the gains to BAA resulting from the capital expenditure under-spend in Q3 due to the delay in BAA obtaining planning permission for Terminal 5, were used to reduce the revenue requirement in Q4. The amount was that recommended by the Competition Commission, whose assessment, based on the period 1

April 1996 to 31 March 2002, did not include the one year extension of Q3 to 31 March 2003, and allocated the whole of the credit to Heathrow;

- allowing a full return on assets in the course of construction;
- the Competition Commission's recommendations for a profiling adjustment under which revenue for Heathrow was brought forward from Q5 to Q4 to permit a smoother and more sustainable path of maximum price adjustment over time and to facilitate BAA's ability to finance its investment programme;
- the Competition Commission's recommendation for the starting regulatory asset base (RAB);
- a cost of capital of 7.75% pre-tax real at each airport;
- the Competition Commission's assessment of projected passenger volumes, operating costs, non-regulated revenues, and capital expenditure;
- and, since each airport was expected to earn its cost of capital over ten years, there was no requirement for any adjustment to reflect the move to 'stand-alone' airport regulation. However, if it could be demonstrated that Stansted was not likely to earn its cost of capital in the future, the CAA might consider a one-off RAB adjustment as part of this decision, with the RAB at Stansted being reduced, and the RAB at Heathrow being increased commensurately.

2.5 The CAA's proposal at Stansted was a continuation of the 2002/3 cap on gross yields of £4.89 per passenger maintained in real terms (i.e. RPI+0%). This was higher than the Competition Commission's proposal of £4.44 per passenger¹⁰. The price cap was based on the following:

- one option, the upper bound, was to adopt BAA's projection of marketing support spending and passenger growth projections, implying a cap on gross yields of £5.14 per passenger in nominal terms. Another option, the lower bound, was to use BAA's projection of marketing support, but the CAA's projection of passenger growth, pointing to a cap of £4.76 per passenger in nominal terms. The cap for 2002/3 of £4.89 per passenger was broadly in the middle of this range, and formed the basis for the CAA's proposal;
- the Competition Commission's assessment of operating costs, non-regulated revenues and capital expenditure (adjusted for the difference in passenger growth underlying the CAA's assumptions at Stansted);
- a cost of capital of 7.75% pre-tax real.

¹⁰ The Competition Commission's recommendation was £4.20 in 2000/1 prices, equivalent to £4.44 in nominal terms

CAA future regulatory policy

2.6 The CAA's proposals included a number of statements concerning future regulatory policy. These were:

- regulatory decisions that provide for the greatest likelihood of additional capacity being delivered where it is valued most are in most instances best calculated to meet its statutory objectives, and that regulation is likely to be most effective when it is founded upon credible incentives;
- that price caps will be based on stand-alone regulation of each airport;
- the potential costs of initiating new runway capacity were explicitly excluded from the settlement, with the CAA willing to consider proposals from BAA as to how any such investments should be handled consistent with the Act;
- the adoption of particular financing arrangements is the responsibility of BAA and that BAA and its financiers should be held accountable for these decisions. Price caps in future will be set on the basis of regulatory fundamentals, and not in order to accommodate any particular financing arrangement adopted. The CAA expected that this general approach would also apply to any application for an interim review of the price caps;
- the RAB should be rolled forward to the next review on the basis of capital expenditure additions (net of disposals at value) minus depreciation, where the depreciation in question would be that projected by the CAA as a component of its decision for the Q4 price caps. This depreciation would include any profiling adjustments;
- the CAA would monitor BAA's performance on delays to balance the air traffic movement incentive;
- the CAA expects the airports to demonstrate clearly that significant new surface access projects that are proposed to be funded in part by airport charges generate expected benefits in excess of their costs in terms of the Act's objectives compared to the next best alternative;
- the CAA would continue to work with market participants to assist better longer-term strategic engagements between the airports and users;
- the CAA would continue to review for the future the prospects for output based incentives linked to their incremental value and incremental cost;
- the CAA considers that the case for moving to a dual till in future would be substantially stronger if the airports were better able to demonstrate the potential benefits that it could bring, and considers that the dual till is only one of a range of possible mechanisms for providing enhanced investment

incentives and that superior alternatives to both the single till or dual till could be considered;

- the CAA proposes to consult on the way in which section 41 of the Act should be implemented and on the wider question of the degree to which the CAA should take a more active role in resolving disputes between airlines and the airports;
- the CAA invited views on whether BAA should give a voluntary undertaking in relation to certain non-regulated charges.

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3. Q4 decision: General regulatory policy

Introduction

- 3.1 This chapter summarises the responses to the CAA’s key general regulatory policies for setting the price cap, and sets out the CAA’s assessment of those responses.
- 3.2 Under section 39 of the Act, the CAA is required to establish a price cap for each of the three BAA London airports in a manner which it considers is best calculated:
- to further the reasonable interests of users of airports within the United Kingdom;
 - to promote the efficient, economic and profitable operation of such airports;
 - to encourage investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports; and
 - to impose the minimum restrictions that are consistent with the performance by the CAA of its functions.
- 3.3 The Act does not provide guidance on the interpretation of these objectives and how the CAA should make trade-offs between these objectives. However, as quoted by the Competition Commission¹¹, in *R v Director General of Telecommunications, ex parte Cellcom Ltd and others*, Mr Justice Lightman said:

“In my view it is plain that the various duties imposed by s.3(2) may pull in different directions and may conflict; there may be a conflict between the duties in s.3(2)(a) and s.3(2)(b); there may be a conflict between the interest of the consumers, purchasers and other users specified in s.3(2)(a) [...]. The Director is not paralysed because such a conflict arises: rather he is given the choice how that conflict is to be resolved and to decide priorities, and so long he bears in mind the entirety of his duties, has a predisposition to fulfil all the duties so far as this is practicable and with those duties in mind makes a decision which promotes one or other of the objectives specified (and is rational) his decision stands and is not open to challenge.”

¹¹ Competition Commission (October 2002), BAA plc. A report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd), paragraph 3.67. The duties refer to the Telecommunications Act 1984 section 3

- 3.4 In the CAA's view throughout this review the central challenge facing airports, users and the regulator is the current shortage of capacity at Heathrow and Gatwick at a desirable level of service quality in the face of growing demand, and the high value for users that additional capacity could generate. The CAA believes that regulatory decisions that provide for the greatest likelihood of additional capacity, with desired levels of service quality, being forthcoming (where it is valued) are in most instances best calculated to meet its statutory objectives. This view has informed its decision on the price caps, and will continue to inform the CAA's views on regulation in the future.
- 3.5 The decision on the price caps in this document achieves this, in the CAA's view, given the recommendations of the Competition Commission and consideration of the responses to the CAA November 2002 proposals. The CAA's focus, given the Competition Commission's recommendations, has been to develop a regulatory policy that produced price caps that could be expected to generate the greatest net benefits to users and airports in aggregate.

Single till – definition of the cost base

- 3.6 All users responding to the CAA's November 2002 proposals, supported the CAA's proposal to set the price caps for Q4 consistent with a single till approach. However, Mr Robbins¹², a BAA shareholder, did argue that the single till should be abolished. BAA¹³ said that it continued to believe that a dual till approach would provide for improved investment incentives, but did not wish to re-open the debate at this stage.
- 3.7 In BAA's view the abandonment of the dual till concept is simply because the Competition Commission and airline opposition would undermine the incentive properties that the dual till would otherwise have brought.
- 3.8 The CAA takes the view that regulation is likely to be most effective when it is founded upon credible incentives. Establishing such incentives can be difficult in an environment where assets are long lived, but price caps are set for five years and where regulators are not able to bind their successors. Within the regulatory framework established under the Act, the CAA believes that incentives are likely to be most effective where there is a considerable degree of agreement between the two regulatory bodies (the CAA and the Competition Commission) and between users and the airports. Where there are major divisions, the risk that future regulatory decisions will diverge from previous commitments increases, the credibility of the incentives suffers, and a framework that may have potentially strong incentive properties may not be the most effective in practice.

¹² Mr Robbins (December 2002), Review of landing charges - South Eastern airports

¹³BAA (January 2003), BAA Response January 2003 to CAA Preliminary Proposals November 2002 CAA/352, paragraph 4.8.1 and 4.8.2

- 3.9 The fact that the Competition Commission did not accept the CAA's view on the dual till, and the fact that airline users were universally opposed to its introduction, are likely to undermine the potentially desirable incentive properties that a move to dual till as part of an overall regulatory policy package at this stage could otherwise have provided.
- 3.10 The CAA has therefore concluded that it is best able to meet its statutory objectives, given the forgoing, by setting the price caps for Q4 consistent with a single till approach.

Stand-alone regulation of each of the BAA airports

- 3.11 British Airways, bmi British Midland, flybe, Lufthansa, Virgin Atlantic, BARUK, BATA, the Charter Airline Group of the UK ('the Charter Group'), IATA, ABTA and the Gatwick Airport Consultative Committee¹⁴ supported the CAA's view that regulation should be on a stand-alone basis.
- 3.12 IATA¹⁵ also stated that stand-alone regulation "is very much in line with the ICAO principle of site specific charges which we always try to persuade airports to adhere to" and that this principle was laid out in ICAO document 9082/6.
- 3.13 buzz, easyJet and Ryanair¹⁶ in a joint submission argued that the system approach should be retained because it was possible that the Government would conclude that there should be additional runway capacity at Stansted, that these costs could not be borne by Stansted users alone and that Government subsidy was unlikely leaving the prospect of a passenger levy that would damage the low fares market. They also argued that the issue of new capacity was an issue for the Government to decide, not the CAA alone. SAS¹⁷ argued that Heathrow users had taken the

¹⁴ British Airways (January 2003), Response to the CAA Proposed Q4 Decisions for BAA London Airports, paragraph 1.2; bmi (January 2003), Proposals for LHR Airport Charges 2003 - 2008 response to CAA consultation paper dated 29 November 2002; flybe (17 December 2002), Heathrow, Gatwick and Stansted Airports CAA Proposals for Consultation, paragraph 4.1; Lufthansa (13 January 2003), Heathrow, Gatwick and Stansted Airports Response to CAA Proposals for Consultation of November 2002; Virgin Atlantic (13 January 2003), Heathrow, Gatwick and Stansted Airports: CAA Proposals for Consultation; BARUK (January 2003), CAA policy proposals for the BAA London airports; BATA (January 2003), Heathrow, Gatwick and Stansted Airports - CAA proposals for consultation; Charter Group (10 January 2003), Heathrow, Gatwick and Stansted Airports, CAA Proposals for Consultation November 2002; IATA (January 2003), IATA response to the UK CAA proposals of November 2002 on the price caps for the BAA London Airports for 2003-2008; ABTA (10 January 2003), Heathrow, Gatwick, Stansted and Manchester CAA Proposals for Consultation November 2002; Gatwick Airport Consultative Committee (10 January 2003), BAA London Airports - CAA Final Proposals

¹⁵ CAA (January 2003b), Transcripts Wednesday 29 January 2003, Minutes of meeting re Proposals of November 2002 Price Caps for BAA London Airports for 2003 - 2008 on Wednesday 29 January 2003

¹⁶ buzz, easyJet and Ryanair (January 2003), CAA Proposals for Stansted Airport Charges 2003-8, paragraph 2

¹⁷ SAS (January 2003), CAA Proposal for BAA Airport Regulation 2003 - 2008

burden for the main capacity expansion at Stansted, and that customers of all of BAA's airports should take the burden of the cost of expansion independent of where the capacity is added.

- 3.14 BAA¹⁸ argued that the system approach should be retained since it would allow more economic pricing of the individual airports, that Stansted's charges did not undermine Luton's competitive position because Stansted charged what the market would bear, and that the CAA's statement was premature in pre-empting the Government's White Paper. BAA¹⁹ argued that the difference of view between the CAA and the Competition Commission undermined regulatory commitments (and pointed out that the CAA had used such a rationale to support the continuation of the single till in Q4). BAA²⁰ also said that the CAA's demonstration that the same pricing formula would be justified on either approach was insufficiently considered and could act only as a general cross check of the Competition Commission's work.
- 3.15 The Department for Transport²¹ submitted though that on balance the system approach was to be preferred since it arguably had allowed Stansted to grow rapidly to the benefit of users, and that additional runway capacity could be economically desirable from the perspective of the aviation market without being financially viable in the absence of perfect price discrimination. It suggested that the CAA's position was premature given the White Paper had not been finalised and that the decision should be deferred to the next review.
- 3.16 The CAA's regulatory policy applies in terms of establishing the price caps for Q4. BAA will be making decisions on investment at Stansted inter alia. Given the potential costs of investments, it is important that the regulatory framework is clear so that investment decisions are taken consistent with the CAA's statutory objectives. This will ensure that investment decisions are not taken on the assumption that any investment at Stansted, for example, would be guaranteed a full return over its life regardless of the fundamental business case in terms of user benefits versus costs for the investment and actual Stansted performance.
- 3.17 The CAA does not believe that its decision in this respect, given the Competition Commission's support for the system approach, undermines the credibility of the regulatory framework as BAA suggests. While the CAA is proposing to set prices that are consistent with the single till for Q4, the CAA believes that the impact of

¹⁸ BAA (January 2003a), BAA Response January 2003 to CAA Preliminary Proposals November 2002 CAA/352, paragraph 4.5.1, 4.5.2, 4.6.2

¹⁹ *Ibid*, paragraph 4.6.1

²⁰ *Ibid*, paragraph 1.6.2

²¹ Department for Transport (January 2003), Heathrow, Gatwick and Stansted Airports: CAA proposals for consultation

the till definition in terms of actual charges is of far greater consequence for BAA and users than the airport system debate, and that a move to the dual till would be a much greater change to the regulatory framework than has prevailed to date. The CAA believes that greater agreement between the two regulatory bodies is required for such a change than for less significant moves such as the move away from the airport system.

- 3.18 On the substantive question of whether the system approach or a stand-alone approach should be preferred, having heard the views of interested parties the CAA's view is that the stand-alone approach is best calculated to meet its statutory objectives. The CAA is not persuaded by the concerns of the low frills carriers that they will have to finance an unaffordable runway. If BAA assesses that users at a particular airport will not be able to cover the costs of major developments that BAA wishes to proceed with, BAA will take that into account in its commercial assessment. Unless there is an external subsidy through the Government or through BAA commercially financing it for broader corporate strategic reasons then the development may not be a commercial proposition and construction would be likely to be later or smaller in scale. If the Government opted to use a levy to provide a subsidy it will be a choice for Government on its coverage.
- 3.19 SAS' view that the system approach should result in non-Heathrow users shouldering part of the burden of the costs of Heathrow expansion seems unlikely to be feasible. The other two airports are unlikely to be capable of generating significant surpluses of value to contribute via regulatory mechanisms.
- 3.20 The CAA does not accept BAA's view that the CAA's assessment of the price caps on a stand-alone basis is insufficiently considered under the Competition Commission's assessment (which was based on the continuation of the system approach). Each airport was expected to earn its cost of capital on a stand-alone basis. BAA has not put forward any detailed analysis to suggest that the CAA's assessment is incorrect. Moreover, the CAA²² invited submissions that might demonstrate that a one-off RAB adjustment should be considered if Stansted was not expected to be able to recover its cost of capital but no such submission has been forthcoming from BAA.
- 3.21 The CAA accepts the Department for Transport's argument that in theory it is conceivable that a runway at Stansted could generate benefits (within the aviation market) that are not fully captured by the charges that Stansted users are willing to pay. One reason could be, as the Department for Transport suggests, that the full surplus earned by Stansted users is not captured in the absence of perfect price discrimination, although airlines are perhaps the most innovative firms in terms of pricing flexibility. Another reason, as indicated in the CAA's November

²² CAA (November 2002), Heathrow, Gatwick and Stansted Airports: CAA Proposals for Consultation, paragraph 2.17

2002 proposals,²³ is that greater competition from Stansted could have net benefits for users of Heathrow and Gatwick.

- 3.22 The CAA believes that, in general, differential pricing including discounts at airports offers considerable scope for developing the airports, and that the net benefits from such developments to users at other airports are likely to be small: the CAA has received no evidence to the contrary. The CAA notes BAA's point that Stansted's charges are above incremental costs and reflect what the market will bear, but does not believe that this eliminates the possibility of undesirable distortions between Stansted and other airports in the South-East. This is because the system approach allows Stansted to undertake investment and capacity expansions in the expectation that part of the cost could be covered by higher charges at Heathrow and Gatwick; once the investments are 'sunk' then pricing will reflect that capacity and wider market conditions: competitors will then have to respond to that reality. Future volume and cost risk at Stansted would have the insurance that if Stansted's performance worsens, charges at Heathrow and Gatwick could be increased to compensate at the next review.
- 3.23 The CAA does not accept buzz, easyJet and Ryanair's view²⁴ that "capacity which will be needed by other airlines at some stage in the future might not come to fruition as a result of the position on stand-alone regulation which they are taking today." Superior mechanisms for financing any future justified new capacity exist apart from the system approach to regulation. buzz, easyJet and Ryanair²⁵ have stated "we do not have a fundamental problem of being regulated on a stand-alone basis. Stansted is approaching a point in its development whereby it is probably capable of standing alone."
- 3.24 The CAA's position²⁶, as set out in the proposals, was qualified by the statement that "in order to modify its current view that stand-alone regulation should be adopted, the CAA would expect compelling evidence to demonstrate that users in aggregate were genuinely better off as a result, and that the impact was not unduly distortionary or discriminatory as regards other airports in the southeast." The CAA considers this allows BAA to present a case justifying subsequent modification of a strictly stand-alone approach consistent with the objectives under the Act, addressing in substance the points made by the Department for Transport and BAA.

²³*Ibid*, paragraph 2.13

²⁴ CAA (January 2003b), Transcript Wednesday 29 January 2003, Minutes of meeting re Proposals of November 2002 Price Caps for BAA London Airports for 2003 – 2008 on Wednesday 29 January 2003

²⁵ *Ibid*

²⁶ CAA (November 2002), Heathrow, Gatwick and Stansted Airports: CAA Proposals for Consultation, paragraph 2.13

3.25 The CAA therefore confirms its position that, subject to this qualification, regulation will be based on a stand-alone basis. Also, since no submissions have been received suggesting that there should be a one-off RAB adjustment, the CAA will not make any such adjustment. The CAA considers that this is best calculated to meet its section 39 objectives.

Service quality

3.26 All respondents agreed that the system of rebates under the proposed remedy to the Competition Commission's public interest finding at Heathrow and Gatwick was the right means of addressing this issue.

3.27 The CAA therefore confirms its proposal that there should not be any service quality term in the price cap itself.

Security costs

3.28 All users that expressed a view supported the CAA's proposal to reduce the degree of pass-through of costs arising from additional security requirements. BARUK, flybe and the Heathrow AOC²⁷ argued that the degree of pass-through should be further reduced, from 75% proposed by the CAA to 50%.

3.29 BAA²⁸ said that it was in favour of retention of the full 95% pass through as recommended by the Competition Commission. It said that the 95% pass through had worked and there was no evidence that it had resulted in excessive spending. It emphasised the high level of concern about the terrorist threat and believed that it was not appropriate to give incentives to reduce funding and minimise the costs of security measures. It said that, despite these incentives BAA²⁹ "would not compromise security", but that the long-term commitment to see security properly funded through regulation would be undermined by the signal given by the CAA's proposals. BAA³⁰ also said that its exposure to unrecoverable costs was not minor, pointing out that three major security directives could result in £60 million of irrecoverable costs, affecting its ability and incentives to invest. However, BAA accepted that in general it should have incentives to be cost efficient, and recognised that eliminating immaterial claims

²⁷ BARUK (January 2003), CAA policy proposals for the BAA London airports; flybe (17 December 2002), Heathrow, Gatwick and Stansted Airports CAA Proposals for Consultation, paragraph 7.2; Heathrow AOC (January 2003), CAA Proposals for Q4 Airport Charges Price Cap and Associated Issues

²⁸ BAA (January 2003a), BAA Response January 2003 to CAA Preliminary Proposals November 2002 CAA/352, paragraph 5.4.9

²⁹ *Ibid*, paragraph 5.4.8

³⁰ *Ibid*, paragraph 5.4.6

through a de minimis hurdle was a legitimate perspective. BAA³¹ therefore proposed substantially lower de minimis hurdles (£1.5m, £0.75m and £0.25m for Heathrow, Gatwick and Stansted respectively) with a pass-through of 95% above these levels.

- 3.30 The Department for Transport³² said that it had concerns that the CAA's proposals might "give BAA arguments for slowing up its security spending".
- 3.31 The CAA, along with all respondents, accepts the critical importance of ensuring that airport security is not compromised. Its view remains that a continuation of the 95% pass through of additional security requirements is not necessary to achieve this. As previously stated these are requirements that BAA has to meet and BAA states that it will not compromise on security. There are similar requirements at non-regulated airports, none of which have an automatic ability to pass-through the costs of additional requirements, and all of which have stronger incentives to meet the requirements efficiently than BAA would have under the CAA's proposals. The CAA reiterates that the pass through only applies to up-front costs of additional security requirements. The vast majority of security activities and costs have no pass-through element at all, again giving stronger incentives for efficient delivery than under the CAA's proposals for additional requirements. None of the Competition Commission, BAA or Department for Transport argued that there should be a pass through arrangement for all of BAA's security costs. The CAA does not accept that the new requirements identified and implemented in between price cap reviews should have the current special treatment, particularly as they have to date been relatively modest increments to the total security cost budget. Nor does the CAA accept that this is sending an inappropriate signal. In relation to giving BAA arguments for 'slowing up' its security spending, while noting that BAA³³ is committed to best practice security and safety and has stated that cutting corners is "not an action which the Company would countenance" and that "in any event, BAA will not compromise security", the CAA considers that the onus is on the Department for Transport to appropriately judge the quality of arguments that BAA puts forward before a new requirement is implemented and then ensure that its inspection function checks on compliance, as it does now.
- 3.32 Nevertheless, the CAA is not persuaded that it should adopt the proposal of some users for a further reduction in the rate of pass through from 75% to 50%.

³¹ *Op cit*, paragraph 5.4.7

³² Department for Transport (January 2003), Heathrow, Gatwick and Stansted Airports: CAA proposals for consultation

³³ BAA (January 2003a), BAA Response January 2003 to CAA Preliminary Proposals November 2002 CAA/352, paragraph 5.4.2 and 5.4.8

The Department for Transport³⁴ told the Competition Commission that 75% would be an acceptable compromise between removing the pass-through and leaving it at 95%. Limiting the pass-through to 75% should provide BAA stronger incentives to manage the cost-effective implementation of new requirements, rather than passing virtually the full burden to airlines who are less well placed to attempt to manage the process. The CAA is satisfied that reducing the amount of the pass-through from 95% to 75% will not compromise security.

- 3.33 The CAA accepts that BAA's exposure to unrecoverable costs in the event of a number of costly new requirements being identified is an issue. The CAA also has concerns that setting the hurdle against each new requirement individually could give inefficient incentives to bundle together as many different requirements as possible. Therefore the CAA has amended its approach such that the hurdles apply against the total annualised spends of all new requirements in the five-year period. In practice, each year, and at each airport, BAA will add up the expected cumulative annualised incremental costs of meeting all the new government requirements since 1 April 2003. If the cumulative total exceeds the threshold it will be able to recover 75% of the amount by which the threshold is exceeded in the following year. In all other respects the CAA confirms its November proposals for the treatment of security costs.

Air traffic movement related incentive

- 3.34 In its November 2002 consultation document, the CAA proposed an air traffic movement related incentive scheme related to declared runway capacity at Heathrow in peak hours. In the view of the CAA, the additional revenue that can be generated via the scheme would incentivise BAA to increase its effort to generate additional declared peak period runway capacity.
- 3.35 In its submission to the CAA's November 2002 document, British Airways³⁵ welcomed "the intention of the CAA to incentivise an increase in runway capacity in the peak periods at Heathrow." However, in the light of the overall price cap package British Airways did not support the air traffic movement related incentive, unless the price cap formula was significantly modified (i.e. a lower cap). At the hearings, British Airways³⁶ reiterated what it had previously said to the CAA stating "We would support the air transport movement incentive proposed by the CAA if there is a significant reduction in the price cap, as we are

³⁴ Competition Commission (October 2002), BAA plc. A report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd), paragraph 11.202

³⁵ British Airways (10 January 2003), Response to the CAA proposed Q4 decisions for BAA's London airports, paragraph 2.1

³⁶ CAA (January 2003d), Transcript Friday 31 January 2003, Minutes of meeting re Proposals of November 2002 Price Caps for BAA London Airports for 2003 – 2008 on Friday 31 January 2003

proposing, but against the background of the current proposed cap, we are not supporting this proposal.”

- 3.36 Although generally not in favour of financial incentives, IATA³⁷ gave conditional support to the incentive and stated at the hearings “What we recognise in this particular case is that you are looking at something that we do very much support which is, for example, to try and persuade the operator in this case to push for something like mixed mode and in circumstances like this we have to agree with you because otherwise there may not necessarily be the incentive for the BAA to take the effort of pushing and cajoling NATS to help them to introduce such a facility.” However, several users questioned the incentive. BARUK, Virgin Atlantic, bmi and the Charter Group³⁸ argued that BAA already had strong incentives to increase the number of movements since this would generate higher regulated and non-regulated revenues. flybe³⁹ said that users should not pay in excess of the costs of expansion.
- 3.37 bmi argued that the incentive could give undesirable incentives for BAA to accept increased delays in order to increase the number of movements. The Charter Group said that monitoring of delays was appropriate. BAA said that the magnitude of the incentive was too small to have a material impact over and above the incentives that it already had to increase the number of movements, but had no objection to the proposal.
- 3.38 As set out in its November 2002 proposals, the CAA accepts that BAA has some incentive to increase runway movements without the proposed air traffic movement related incentive. However the problem is that the additional revenue to BAA is likely to be well short of the additional benefits to customers. As a result BAA’s incentives are not fully aligned with user interests. BAA⁴⁰ itself emphasises the hurdles that it faces in increasing the capacity of the existing runways. In terms of magnitude of the incentive if capacity was increased by 5 movements per hour, the total gain to BAA would be around £3.65 million per annum.⁴¹

³⁷ CAA (January 2003b), Transcript Wednesday 29 January 2003, Minutes of meeting re Proposals of November 2002 Price Caps for BAA London Airports for 2003 – 2008 on Wednesday 29 January 2003

³⁸ BARUK (January 2003), CAA policy proposals for the BAA London airports; Virgin Atlantic (13 January 2003), Heathrow, Gatwick and Stansted Airports: CAA Proposals for Consultation; bmi, (January 2003), Proposals for LHR Airport Charges 2003 – 2008: Response to CAA consultation paper dated 29 November 2003; Charter Group (10 January 2003), Heathrow, Gatwick and Stansted Airports, CAA Proposals for Consultation November 2002, paragraph 2.47

³⁹ flybe (December 2002), Heathrow, Gatwick and Stansted Airports CAA Proposals for Consultation, paragraph 9

⁴⁰ BAA (January 2003a), BAA Response January 2003 to CAA Preliminary Proposals November 2002 CAA/352, paragraph 5.5.1

⁴¹ 5 movements per hour * 10 hours per day * 365 days per year. * £200 = £3.65 million

- 3.39 The CAA acknowledges the point made by users that the incentive could potentially result in BAA increasing peak period movements at the expense of increased delays. Therefore in addition to the CAA monitoring BAA's performance in this area and while noting that major airlines such as British Airways also have an incentive to monitor performance, the CAA will make the introduction of the air traffic movement incentive conditional on the introduction of an aerodrome congestion term as part of the approach towards service quality.
- 3.40 Given the fact that users at Heathrow value new capacity highly, the CAA has decided that implementing this incentive on this basis will provide the appropriate signal to BAA to increase its effort to provide additional declared peak period runway capacity.
- 3.41 On the definition of the peak hour period for the incentive, BAA⁴² said that Airport Coordination Limited should define the period. Airport Coordination Limited⁴³ said that the peak period should be defined as 06:00-20:59 for arrivals and 07:00-20:59 for departures, and that there should be scope for reviewing the period over the quinquennium.
- 3.42 Airport Coordination Limited⁴⁴ also said that the formula required some alteration to address the seasonal nature of declared capacity. As the peak period threshold is defined as an average over the entire year, the CAA does not see the need to modify the incentive mechanism to take account of seasonal variations as Airport Coordination Limited has suggested. The CAA understands these concerns, but believes that there is a gain from keeping the pricing formula as simple as possible. The CAA considered three options for setting the threshold levels of movements:
- the summer average declared capacity, which is 83.1 movements per hour using Summer 2002 data;
 - the winter average declared capacity, which, according to Airport Coordination Limited, is 81.2 movements per hour;
 - and the average of the two, 82.15 movements per hour.
- 3.43 Using either of the latter two has the disadvantages that BAA would immediately benefit from the ATM incentive during the Summer months without actually instituting any changes that led to an increase in declared peak period capacity.

⁴² BAA (January 2003), BAA Response January 2003 to CAA Preliminary Proposals November 2002 CAA/352

⁴³ ACL (January 2003), Comments on the CAA's proposal for Air Traffic Movement incentives in the Heathrow Pricing Formula

⁴⁴ *Ibid*

The CAA therefore confirms its November 2002 proposal to set the threshold for the air traffic movement incentive at 83.1 movements per hour.

- 3.44 British Airways⁴⁵ said, in their January 2003 submission, that the definition of peak hours should be limited in the evening to between 17:00 and 19:00 and that the base line should be set at 84 movements per hour but provided no evidence to substantiate this.
- 3.45 The CAA accepts that there is judgement involved in defining the peak periods for this incentive at Heathrow. The CAA notes Airport Coordination Limited's views, but considers that British Airways also has a legitimate perspective on which periods carry the greatest potential value for users. Although Airport Coordination Limited is an authority on the process of slot allocation at the airport and has put forward the reasonable observation that demand exceeds supply over very long periods and that setting an arbitrary peak period could cause some perverse changes in behaviour at the boundaries, the CAA will use a definition of the peak periods, based on British Airways' data, as defined in the CAA November 2002 proposals.⁴⁶ In the absence of other airline evidence British Airways' initial judgement of value should be a reasonable proxy for airlines generally as it has a representative cross section of services – short haul/long haul and business/leisure and slot times and its assessment is probably sufficiently close to the true worth of additional slots.
- 3.46 The CAA will therefore define the peak period for the forthcoming quinquennium as in the November proposals, that is 07:00-11:59 and 16:00-20:59.
- 3.47 Given the innovative nature of the incentive, and the views expressed by users, the CAA believes that it would be premature to increase the magnitude of the incentive. However, the incentive would still provide sufficient additional gain to BAA raising the likelihood of increased desirable capacity to the benefit of users.
- 3.48 In conclusion, the CAA has decided to implement the air traffic movement incentive conditional on the introduction of the aerodrome congestion term in the service quality condition.

⁴⁵ British Airways (10 January 2003), Response to the CAA Proposed Q4 Decision for BAA's London Airports, paragraph 2.4

⁴⁶ CAA (November 2002), Heathrow, Gatwick and Stansted Airports: CAA Proposals for Consultation

Capital expenditure triggers at Heathrow and Gatwick

- 3.49 The CAA's proposals incorporated the capital expenditure triggers recommended by the Competition Commission. IATA⁴⁷ thought that the triggers would be more effective if they reward the airport when it actually delivers additional capacity, rather than reduce the charges if they fail. bmi⁴⁸ considered that the triggers would be ineffectual as an incentive for BAA to progress Terminal 5 to plan.
- 3.50 British Airways⁴⁹ welcomed the introduction of the triggers, but proposed some amendments, it argued that the "core terminal building weatherproof" and "satellite 1 weatherproof" triggers be replaced by having "high voltage power available" in each case. The basis for this was that weatherproofing the buildings was a pre-condition for having high voltage power available and that the latter had the merits of simplicity and evidential proof. British Airways⁵⁰ argued that the impact of the revised triggers should be increased to 4% (rather than 2%). British Airways also argued that the completion dates should be brought forward to reflect BAA's current master plan showing a target construction completion date of April 2007. British Airways also suggested a plan for how the CAA should assess whether the triggers have been met, under which the CAA would accept that a trigger had been met if BAA and the airline body agreed that it had been, but the CAA would adjudicate if there was disagreement. At the hearings, BAA⁵¹ was strongly opposed to any changes in the trigger conditions and definitions.
- 3.51 There were no objections to the concept of the triggers and the CAA has decided to proceed with them as part of the RAB approach to the Q4 price caps. The CAA considers that British Airways' substitution of "high voltage power" in place of "weatherproof" does not fully reflect project progress although it may provide one indicator along with others as to whether and when Terminal 5 is weatherproof. British Airways did not give strong reasons for increasing the magnitude of the penalty on BAA for failure to meet the two weatherproofing triggers and the CAA is not persuaded that it should do so given that the Competition Commission recommended a package approach. Changes here would require consideration of changes elsewhere in the policy package. Neither

⁴⁷ IATA (January 2003), IATA response to the UK CAA proposals of November 2002 on the price caps for the BAA London Airports for 2003-2008, paragraph 4.1.8

⁴⁸ bmi (January 2003), Proposals for LHR Airport Charges 2003 – 2008: Response to CAA consultation paper dated 29 November 2003

⁴⁹ British Airways (January 2003), Response to the CAA Proposed Q4 Decision for BAA's London Airports, Section 3

⁵⁰ *Ibid*

⁵¹ CAA (January 2003d), Transcript 31 January 2003, Minutes of meeting re Proposals of November 2002 Price Caps for BAA London Airports for 2003 – 2008 on Friday 31 January 2003, pages 237-239

is the CAA persuaded that the timing of the triggers should be moved forward. It may be the case that BAA has put forward a more ambitious plan for progress, but the original triggers were identified by the Competition Commission as part of a wider package of policies, including its assessment of revenue and cost projections and the cost of capital.

- 3.52 The CAA therefore has decided to implement the capital expenditure triggers included in the draft charge control condition set out in the CAA's November 2002 proposals. These are specified in Annex 9 of this decision document.

Revenue yield, non-passenger flights, and direct contracting

- 3.53 There were no suggestions that the revenue yield approach should not be maintained, no objections to the use of published charges to determine compliance with the cap, nor objections to the use of a separate cap for non-passenger flights. The CAA therefore confirms its November proposals in these respects.

- 3.54 The CAA considers that these measures will facilitate direct contracting between the airport and users should both parties desire it. The CAA notes the comments by BAA that it doubts that extensive direct contracting will occur in practice.

- 3.55 IATA⁵² thought that establishing base standards was a pre-requisite and that there should not be any 'contracting down'. flybe⁵³ thought that a base level of service should be set at the lowest possible level of airport service'. British Airways⁵⁴, which is in favour of the regulatory framework facilitating direct contracting, argued that it would be desirable for there to be a proper description of the base service that users are entitled to receive and that BAA has the monopoly power in negotiations that would be mitigated if the CAA were less reluctant to get involved. British Airways⁵⁵ also said that these issues were best addressed through the processes linked to service quality and the CAA's consultation on the implementation of section 41 of the Act and its wider involvement in airline-airport relationships.

- 3.56 The CAA agrees that these are the appropriate processes to address these issues. It does not believe that the arrangements preclude 'contracting down' nor that they should do so since given the variety of different users it is quite possible that

⁵² IATA (January 2003), IATA response to the UK CAA proposals of November 2002 on the price caps for the BAA London Airports for 2003-2008, paragraph 2.6.2

⁵³ flybe (January 2003), Heathrow, Gatwick and Stansted Airports CAA Proposals for Consultation, paragraph 6

⁵⁴ British Airways (January 2003), Response to the CAA Proposed Q4 Decision for BAA's London Airports, paragraph 8.2

⁵⁵ *Ibid*, paragraph 8.4

some users would prefer to pay lower airport charges in return for lower service quality. Concerns about anti-competitive behaviour can be handled through section 41 of the Act or the Competition Act 1998.

Inclusion of transfer baggage infrastructure charges in the price cap

- 3.57 There were no objections to inclusion of the transfer baggage infrastructure charge ('TIFGAH') in the price cap, and the CAA confirms that this is included. United Airlines⁵⁶ endorsed the inclusion of TIFGAH in regulated charges, but said that there should be transparent auditing of the charges. The CAA does not see that this is required since by inclusion in regulated charges, any further levying of the TIFGAH charge itself will be part of the wider price cap.
- 3.58 The CAA's November 2002 proposals incorporated the recommendation of the Competition Commission that the price cap should remain subject to a correction factor (K) whereby any under- or over-recovery against the price cap in one year is taken into account in the calculation of the price cap two years later. However, there would be no correction factor applied during the first two years of Q4 as it would be inappropriate for BAA to be compensated for the intentional under-recovery against the 2001/02 and 2002/03 price caps.
- 3.59 This matter was not specifically addressed in the responses from BAA or from users. In the absence of any objections the CAA has decided to follow the recommendation of the Competition Commission. Consequently there will be no correction mechanism allowing any carry over from Q3 to Q4.
- 3.60 British Airways⁵⁷ argued that the charges associated with the Terminal 1-Terminal 4 tunnel should also be included in regulated charges, asserting that this had the support of the majority of the user community as represented by the Heathrow AOC and as represented by the oneworld alliance. However, a number of other respondents⁵⁸ agreed with the CAA's exclusion of the tunnel. The CAA notes that the Competition Commission recommended that the tunnel be excluded against a similar division of view, that the Heathrow AOC⁵⁹ appeared satisfied with the CAA's proposed treatment in its response to the CAA's proposals and

⁵⁶ United Airlines (January 2003), Re: CAA Proposals on Revenue Caps

⁵⁷ British Airways (January 2003), Response to the CAA Proposed Q4 Decision for BAA's London Airports, paragraph 6.6 and 6.7

⁵⁸ CAA (January 2003b), Transcript 29 January 2003, Minutes of meeting re Proposals of November 2002 Price Caps for BAA London Airports for 2003 – 2008 on Wednesday 29 January 2003; BARUK (January 2003), CAA policy proposals for the BAA London airports; bmi (January 2003), Proposals for LHR Airport Charges 2003 - 2008 Supplementary Response to CAA consultation paper dated 29 November 2002 by bmi - 20 January 2003

⁵⁹ Heathrow AOC (January 2003), CAA Proposals for Q4 Airport Charges Price Cap and Associated Issues – Heathrow AOC General Response and Comments, p. 1

sees no reason to depart from the Competition Commission's recommendation, particularly as this is a contractual arrangement. The CAA therefore has not allowed for the costs of the tunnel in regulated charges.

Price corrections for 2001/2 and 2002/3

- 3.61 The CAA's proposals incorporated the recommendation of the Competition Commission that the price cap should remain subject to a correction factor (K) whereby any under- or over-recovery against the price cap in one year is taken into account in the calculation of the price cap two years later. However, there would be no correction factor applied during the first two years of Q4 as it would be inappropriate for BAA to be compensated for the intentional under-recovery against the 2001/2 and 2002/3 price caps.
- 3.62 This matter was not specifically addressed in the responses from BAA or from users. In the absence of any objections the CAA has decided to follow the recommendation of the Competition Commission. Consequently there will be no correction mechanism allowing any carry over from Q3 to Q4.

Enhanced information disclosure and consultation

- 3.63 IATA, Heathrow AOC, British Airways, bmi, United Airlines, Ryanair, buzz and easyJet supported the CAA agreement with BAA on enhanced information disclosure and consultation. The CAA considers that the current agreement is sufficiently comprehensive to accommodate the detailed points made by these parties. BAA has undertaken to produce a revised capital investment plan consistent with the agreement in April 2003. This will provide the basis for more effective consultation and strategic dialogue with users. The CAA considers that effective consultation by BAA will make it more worthwhile for interested users to engage in the process. As suggested by British Airways⁶⁰ the CAA will review performance under these arrangements after two years.

Conclusion

- 3.64 The CAA has decided to set price caps for Q4 as recommended by the Competition Commission that are consistent with the single till framework.
- 3.65 The CAA confirms its position that from Q4 onwards regulation will be based on a stand-alone airport basis.
- 3.66 The CAA has decided that there should not be any service quality term in the price cap itself.

⁶⁰ Op cit p.27

- 3.67 The CAA has decided to allow a 75% security cost pass through in respect of new requirements of costs in excess of a threshold.
- 3.68 The CAA has decided to implement the air traffic movement incentive conditional on the introduction of the aerodrome congestion term.
- 3.69 The CAA has decided to implement the capital expenditure triggers as specified in Annex 9 of this document.
- 3.70 The CAA has decided to maintain the revenue yield approach, use published charges to determine compliance with the caps, and use separate conditions for non-passenger flights.
- 3.71 Enhanced information disclosure and consultation arrangements are agreed between CAA and BAA.

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4. Q4 decision: Financial regulatory policy

Introduction

- 4.1 In its consideration of the appropriate price caps for the three BAA London airports, the CAA, following consideration of the Competition Commission report and the consultation following the CAA's proposals, formulated and applied regulatory policy so as to set caps that are best calculated to meet the CAA's statutory objectives. These regulatory judgements are integral to the CAA's determination of the price caps and as such, this chapter considers financial regulatory policy.
- 4.2 The financial regulatory policy adopted by the CAA in the course of this review is framed in the context of the factors that drive the financial performance of BAA. The key drivers of BAA's financial performance are expected passenger and cargo volumes, planned operating expenditure, planned capital expenditure and projected non-regulated revenue.
- 4.3 There are several specific policy areas that warrant particular emphasis, given the CAA's statutory objectives. These are summarised below and considered in more detail in the remainder of this chapter:
- capital expenditure: during Q4 and Q5 BAA will incur significant levels of capital expenditure, most notably in relation to Terminal 5. This has raised several regulatory policy issues given the costly and long-lived nature of these assets, namely:
 - Q3 claw-back;
 - revenue advancement;
 - assets in the course of construction;
 - projections of operating expenditure, regulatory depreciation and other revenues;
 - the cost of capital applied to the BAA London airports.
- 4.4 The CAA's policy decisions have been translated through a financial model developed by the CAA to determine the price caps. The CAA model is the reference point for this price cap decision. For this reason, this chapter concludes with an overview of the modelling process employed in setting prices for the BAA London airports and for rolling forward the RAB subsequently.

Claw-back of advanced revenue and capital expenditure under-spend in Q3

- 4.5 Users generally supported the claw-back. bmi⁶¹ and Virgin Atlantic⁶² said that revenue advancement of £52 million from 2002/3 should be added to the amount clawed back. IATA requested clarification of how the claw-back operated and Virgin Atlantic suggested that the monies be paid back in the near future directly to users (rather than through the price cap over Q4).
- 4.6 BAA objected to the claw-back of capital expenditure under-spend, but accepted the consequences as part of a balanced decision.
- 4.7 The CAA understands that the figure of £52 million cited by Virgin Atlantic and bmi is based on the Competition Commission's paragraph 10.8. This figure relates to the under-spend of projected capital expenditure, not the advanced revenue. Given the different methodologies employed by the Competition Commission and, originally, by the CAA, there is no direct connection between this figure and the amount that would be adopted if 2002/3 was included in the claw-back calculation. Both the CAA and Competition Commission allowed for capital expenditure efficiencies in calculating the actual claw-backs.
- 4.8 The Competition Commission's use of BAA's actual depreciation in rolling forward the RAB significantly reduced the amount in practice.
- 4.9 More generally, the CAA agrees with the Competition Commission that 2002/3 should not be included in the calculation since the counterfactual is far from clear. bmi⁶³ argued that the counterfactual would be RPI-8% on the grounds that this would have been the price cap in the extension year if RPI-8% had originally been adopted. This seems too simplistic a basis for the determination. Adopting RPI+2%, the 1996 projection for 2002/3, could be a valid comparator, and one that would reduce the totality of the claw-back, not increase it.⁶⁴ It is likely that had the cap been RPI-8%, BAA would not have sought the extension. The most obvious basis for determining the counterfactual would be a one-off determination of BAA's revenue requirement in 2002/3 in order to generate its

⁶¹ bmi British Midland (10 January 2003), Proposals for LHR airport charges 2003-2008, Response to CAA consultation paper dated 29 November 2002, p. 2

⁶² Virgin Atlantic Airways (13 January 2003), Heathrow, Gatwick and Stansted Airports: CAA proposals for consultation, p. 2

⁶³ bmi British Midland (10 January 2003), Proposals for LHR airport charges 2003-2008, Response to CAA consultation paper dated 29 November 2002, p. 6

⁶⁴ In its original proposals to the Competition Commission, the CAA included 2002/3 for the revenue advancement calculation, but used RPI+2% as the comparator, leading to a lower proposed claw-back of advanced revenue than that now being adopted

cost of capital. The Competition Commission's recommendation⁶⁵ to exclude 2002/3 was based in part on its observation that BAA was expected to approximately earn its cost of capital in that year, indicating that the extension would make little difference. The CAA concurs and has decided not to amend the magnitude of the claw-back to include 2002/3.

- 4.10 The claw-back operates via a revenue offset that has been credited to Heathrow in each year of Q4 to equal the present value of the claw-back determination at the cost of capital⁶⁶. Prices are therefore relatively lower than they would otherwise have been. The CAA cannot accept Virgin Atlantic's suggestion⁶⁷ that the monies be paid back directly to users, rather than through the price cap, since in the absence of a public interest finding to that effect the CAA has no statutory powers to impose this.

Revenue advancement from Q5 to Q4

- 4.11 The Competition Commission's recommended price caps for Heathrow involves an advancement of revenues from Q5 to Q4 amounting to £300 million⁶⁸ in net present value terms as of 2003/04, a recommendation that the CAA accepted in its proposals. This issue is quite distinct from allowing a return on the assets in the course of construction.

- 4.12 British Airways, bmi, Virgin Atlantic, United, IATA, and BATA all objected to the revenue advancement. The arguments presented are summarised below:

- British Airways⁶⁹ argued that advancing the revenue from Q5 to Q4 was unreasonable in the difficult commercial conditions currently faced by airlines. United Airlines⁷⁰ considered revenue advancement to be contrary to the recommendations of the Transport, Local Government and the Regions Select Committee that the CAA should seek to postpone price increases in the light of these adverse conditions;

⁶⁵ Competition Commission (2002), BAA plc, A report on the economic regulation of the London airport companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd), paragraph 10.5

⁶⁶ *Ibid*, Table 10.9

⁶⁷ Virgin Atlantic Airways Ltd (13 January 2003), Heathrow, Gatwick and Stansted Airports: CAA proposals for consultation, p. 2

⁶⁸ Competition Commission (2002), BAA plc, A report on the economic regulation of the London airport companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd, paragraph 10.40

⁶⁹ British Airways Plc (10 January 2003), Response to the CAA proposed Q4 decisions for BAA's London airports

⁷⁰ United Airlines Ltd (14 January 2003), CAA proposals on Revenue Caps

- there was no reason to assume that BAA would not be able to raise prices substantially in Q5 when Terminal 5 opens if the revenue advancement were abandoned,⁷¹ the rise in charges required in Q5 is uncertain and may not be as large as the Competition Commission had projected (since the cost of capital determination is considered to be excessive and Terminal 5's costs may be overstated), the citation by the Competition Commission of the instance of prices at Hong Kong airport was not a relevant precedent, and prices at Heathrow would remain below market clearing levels such that BAA would be able to secure price rises in Q5⁷²;
- the increases would be particularly adverse for hub operators⁷³ and for short haul operators, particularly those operating regional services, effectively undermining the competitive position of these operators compared to their European counterparts⁷⁴;
- current users were paying for infrastructure that would be to the benefit of users in future⁷⁵, who may be different⁷⁶;
- it represented a repetition of the settlement for Q3, which was not successful⁷⁷;
- a ten year smoothing profile ran counter to the normal principles of economic regulation and may be inconsistent with the Act⁷⁸;
- it would allow BAA to earn a return above its cost of capital in Q4⁷⁹;

⁷¹ British Airways Plc (10 January 2003), Response to the CAA proposed Q4 decisions for BAA's London airports

⁷² Virgin Atlantic Airways Ltd (13 January 2003), Heathrow, Gatwick and Stansted Airports: CAA proposals for consultation

⁷³ British Airways Plc (10 January 2003), Response to the CAA proposed Q4 decisions for BAA's London airports, paragraph 1.17(d)

⁷⁴ CAA (January 2003a), Transcript Wednesday 22 January 2003, Minutes of meeting re Proposals of November 2002 Price Caps for BAA London Airports for 2003 – 2008 on Wednesday 22 January 2003

⁷⁵ IATA (10 January 2003), IATA response to the UK CAA proposals of November 2002 on the price caps for the BAA London airports for 2003-2008

⁷⁶ bmi British Midland (10 January 2003), Proposals for LHR airport charges 2003-2008, Response to CAA consultation paper dated 29 November 2002; Virgin Atlantic Airways Ltd (13 January 2003), Heathrow, Gatwick and Stansted Airports: CAA proposals for consultation

⁷⁷ British Airways Plc (10 January 2003), Response to the CAA proposed Q4 decisions for BAA's London airports, paragraph 1.17(e); bmi British Midland (10 January 2003), Proposals for LHR airport charges 2003-2008, Response to CAA consultation paper dated 29 November 2002

⁷⁸ Virgin Atlantic Airways Ltd. (13 January 2003), Heathrow, Gatwick and Stansted airports: CAA proposals for consultation, p. 7

- it diluted the incentives on BAA to deliver its capital expenditure programme efficiently or otherwise drive down its costs⁸⁰;
- it eliminated the benefit to users of the claw-back of revenue advancement and capital expenditure under-spend from Q3⁸¹;
- higher charges should be linked to the delivery of improved infrastructure, potentially allowing a 'bonus' in the final year of Q4 if Terminal 5 is completed;
- it is not necessary for BAA to be able to finance its investment programme given BAA's strong financial position.⁸²

4.13 The CAA understands the difficult position that many airlines currently face, although the low frill carriers continue to expand rapidly and BAA's capital expenditure programme, supported by airlines, is driven by projections for medium term growth at the airports.

4.14 The CAA notes the Select Committee's recommendation⁸³. However, the full extent of the '40%' increase in charges widely cited by users would not take effect until 2007/8, by which time the conditions facing airlines may be very different and airlines will have adjusted to those conditions including Heathrow's charges and performance.

4.15 The impact on airlines in the early years of Q4 will be much smaller. If it is the case that airlines cannot accept a 40% increase by 2007/8, implemented gradually, the CAA finds it difficult to understand how they would be in a position to accept significantly larger increases in 2008/9 (which would be the likely effect of deferring the revenue advancement).

4.16 The Competition Commission⁸⁴ calculated that a one-off price adjustment of approximately 80% would be needed when Terminal 5 is projected to come into

⁷⁹ British Airways Plc (10 January 2003), Response to the CAA proposed Q4 decisions for BAA's London airports, paragraph 1.22

⁸⁰ bmi British Midland (10 January 2003), Proposals for LHR airport charges 2003-2008, Response to CAA consultation paper dated 29 November 2002, p. 4

⁸¹ Virgin Atlantic Airways Ltd. (13 January 2003), Heathrow, Gatwick and Stansted airports: CAA proposals for consultation, p. 6; British Airways Plc (10 January 2003), Response to the CAA proposed Q4 decisions for BAA's London airports, paragraph 1.17(b)

⁸² *Ibid*, p. 9

⁸³ Select Committee on Transport, Local Government and the Regions (2002), Eleventh Report, Air Transport Industry, paragraph 20

⁸⁴ Competition Commission (2002), BAA plc, report on the economic regulation of the London airport companies, paragraph 10.38

operation at the start of Q5 if prices are held constant in real terms over the next five years. Given the scale of objections from users to the proposed RPI+6.5% for Q4, the CAA considers it unlikely that BAA and its investors would place great weight on airlines being prepared to accept increases of RPI+20% per annum in Q5 without protest or regulators being willing to permit such increases, therefore undermining the incentives for BAA to deliver its investment programme now. There would be a high risk that Terminal 5 would be delayed.

- 4.17 British Airways' point that because prices will be below market clearing levels in Q5, BAA would be able to secure sufficient increases is not convincing: the same applies at this review yet airlines are strongly objecting to the more moderate increases proposed consistent with conventional single till regulation. Regulation has consistently operated to keep charges well below such prices at Heathrow. The issue is whether BAA and its investors would be confident over Q4 that the regulatory process, and in the absence of binding, bankable contracts, would be able to deliver the increases, particularly as much of the expenditure would have been sunk by then.
- 4.18 The CAA cannot rely upon the possibility that the price cap increases in Q5 would be lower due to variations in the actual cost of Terminal 5, the cost of capital and other variables. It is equally possible that the underlying demand and cost drivers of the price cap result in higher price cap increases, particularly if a major new capacity development at Heathrow was then under consideration.
- 4.19 The CAA accepts that the investment encouraged by the revenue advancement can be thought to benefit future users at the expense of current users to a degree. However, the purpose of Terminal 5 is to alleviate terminal congestion and maintain service quality in the face of expected passenger growth at Heathrow. For large capacity additions it promotes the efficient, economic operation of airports and is in the interests of users to allow prices to adjust such that prices are relatively higher prior to the capacity coming on stream (when there is excess demand and congestion) and relatively lower when it is completed (when there is less excess demand). This is one further reason why the CAA does not accept that higher charges should be deferred until Terminal 5 is opened.
- 4.20 British Airways's⁸⁵ proposal for a completion 'bonus' of a 20% price increase if Terminal 5 is completed in Q4 has some similarities with elements of the price path commitment originally proposed to the Competition Commission by the CAA in February 2002. However, British Airways' suggestion was in the context of stable real prices over Q4 and the CAA believes that British Airways would not support such a bonus if the price cap were set at RPI+6.5%. No other user proposed such a bonus payment.

⁸⁵ British Airways Plc (10 January 2003), Response to the CAA proposed Q4 decisions for BAA's London airports, paragraph 1.18

- 4.21 The approach to profiling adopted by the CAA and Competition Commission is indeed similar in concept to the settlement at the 1996 review. Since the CAA has clawed back to the benefit of users the revenue advancement from Q4 into Q3, and since the profiling adopted is integrated into the regulatory settlement through a fixed pricing profile adjustment (see Annex 6), the CAA does not see that this undermines the case for advancement of revenue at this review.
- 4.22 The CAA does not accept that profiling runs counter to good practice or that ten year smoothing is inconsistent with the Act. It was adopted at the 1996 review of BAA and the CAA has adopted a similar approach in the case of NATS albeit under separate legislation. It also follows the recommendation of the Competition Commission, which for other regulated utilities is the authoritative appellate body and reflects the challenge of financing major investment plans with long lived assets that run across regulatory periods.
- 4.23 The argument that the return on capital will be excessive in Q4 is not persuasive. Profiling or smoothing will mean that other things being equal the return on capital in future periods will be correspondingly lower. Also, the determination of the 'return on capital' in accounting terms depends on the depreciation profile adopted. If a different depreciation profile is adopted the return on capital will vary. There is a circularity, and in a technical sense BAA will not be expected to earn a regulatory return greater than its cost of capital in Q4 since the depreciation used in rolling forward the RAB will be adjusted. The depreciation adjustment used to reflect the profiling will largely counterbalance the claw-back of the revenue advancement and capital expenditure under-spend from Q4 to Q3. However, the CAA does not consider that this undermines the case for revenue advancement from Q5 into Q4 based on other criteria. The key point is that the price cap for Heathrow is set so that it can be expected to earn its cost of capital on the resources invested over the ten years given current projections.
- 4.24 The CAA does not believe that the revenue advancement would materially alter BAA's incentives adversely to deliver the capital expenditure plan efficiently or to otherwise be an efficient service provider.
- 4.25 The assertion that BAA would be able to finance its investment programme in the absence of revenue advancement is countered by BAA which says that it would not be able or willing to do so. The Competition Commission placed weight on this argument in advocating the revenue advancement as part of the set of overall regulatory policies.⁸⁶ Clearly revenue advancement will facilitate the financing of the programme. Given the scale of BAA's ten year investment programme that is more than 120% of BAA's current RA, the CAA agrees with the Competition Commission that financing considerations together with

⁸⁶ Competition Commission (October 2002), BAA Plc, report on the economic regulation of the London airports companies, paragraph 2.374 and 14.121

improving regulatory commitment provide a strong rationale for revenue advancement.

- 4.26 The CAA considers that a tighter price cap resulting from reduced revenue advancement is more likely than not to cause BAA to slow or reduce its investment programme with likely adverse effects on users. The CAA considers that this would be inconsistent with its statutory objectives given the expected unsatisfied demand at Heathrow.
- 4.27 Not remunerating assets in the course of construction and not proceeding with profiling would result in a substantial lessening of the RPI+6.5% at Heathrow, pointing instead to substantial real price reductions in Q4 to be followed in Q5 with a much larger real increase than the 20% per annum identified by the Competition Commission.⁸⁷ The CAA believes that this profile would be contrary to achievement of its statutory objectives, by providing for an inefficient profile of pricing, by diluting BAA's investment incentives since large price increases in 2008/9 would have a low probability of being seen as credible or deliverable, and by making the delivery of BAA's investment programme more difficult. Not allowing revenue advancement for this review would increase the likelihood that a much larger revenue advancement, in future, or higher cost of capital would have to be adopted, now or in future, to compensate.
- 4.28 In conclusion, the CAA is not persuaded by the arguments by airlines that its policy on revenue advancement should be reversed. The CAA has therefore decided to apply profiling in setting the price caps as recommended by the Competition Commission.

Assets in the course of construction

- 4.29 The Competition Commission's recommendations and the CAA's decision allow for full return on these assets. This follows regulatory practice in many other sectors and this was the model adopted at the 1996 review.
- 4.30 This is especially an issue in relation to Terminal 5. Since Terminal 5 is not expected to open in Q4, the main part of this investment is categorised as assets in the course of construction.
- 4.31 bmi objected in principle to remunerating the assets in the course of construction, but at the oral hearing with the CAA bmi stated that it could accept this if the revenue advancement was abandoned. Since the CAA has decided that the revenue advancement should continue it is likely that bmi objects to remunerating the assets in the course of construction in practice. bmi's objection

⁸⁷ *Op cit*, paragraph 2.383

was partly based on similar reasons to its objection to the revenue advancement. The CAA does not accept these arguments for the reasons set out above in the assessment of revenue advancement. In addition bmi argued that remunerating the assets in the course of construction did not protect airlines from the limited incentives BAA would have to actually progress Terminal 5, and that the capital expenditure triggers would be insufficient to counter this⁸⁸.

- 4.32 The CAA accepts that this is a potential drawback of remunerating the assets in the course of construction. Setting a price cap that allows a return on capital expenditure as it is projected to be incurred can give incentives subsequently not to undertake the expenditure in practice, or to delay it, since the airport can gain by so doing. This is a potential problem of RAB-based price caps generally, although it can be remedied by regulatory adjustments for non-delivery of capital expenditure outputs, as referred to above in relation to Q3. But the alternative, to defer the returns, has other undesirable incentive properties (including regulatory risk). Where a mechanism of capitalising the return is adopted, the incentives to deliver the programme efficiently become far more muted. bmi made plain its concerns that Terminal 5 was excessively costly on current plans, and its concern that in practice the terminal's costs may rise further. The CAA believes that concerns of this type are best addressed by an incentive mechanism, that gives BAA a price cap consistent with funding a major capital expenditure plan which generates returns across many regulatory periods together with some incentive to deliver its capital expenditure plan efficiently.⁸⁹ The CAA also considers that the combination of the capital expenditure triggers, the fact that planning permission has now been received, and the weight of expectation on BAA from users and the regulatory bodies to deliver Terminal 5 mean that even if BAA does have some commercial incentives to delay or modify the delivery of Terminal 5, it is highly unlikely to do so in practice.
- 4.33 For these reasons the CAA's conclusion is that remunerating BAA's assets in the course of construction at the regulatory cost of capital should be permitted for the purpose of setting the price caps, as recommended by the Competition Commission and proposed in the CAA's November 2002 consultation document.

Projections of operating expenditure and non-regulated revenues

- 4.34 The CAA's proposals reflected the Competition Commission's views on operating expenditures and non-regulated revenue. Virgin Atlantic said that the

⁸⁸ bmi British Midland (10 January 2003), Proposals for LHR airport charges 2003-2008, Response to CAA consultation paper dated 29 November 2002, p. 3

⁸⁹ The CAA's original proposals for a price path commitment could have had superior properties to both of these mechanisms in terms of providing both strong incentives to complete Terminal 5, and to do so efficiently. However, airlines in general did not support that proposal

Competition Commission's projections of operating expenditure and commercial revenues were conservative. No evidence was provided to support this assertion, and the CAA notes that the Competition Commission⁹⁰ undertook a review of BAA's scope for operating efficiencies and of its commercial revenue projections. The caps recommended by the Competition Commission⁹¹ and adopted by the CAA reflect some efficiencies in excess of those projected by BAA. The CAA considers these to be reasonable judgements and therefore does not accept that it should set the price caps on the basis of different assumptions on operating expenditure or commercial revenues.

Cost of capital

- 4.35 The cost of capital is a key input when determining the price cap for capital-intensive businesses.
- 4.36 During this review the CAA has published three papers specifically addressing the key issues in relation to cost of capital. The first paper on the cost of capital was published in June 2001. This was followed by an extensive annex addressing methodological as well as more specific data related issues in relation to the cost of capital⁹². In February 2002 the CAA presented its recommendations to the Competition Commission which also included an annex addressing the cost of capital aspects of its proposals.
- 4.37 Having considered the methodological issues surrounding the cost of capital, i.e. appropriateness of Capital Asset Pricing Model (CAPM) and the assumptions underlying the arithmetic of Weighted Average Cost of Capital (WACC), the CAA is supportive of the Competition Commission's conclusion that the conventional framework in spite of its shortcomings is the best available and most appropriate when dealing with conventionally financed firms.
- 4.38 Both the CAA and the Competition Commission pointed out that considerable uncertainty surrounds the estimation of the empirical parameters that are inputs to the cost of capital, meaning that the confidence intervals within which the true parameter lies are wide. Nevertheless, both have come to the same conclusions with respect to the point estimate to be used for the regulatory cost of capital, 7.75%, albeit with slightly different regulatory policy settings.

⁹⁰ Competition Commission (2002), BAA plc, A Report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd, Chapter 7 and 8

⁹¹ *Ibid*, Chapter 10

⁹² CAA (2001), Cost of Capital Annex to Heathrow, Gatwick, Stansted and Manchester Airports' Price Caps 2003-2008, CAA Preliminary Proposals, Consultation paper published in November 2001

- 4.39 All airlines and airline bodies (i.e. IATA) which commented on the November 2002 cost of capital proposals, argued that the proposed regulatory cost of capital is too generous and incorporates an excessive allowance for risk. British Airways⁹³ and Virgin Atlantic⁹⁴ argued that given the practice of other UK utility regulators of monopoly infrastructure providers, a real rate of return in the range of 6.0%-6.5% would be more appropriate.
- 4.40 Virgin Atlantic⁹⁵ argued that according to financial markets BAA's cost of capital and that of other European airports is more likely to be between 5% and 7%, British Airways⁹⁶ argued that the pre-tax real cost of capital of European airports lies in the range of 6%-7%, with BAA being close to the average.
- 4.41 However, in the view of the CAA great care should be taken when making these types of comparisons. For example, the regulated UK water companies currently face little volume risk compared with BAA and hence such a comparison is not appropriate. Also, comparisons with other airports which do not face investment projects on a scale such as Terminal 5 or do not face a regulatory environment such as BAA are unlikely to be appropriate. Moreover, in the case of BAA market data is available, i.e. data is available on its equity beta and debt premium. Therefore the need for and value of comparators is significantly reduced: the designated BAA airports representing the major part of BAA's value.
- 4.42 As identified in the CAA documents, the responses to these documents, and the January 2003 hearings the key issues at stake when determining the regulatory cost of capital are the cost of equity, the cost of debt, gearing and the treatment of tax.

Cost of equity

- 4.43 The main input in the cost of capital for a conventionally financed firm is the cost of equity. However, considerable uncertainty surrounds the cost of equity. Stock returns display high variability. The CAA previously noted that the real post-tax return on equity in the UK over the 1919-1998 period was 7.7% per annum with a standard deviation of 22%. Under certain technical assumptions⁹⁷, this implies that there is approximately a 95% chance that the true mean return

⁹³ British Airways (2003), Response to the CAA Proposed Q4 Decisions for BAA's London Airports, 10 January 2003

⁹⁴ Virgin Atlantic (2003), Heathrow, Gatwick and Stansted Airports: CAA Proposals for Consultation, 13 January 2003

⁹⁵ *Ibid*

⁹⁶ British Airways (2003), Response to the CAA Proposed Q4 Decisions for BAA's London Airports, 10 January 2003, paragraph 1.14

⁹⁷ I.e. that returns are "white noise" and the true mean is constant (the classical Gaussian assumptions)

lies between 2.75% per annum and 12.65% per annum. The Competition Commission recommends a post-tax cost of equity range of 5%-7.25% per annum, which falls within this wider range. In the CAA's view, the Competition Commission range for the cost of equity is acceptable.

- 4.44 The two main approaches to establishing the appropriate cost of equity are either an approach based on the return of equity or an approach in which the cost of equity is built up using the risk free rate, equity risk premium and the firm's beta.
- 4.45 Beta estimation, as well as determination of the true risk free rate and equity risk premium, is surrounded by considerable uncertainty. In its recommendation to the CAA, the Competition Commission addressed the uncertainty surrounding the inputs by adopting what it considered reasonable ranges for each input. It took the overall mid-point as a starting point, which was then adjusted for special additional features such as Terminal 5. A degree of smoothing was applied to address changes in some of the generic inputs (especially the recent downward movement in estimates of the equity risk premium seen by the Competition Commission) to prevent undue volatility in the short-term, given the impact that might have on investment⁹⁸.
- 4.46 Professor Dow in a Cost of Capital paper submitted by British Airways⁹⁹ commented "As a general point in any cost of capital exercise, I believe it is important to start by noting that the margin of error in beta estimation is quite large". The CAA agrees with this observation and Professor Dow's evidence of a standard error of 0.18¹⁰⁰ for the BAA estimate is a case in point. Under the earlier mentioned assumptions,¹⁰¹ this would imply that there can be 95% confidence that BAA's true beta lies in a range of 0.36 – 1.08. This illustrates that the capital market assesses the non-diversifiable risk faced by a monopoly as not necessarily low compared with the risk faced by the 'average' firm.
- 4.47 The Competition Commission adopted a range for beta of 0.8-1.0, which given the uncertainty surrounding beta estimation seems justifiable especially considering that the cost of capital has to be forward looking. One of the key objections of the airlines to the CAA's cost of capital determination has been to the CAA's view that, given the risks faced by BAA, given the fact that the cost of capital should be forward looking, and considering the uncertainty surrounding

⁹⁸ Competition Commission (2002), BAA plc, A Report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd, paragraph 2.326

⁹⁹ Dow, J. (2002), Comments on the CAA Proposed Q4 Decisions for BAA's London Airports, p.4

¹⁰⁰ *Ibid*, p.4

¹⁰¹ Returns are "white noise" and the true mean is constant

beta estimation, a beta figure similar to that of the market average might be appropriate.

- 4.48 In the view of the CAA, given the investment focus of the CAA review in terms of meeting the CAA's statutory objectives and the consequential risk of adopting a cost of capital (and thus cost of equity figure) which is too low, it is prudent to adopt a figure higher than the mid-point.
- 4.49 The CAA endorses the Competition Commission's analysis and accepts its recommendation. It has therefore adopted a figure for the cost of equity in the upper half of the range rather than the mid-point.

Cost of debt

- 4.50 British Airways¹⁰² has consistently argued, both in responses to the CAA and also to the Competition Commission¹⁰³, that BAA should be able to borrow on 50 basis points or less over the risk free rate. However, the CAA's analysis of the actual market data shows this not to be the case. Both the CAA and the Competition Commission have followed the standard approach using the risk free rate rather than LIBOR in calculating the debt premium.
- 4.51 On 25 February 2003 the BAA 2031 bond has a debt premium of 128 basis points¹⁰⁴ over the comparable UK government bond. However, even over LIBOR, the credit spread of the 2031 bond is 80 basis points.
- 4.52 The Competition Commission recommended a debt premium for BAA in the range of 90 basis points to 120 basis points. In the view of the CAA, in the light of the risk free rate as well as BAA market data on its shorter as well as longer term debt, this range is appropriate.

Capital structure

- 4.53 In the view of the CAA capital structure decisions are best left to the firm and its financiers as they should and will be carrying the full risk associated with a change in financial strategy/policy and hence capital structure. bmi argued in the January 2003 hearing that a debt/equity ratio of one for Terminal 5 would be appropriate. The CAA approach in determining the price caps is based on actual

¹⁰² British Airways (2002), The British Airways Response to the CAA Preliminary Proposals Consultation Paper on Heathrow, Gatwick, Stansted and Manchester Airports' Price Caps 2003-2008 (2 January 2002), paragraph 11.14

¹⁰³ Competition Commission (2002), BAA plc, A Report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd, paragraph 4.39

¹⁰⁴ HSBC (2003), Sterling Bond Daily, Wednesday 26 February 2003, p9

gearing rather than notionally “optimal” gearing, due to the lack of a normative model in order to establish the latter¹⁰⁵.

- 4.54 In its response to the CAA proposals, IATA¹⁰⁶ stated “Financial structure is obviously a matter for the BAA, but we note that higher gearing would considerably lower the cost of capital”.
- 4.55 As Virgin Atlantic¹⁰⁷ noted in its supplementary submission, business value (and its cost of capital) is unaffected by a firm’s financial structure. In this more realistic view, the cost of equity rises in proportion with the gearing ratio¹⁰⁸. The effect of ‘cheap’ debt is offset by the higher risks and hence costs of leveraged equity. As British Airways¹⁰⁹ pointed out in the January 2003 hearings: “[...] BAA is going to undertake a large investment, may well borrow considerably more money, and that does increase the risk to shareholders, but in the cost of capital calculation these two things offset each other [...]”.
- 4.56 Thus as recognised by both Virgin Atlantic and British Airways, corporate finance implies that even if the CAA were to adopt projected gearing rather than actual gearing, the overall cost of capital figure probably should not change materially. In a situation where the default probability on interest payments increases, the cost of equity would increase as the equity holders would become more exposed. Equity volatility is therefore especially an issue for firms with high levels of debt in relation to their assets. The CAA presented these arguments in more detail in its November 2001¹¹⁰ and February 2002¹¹¹ consultation documents.
- 4.57 This implies that generally and before the tax issue is considered, the impact of a higher gearing ratio in a WACC framework would be offset by a correspondingly higher cost of debt and higher cost of equity, consistent with the view, certainly for regulatory policy purposes, that the value of the business, and, by implication, the cost of capital, is not materially affected by capital structure.

¹⁰⁵ This point is discussed in greater detail in the CAA November 2001 and February 2002 Cost of Capital annexes

¹⁰⁶ IATA (2003), IATA response to the UK CAA proposals of November 2002 on the price caps for the BAA London Airports for 2003-2008, paragraph 2.7.2

¹⁰⁷ Virgin Atlantic (2003), Response to CAA’s proposals on the regulation of BAA’s London Airports, p.7

¹⁰⁸ Miller, M.H.(1988), “The Modigliani-Miller Propositions After Thirty Years” in Journal of Economic Perspectives, Vol.2, Number 4, pp.99-120

¹⁰⁹ CAA (2003d), Transcript Friday 31 January 2003, Minutes of meeting re Proposals of November 2002 Price Caps for BAA London Airports for 2003 – 2008 on Friday 31 January 2003, p.78 line 5-9

¹¹⁰ CAA (November 2001), Economic regulation and the Cost of Capital, paragraph 4.49

¹¹¹ CAA (February 2002), Annex on the Cost of Capital for Heathrow, Gatwick and Stansted, paragraph 1.120

- 4.58 The CAA has therefore decided to adopt a cost of capital figure consistent with a robust view on the cost of equity, in line with the Competition Commission, that allows for the raising of new equity as well as debt when appropriate from the perspective of BAA. The CAA considers that this should allow BAA a range of options regarding future financial policy including a continuation of the current capital structure.
- 4.59 In the view of the CAA, the price caps in future should be set on the basis of regulatory fundamentals, and not set in order to accommodate any particular financing arrangement that has been adopted. The CAA expects that this general approach would also apply to any applications for an interim review of the price caps, for example, arising from BAA's response to the Air Transport White Paper.

Tax

- 4.60 Both the CAA and Competition Commission have adopted a full tax shelter in the cost of capital calculations, i.e. corporate tax rate of 30%. As pointed out by the Competition Commission there are a number of reasons why the actual corporate tax rate might be lower than the standard corporate tax rate used in the modelling, e.g. effect of capital allowances and other timing differences.
- 4.61 British Airways¹¹² argued that the CAA and Competition Commission approach favours BAA. The CAA accepts that this approach probably creates some headroom for BAA but this should be seen as part of an overall package of regulatory policies.
- 4.62 In line with the Competition Commission's recommendations and usual UK regulatory practice¹¹³ the CAA has therefore adopted the standard corporate tax rate for its cost of capital calculations.

Cost of capital: airport by airport

- 4.63 In its determination of the cost of capital for the BAA London airports on a stand-alone basis, the CAA had to make judgements given that the available financial data refers to BAA as a whole. BAA argued that this approach is insufficient to form a considered basis for separate price calculations¹¹⁴. However traffic composition data along with revenue and cost data is available on a per

¹¹² British Airways (10 January 2003), Response to the CAA Proposed Q4 Decisions for BAA's London Airports, paragraph 1.8

¹¹³ To the CAA's knowledge only Ofwat uses a post tax cost of capital. All other regulators use a pre-tax cost of capital

¹¹⁴ BAA (January 2003), BAA Response to CAA Preliminary Proposals November 2002, CAA/352

airport basis, which gives an indication of the degree of risk faced by each individual airport.

- 4.64 Although the majority of airlines have been supportive of regulation on a stand-alone approach, all the airlines and IATA which responded to the CAA proposals argued that the CAA had made an excessive allowance for risk, resulting in a too high cost of capital figure. The CAA does not accept this view. The CAA had to make a forward-looking assessment about the risks faced by the individual BAA London airports consistent with a stand-alone approach to economic regulation. Although the Competition Commission¹¹⁵ applied a system approach, it did observe that it makes a negligible difference to the price caps in Q4. The Competition Commission's¹¹⁶ recommendations allow BAA not only to earn its regulatory cost of capital on a system basis but also on an airport by airport basis once profiling has been taken into account. The CAA also notes that the Competition Commission¹¹⁷ quoted British Airways as saying that it did not believe that it was appropriate to use different cost of capital estimates for the three London airports.

Heathrow

- 4.65 In the case of Heathrow, the key determinants with respect to its non-diversifiable risk, captured by equity beta, are likely persistent excess demand for runways and the scale and associated demand risk of Terminal 5 and potential developments beyond that. Persistent excess demand for runway slots implies that Heathrow will be less susceptible to ATM demand volatility in general terms, although passenger numbers and expenditure (relevant under the single till approach) will be more volatile. The CAA notes the downturn in traffic following September 11 has affected Heathrow to a much lesser degree than, for example, Gatwick.
- 4.66 Nevertheless the scale of a project like Terminal 5 clearly involves accessing the capital markets as it is unlikely to be possible to fully finance such a project from internally generated cash flow.
- 4.67 Large investment projects tend to be risky in a number of ways. The scale of Terminal 5 will increase BAA's risks, not only with respect to construction risk but also risks of uncertain demand and risks associated with the Terminal 5

¹¹⁵ Competition Commission (2002), BAA plc, A Report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd), paragraph 2.382

¹¹⁶ *Ibid*, paragraph 2.383

¹¹⁷ *Ibid*, paragraph 4.39

triggers as pointed out by the Competition Commission¹¹⁸. Regulatory commitment is another issue influencing risk. The degree to which these risks are diversifiable will differ.

- 4.68 To address regulatory commitment issues and in line with the Competition Commission's recommendations, the CAA has adopted an approach based on a 10-year profile to assist setting of a 5-year price cap to better achieve the CAA's statutory objectives. However, ultimately neither the CAA nor the Competition Commission can commit its successors. Some degree of regulatory risk will therefore remain an issue and hence is likely to increase the cost of new equity.
- 4.69 Especially when considering the considerable uncertainty when estimating equity beta in the first place, and hence the wide range in which the true beta lies, a beta close to one seems appropriate for Heathrow, given the specific circumstances as discussed above, most notably the option to raise new equity.
- 4.70 This results in a cost of equity figure above the mid-point of the range as determined by the Competition Commission. This therefore results in a pre-tax real cost of capital figure also above the mid-point of the range.
- 4.71 In the view of the CAA a point estimate of 7.75% pre-tax real for Heathrow's cost of capital is appropriate and reasonable. This figure reflects the uncertainty surrounding the cost of equity, and especially the cost of new equity, and the importance of enabling BAA to finance Terminal 5 on a commercial basis given the risks involved. The other side of the coin is clearly that all risk, i.e. demand risk as well as cost risk, lies with BAA. This implies that whatever capital structure BAA and its financiers adopt, the risk associated with this structure lies entirely with BAA and its financiers.

Gatwick

- 4.72 At Gatwick no large increases in capacity are planned. However, Gatwick does seem to face more demand risk than previously anticipated. Since September 11, it has become clear that Gatwick is much more vulnerable to traffic volatility than the other BAA London airports. This has to a large extent to do with the traffic composition of Gatwick. For example, British Airways has scaled back its operation at Gatwick and has transferred many long-haul routes to Heathrow.
- 4.73 An Open Skies agreement with the US or the Trans-Atlantic Common Aviation Area as proposed by the European Commission could have considerable implications for Gatwick: US carriers at Gatwick might be expected to want to move to Heathrow. How far low frills carriers would move to Gatwick to take runway slots as they become available is uncertain.

¹¹⁸ Competition Commission (2002), BAA plc, A Report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd, paragraph 2.327

- 4.74 BAA¹¹⁹ pointed out that the prospects of individual airports have changed. Gatwick traffic might therefore be weaker due to several factors, such as a more negative outlook on long haul and charter traffic as well as increasing difficulties in increasing runway movements.
- 4.75 Gatwick's particular traffic composition exposes Gatwick to more uncertain demand conditions especially when compared with Heathrow. These types of uncertainty are reflected in equity beta. This implies that Gatwick for regulatory purposes merits a cost of equity above the mid-point of the range, given these uncertainties. The CAA has therefore adopted a pre-tax real cost of capital figure of 7.75% as being a reasonable judgement in order to set the price cap for Gatwick.

Stansted

- 4.76 Stansted is an airport characterised by rapid growth. It has been granted planning permission to increase its terminal capacity to 25 million passengers per annum, however it is subject to an ATM limit and a noise cap contour.
- 4.77 Stansted's success is directly linked to the success of the low frills carriers. In their joint submission buzz, easyJet and Ryanair¹²⁰ argued that Stansted's cost of capital should reflect that it is predominantly a low frills carrier airport and the rate of return should be set in line with the net yield achieved at Stansted. As previously set out, the CAA has adopted a WACC approach to the cost of capital based on CAPM for determining the cost of equity.
- 4.78 In this approach the main driver of the cost of equity is volume risk. Low frills carriers are very much dependent on traffic volumes and hence tend to have betas higher than those of the average firm. Given Stansted's reliance on this particular type of traffic it might be expected to face more risk than airports which rely on different types of traffic rather than just one particular type of traffic.
- 4.79 BAA argued that the higher passenger growth as forecast by the CAA would require additional investment¹²¹. The stand-alone approach implies no cross-subsidisation by Heathrow users, which (in a notional sense¹²²) would imply that Stansted might have to access the capital markets to fund the Stansted expansion.

¹¹⁹ BAA (2003), BAA Response to CAA Preliminary Proposals November 2002

¹²⁰ buzz, easyJet, Ryanair (2003), CAA proposals for Stansted Airport Charges 2003-2008 (20 January 2003)

¹²¹ Competition Commission (2002), BAA plc, A Report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd, paragraph 2.318

¹²² Notional, because Stansted is part of BAA plc and it is BAA plc which raises capital

- 4.80 This would point to a cost of equity above the mid-point of the range, indicating that its pre-tax real cost of capital figure of 7.75% is reasonable on its own merits. Based on a 10-year price profile Stansted is expected to be able to earn its regulatory cost of capital.

Financing, risk allocation and regulatory commitment

- 4.81 Investment has been the key issue in this review, not only in the view of the CAA and the Competition Commission, but also in the view of BAA and airlines. The broad approach to regulation underlying this decision is based on the conventional cost-based approach with the firm's expected costs including capital costs being remunerated through the price caps. BAA has to be confident that its investments will be profitable yet this can only be achieved over a number of regulatory reviews given the length of the lives of the assets involved.
- 4.82 In addition, given the size of BAA's ten-year investment programme in relation to BAA's market capitalisation, BAA needs to be able to access the capital markets to finance it. To address the problem of regulatory uncertainty profiling of revenue is one of the key regulatory policies available.
- 4.83 Capital markets require regulatory credibility and regulatory commitment in order to finance projects of this scale and duration cost-effectively. In addition to fully allowing for assets in the course of construction and an appropriate cost of capital, profiling has therefore been based on 10 years rather than 5 years. This implies that each airport will be able to earn its regulatory cost of capital over the period used for profiling.
- 4.84 BAA¹²³ has stated that "it would be reasonable to expect some regulatory protection, as the CAA has given to NATS, within a framework of 7.75% cost of capital" if it were to approach critical levels of interest cover through no particular fault of its own. As previously indicated by the CAA, the 7.75% pre-tax real cost of capital should be firmly seen in a conventional risk-return framework. This implies that the cost as well as demand risk lies with BAA. Which capital structure to adopt is clearly a decision for BAA and its financiers, however, the CAA considers that the regulatory settlement reflecting inter alia a cost of capital of 7.75% for each of the airports allows an efficiently managed BAA to access the equity as well as the debt markets.

¹²³ BAA (January 2003), BAA Response to CAA Preliminary Proposals November 2002, CAA/352, paragraph 3.23e

Financial model

- 4.85 To arrive at the price cap the CAA has used a financial model that calculates the 'X' factors in the established regulatory mechanism for setting future prices (the RPI-X charge control formula). The RPI-X mechanism establishes airport charges in accordance with CAA regulatory policy decisions and assumptions on key economic policy variables and other operating and financial assumptions.
- 4.86 The model computes regulatory valuations and the required revenues to support a sufficient return on these valuations. Required revenues are calculated for each year as the sum of:
- directly remunerated net expenditure such as operating costs;
 - regulatory depreciation of remunerated assets (i.e. depreciation of the RAB);
 - required returns on the average value of remunerated assets.
- 4.87 The primary method through which the model determines the level of these required revenues is by calculating required annual accounting returns. Discounted cash flow valuations for each airport are then used to check the consistency of the required revenue and accounting calculations.
- 4.88 In respect of profiling, the discounted value of revenues projected using the RPI-X charge control formula over time, will equal that of the required revenue calculation.
- 4.89 In conjunction with the financial modelling work undertaken by the CAA, the Competition Commission has also produced a detailed financial model. This model forms an integral part of the CAA's financial modelling, providing key data for judgements made by the Competition Commission and a reference point for reconciling the two models.
- 4.90 There is consistency between the modelling of the Competition Commission, and that of the CAA. The CAA model draws from the same source data as the Competition Commission, and when using the Competition Commissions' policy settings and assumptions, draws the same conclusions about the price cap.
- 4.91 The CAA model has been audited and validated by independent consultants. Both the model and supporting documentation were made available to BAA throughout the review process.
- 4.92 Key outputs from the CAA model for Heathrow, Gatwick and Stansted reflecting the price caps in this decision document are summarised in Annex 5.

Conclusion

- 4.93 The CAA's decisions on financial regulatory policies, which underlies its price cap decision given the model-based approach, are firmly based on an assessment of how to best meet the CAA statutory objectives given the problems being addressed and the inherent risks and uncertainties. As stated in its consultation documents and recommendations to the Competition Commission, the CAA believes that it best meets its statutory objectives through enabling BAA to proceed with its large capital expenditure programme, most notably Terminal 5.
- 4.94 The CAA has applied the Competition Commission's approach in setting the cost of capital for each of the regulated BAA airports to reflect the risks faced by these airports in an adequate manner.
- 4.95 In line with the Competition Commission's recommendations, the CAA has applied price profiling to smooth returns in order to avoid large price increases in Q5, which could undermine regulatory credibility, or result in delayed capital expenditure or result in more risky and ultimately more costly financing arrangements.
- 4.96 In line with the Competition Commission and in accordance with regulatory practice in other sectors, the CAA has allowed a full return on assets whilst in the course of construction.
- 4.97 In line with the Competition Commission, the CAA has incorporated a claw-back of revenue advancement and capital under-spend in Q3, in arriving at the Q4 price caps.
- 4.98 In the view of the CAA, its financial regulatory policy as set out in this chapter, enables BAA to proceed with its planned capital expenditure, with BAA being appropriately remunerated and accountable for the operational and financial risks involved.

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5. Q4 Decision: Price caps for BAA London airports

Introduction

5.1 The first part of this chapter presents and assesses the responses to the CAA's November 2002 price cap proposals in relation to each of the three BAA London Airports. This chapter then presents the CAA decision on the price caps for Heathrow, Gatwick and Stansted against the objectives under section 39 of the Act.

Heathrow price cap

5.2 In its response to the CAA's proposals, BAA¹²⁴ accepted the proposed price cap, but said that it represented the minimum necessary to provide appropriate incentives for the investment programme and contained no latitude for downside risk. It noted that the CAA's proposals were significantly tougher than the CAA's initial recommendations to the Competition Commission in February 2002. If the cap was further reduced, even by a small amount, BAA¹²⁵ could not commit to implementing the planned investment programme in full.

5.3 In BAA's view a lower cap would not allow an adequate level of remuneration or allow BAA to operate within reasonably prudent financial ratios. BAA¹²⁶ also objected to the basis of the initial RAB determination. BAA¹²⁷ also argued that its cost of capital was in excess of the CAA's 7.75% pre-tax real.

5.4 The Heathrow users which responded to the CAA November 2002 proposals all objected to the proposed cap for Heathrow arguing for a much lower X factor (around RPI+0.5% or below) or for policy changes that would have that effect. British Airways¹²⁸ suggested that RPI+2, as indicated at the last price cap review, would not have been unexpected. The CAA notes that for Heathrow alone this translates into RPI+3 approximately as the RPI+2 applied to Heathrow and Gatwick combined: Gatwick without major capital expenditure planned in Q3 would, on a stand-alone basis, have had a tighter price cap. The airline objections involved particular aspects of the CAA's financial regulatory policy, in particular

¹²⁴ BAA (January 2003a), BAA Response January 2003 to CAA Preliminary Proposals November 2002, CAA/352

¹²⁵ *Ibid*, paragraph 1.4.1 to 1.4.5

¹²⁶ *Ibid*, paragraph. 4.2.1

¹²⁷ *Ibid*, 3.2.1

¹²⁸ CAA (January 2003d), Transcript Friday 31 January 2003, Minutes of meeting re Proposals of November 2002 Price Caps for BAA London Airports for 2003 – 2008 on 31 January 2003, p.57, line 8-10

revenue advancement and the cost of capital. These responses and the CAA's assessment have been addressed in the previous chapter of this decision document.

- 5.5 Several users also felt that the projected costs of Terminal 5 had not been properly reviewed or indicated that the project was not economically viable and that the magnitude of the price increases was simply unacceptable, particularly given the commercial difficulties faced by airlines.
- 5.6 bmi¹²⁹ also argued that the price cap would have an adverse impact on regional services to Heathrow and that given the unique nature of bmi's type of traffic, the charging regime singles out bmi.
- 5.7 On the issue of the projected cost levels of Terminal 5, IATA, BATA, bmi, Virgin Atlantic, and SAS stated that the projected costs of Terminal 5 had increased dramatically since the last review. Several respondents argued that there should be a review of the Terminal 5 costs. The £600 million of contingency allowed for in the projections was strongly contested. In the view of BATA¹³⁰ and bmi¹³¹, this should not be allowed for in the price caps. bmi¹³² argued that if these costs were genuine then Terminal 5 was not an economic project. On a similar note, IATA¹³³ argued that the business case should be reviewed. bmi¹³⁴ also pointed out that users other than British Airways had not had detailed access to the cost projections.
- 5.8 The CAA accepts that the projected costs have continued to rise. Airlines have however expressed different views with respect to this. At the oral hearing, bmi's¹³⁵ concern appeared to be that the actual cost of Terminal 5 could be higher than currently projected given construction/commissioning risk. This would indicate a higher price cap for BAA, not lower.

¹²⁹ CAA (January 2003a), Transcript Wednesday 22 January 2003, Minutes of a meeting with bmi British Midland on re Proposals for LHR Airport Charges 2002 – 2008 on Wednesday 22 January 2003

¹³⁰ BATA (10 January 2003), Heathrow, Gatwick and Stansted Airports – CAA proposals for consultation, p.2

¹³¹ bmi (January 2003), Proposals for LHR Airport Charges 2003 – 2008: Response to CAA consultation paper dated 29 November 2003

¹³² *Ibid*, p. 4

¹³³ IATA (January 2003), IATA response to the UK CAA proposals of November 2002 on the price caps for the BAA London Airports for 2003-2008, paragraph 4.1.6

¹³⁴ CAA (January 2003a), Transcript Wednesday 22 January 2003 Minutes of a meeting with bmi British Midland on Wednesday 22 January 2003 re Proposals for LHR Airport Charges 2002 – 2008 on Wednesday 22 January 2003

¹³⁵ *Ibid*

- 5.9 The Competition Commission employed independent external advisers to review the Terminal 5 costs. While the consultants had some reservations, the Competition Commission¹³⁶ concluded that the full projected cost should be included in the price cap on the grounds that “[...] even if there is scope for lower costs on some projects, there is in our view likely to be demand for any cost savings to be spent on additional projects. It would not therefore be appropriate for us to base charges on a lower level of expenditure.”
- 5.10 The CAA has seen no evidence or strong argument to reject the views and recommendations of the Competition Commission with respect to this given the prevalence of excess demand. This applies equally to the Terminal 5 contingency, which was a particular point raised by the Competition Commission’s consultants.¹³⁷ The CAA considers that as there is insufficient capacity at Heathrow, reducing BAA’s investment programme and hence the price cap would not be consistent with the CAA’s statutory objectives and would not be in the interest of users.
- 5.11 The CAA accepts that consultation with users other than British Airways on the costs of Terminal 5, or planning for Terminal 5 more generally, may have been inadequate. The CAA expects BAA to pro-actively implement the agreement for enhanced information disclosure and improved consultation to ensure that such a situation does not continue.
- 5.12 Terminal 5 represents the first major single capacity addition at Heathrow for more than a decade. It follows a long and exhaustive process of obtaining planning permission. The incremental costs suggested by bmi¹³⁸ are in line with CAA estimates and compare well to the likely value to customers of additional capacity. British Airways has been closely involved in the development of the project and indicated orally that it was broadly comfortable with the scale and costing of the programme including the contingency provision.¹³⁹ It is clearly not feasible to complete a full review of the business case for Terminal 5 prior to setting the caps as IATA requested, and the CAA believes it extremely unlikely that any review would point to a lower price cap: the Competition Commission conclusion quoted above is relevant. The CAA therefore does not believe that the concerns are sufficient or that there is any evidence for it to consider

¹³⁶ Competition Commission (2002), BAA plc. A report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd), paragraph 2.343

¹³⁷ *Ibid.*, paragraph 2.341

¹³⁸ bmi (2003), Proposals for LHR Airport Charges 2003 – 2008: Response to CAA consultation paper dated 29 November 2003, p. 3

¹³⁹ CAA (January 2003d), Transcript Friday 31 January 2003, Minutes of meeting re Proposals of November 2002 Price Caps for BAA London Airports for 2003 – 2008 on Friday 31 January 2003, pp. 61-2

disallowing part of the funding of Terminal 5 with consequential tightening of the price cap on the grounds that it is an uneconomic project.

- 5.13 The CAA does not accept that because British Airways is the likely user of Terminal 5, it should bear the costs. British Airways' move to Terminal 5 will free up congested terminal capacity elsewhere in the airport to the benefit of other users. To the extent that British Airways gets a different quality of service, it is for BAA to judge whether or not it should set different charges to British Airways in consequence (within the cap set by the CAA in this decision).
- 5.14 Apart from the specific points raised on financial regulatory policy and the cost of Terminal 5, a key concern of users was that the magnitude of the increases was simply unacceptable, especially given the current financial climate¹⁴⁰.
- 5.15 The CAA has sympathy with users given the current difficult commercial situation and environment many (but not all) airlines face. However, the CAA also believes that investment that will result in an increase in capacity at Heathrow is of primary importance and is highly valued by users. The CAA has long signalled that real price rises were likely at Heathrow in Q4. The CAA's 1996 decision¹⁴¹ suggested that real price reductions in Q3 would be followed by price increases of around RPI+2% per annum in Q4: as discussed above, higher increases would have been implied at Heathrow.
- 5.16 The CAA in its November 2001 preliminary proposals indicated that there would need to be a real increase in prices at Heathrow under the single till¹⁴² and in its February 2002 recommendations to the Competition Commission the CAA¹⁴³ indicated that the increases for Q4 would need to be around RPI+6% per annum if the single till were continued.
- 5.17 The CAA considers that it has come to a balanced settlement. The package at Heathrow gives BAA the resources and incentives to implement its investment plan. Although there is the possibility of BAA benefiting from out-performance, this is balanced by BAA facing all risks. Airlines' opposition to the increases is noted, but users will receive large benefits from the increases in capacity at

¹⁴⁰ Heathrow AOC (January 2003), CAA Proposals for Q4 Airport Charges Price Cap and Associated Issues – Heathrow AOC General Response and Comments, p. 1; BARUK (January 2003), CAA policy proposals for the BAA London airports, p. 2; IATA (January 2003), IATA response to the UK CAA proposals of November 2002 on the price caps for the BAA London Airports for 2003-2008, paragraphs 1.2 and 4.2.2; United Airlines (January 2003), Re: CAA Proposals on Revenue Caps, p. 2

¹⁴¹ CAA (October 1996), CAP 664 Economic Regulation of BAA London Airports 1997 – 2002, paragraph. 172

¹⁴² CAA (November 2001), Heathrow, Gatwick, Stansted and Manchester Airports' Price Caps 2003 – 2008: CAA Preliminary Proposals, paragraph. 17.42

¹⁴³ CAA (March 2002), Heathrow, Gatwick and Stansted Airports' Price Caps, 2003-2008: CAA Recommendations to the Competition Commission, p. xi

Heathrow brought about by the construction of Terminal 5. Given that prices were set to rise in Q4, it is worth noting that airlines, particularly British Airways, have, nonetheless been acquiring further slots at Heathrow and have been actively campaigning for further capacity at Heathrow. This clearly indicates the high value placed on capacity at Heathrow by both airlines and travellers, in relation to costs.

- 5.18 In relation to concerns over regional services, the CAA believes that charges at Heathrow are likely to be one of a wide range of factors determining whether services to the UK regions are commercially viable or not. Far more important is likely to be capacity limitations at Heathrow and the alternative use that could be made from scarce Heathrow slots. The CAA notes that a number of regional services to Heathrow have been discontinued or moved to other airports at times when Heathrow charges were lower. It would be difficult for the CAA to set Heathrow's price cap consistent with its statutory objectives on the criterion that regional services remain viable and considers that any attempt to do so would in any event be ineffectual, given that slot values and availability, rather than charges, will dominate in airline scheduling policy
- 5.19 Thus while the CAA acknowledges the problems faced by some airlines at Heathrow, it believes that its statutory objectives are best calculated to be met by the RPI+6.5% for Q4, recommended by the Competition Commission, which the CAA notes is similar to the cap originally proposed by the CAA.
- 5.20 In conclusion, the CAA is not persuaded by the arguments and evidence presented by Heathrow users to the effect that it should reduce its proposed increased price cap at Heathrow in Q4.

Gatwick price cap

- 5.21 BAA accepted the Gatwick price cap with the same caveats as applied to its general acceptance of the price caps proposed across the three BAA London airports.
- 5.22 There were no substantial user objections to the CAA's proposed price cap for Gatwick. British Airways¹⁴⁴ suggested that the cost of capital should be 7.5% at Gatwick. For the reasons discussed in chapter 4 the CAA considers that 7.75% is more reasonable given the risks Gatwick faces.
- 5.23 The Charter Group¹⁴⁵ said that part of the claw-back of the revenue acceleration from Q4 to Q3 should be credited to Gatwick, not wholly to Heathrow. The

¹⁴⁴ British Airways (10 January 2003), Response to the CAA Proposed Q4 Decisions for BAA's London Airports, paragraph 1.23

¹⁴⁵ The Charter Airline Group of the UK (10 January 2003), Heathrow, Gatwick and Stansted Airports, CAA Proposals for Consultation November 2002, p.3

CAA agrees with the Competition Commission that since the revenue advancement was projected to allow for a higher return than the cost of capital at Heathrow, but not at Gatwick, it is reasonable to confine the recovery of the claw-back to Heathrow users. Returns at Gatwick were expected to be modestly above the cost of capital for at least some years of Q3, but not over the five years as a whole. The arithmetic average return on capital value over five years was expected to be 7.5%. As Gatwick users were not expected to be remunerating more than the cost of capital, there does not seem to be compelling justification for them to share in the unwinding of the revenue advancement.

Stansted price cap

- 5.24 BAA agreed with the CAA's assessment of the price cap at Stansted (other than the move to a stand-alone approach to regulation).
- 5.25 buzz, easyJet and Ryanair¹⁴⁶ objected to the proposed cap on the following grounds:
- the cost of capital should reflect Stansted's position as a predominantly low fares airport;
 - the returns allowed to BAA should be set closer to the net yield achieved at Stansted, which is significantly below the gross yield;
 - the proposals would potentially allow BAA to increase current charges by 63%. There is nothing to stop BAA from doing this which would be damaging given the price sensitive market for low fares carriers;
 - the CAA's proposal to adopt a higher charge at Stansted than proposed by the Competition Commission is unacceptable;
 - a tighter cap would force BAA to improve its efficiency and pass on the savings to users;
 - the cap at Stansted should be no higher than that at Gatwick.
- 5.26 There was no detailed analysis or evidence provided by the users on the substance of the CAA's cost of capital determination for Stansted, and the CAA therefore sees no reason to alter its view on the cost of capital at Stansted.
- 5.27 The large difference between net yields and gross yields does create additional complexity at Stansted. If the price cap was based on actual net yields, then BAA would be forced to eliminate its marketing support payments in order to generate the required returns. This would indeed, as the users suggest, eliminate the

¹⁴⁶ buzz, easyJet and Ryanair (January 2003), CAA Proposals for Stansted Airport Charges 2003-8

potential for BAA to over-recover against the cap. However, the CAA concurs with the Competition Commission that the degree of marketing support at Stansted is evidence of the competitive nature of the market there and believes that the approach based on gross yields has provided considerable flexibility to BAA to price in relation to that market, assisting the efficient operation of the airport and benefiting users.

- 5.28 It is also questionable whether BAA would be in a contractual position to eliminate its market support. At the hearings, buzz, easyJet and Ryanair¹⁴⁷ stated that they paid the published tariff only on 'some' of their routes and that the various contracts would terminate at various times over Q4 and Q5. BAA¹⁴⁸ stated in the hearings that only about 15% of the small users paid the list price and that "the vast majority of people are on discounts, because they are the ones that are growing."
- 5.29 Any forced rapid unwinding of discounts would call into question the sustainability of the rate of growth at Stansted. BAA¹⁴⁹ stated in the hearings that they will only be "progressively reducing the discounts" and that they "will continue to price according to what the market will bear and that the strategy is [...] to progressively remove the discounts as best we can, but [...] are aware of the fundamental dynamics of the market." This would indicate that it is unlikely that buzz, easyJet and Ryanair will be paying charges consistent with the full price cap early in Q4.
- 5.30 The CAA therefore confirms its proposal to base the price cap on gross yields, adopting marketing support expenditures as a cost (as is the practice at other designated airports) rather than on net yields.
- 5.31 The CAA accepts that if BAA were to eliminate its marketing support in its entirety, and to set prices to all users at the level allowed by the cap without discounts or marketing support, it would be able to over-recover against regulatory projections. The CAA considers this unlikely for several reasons. Firstly, BAA has had this latitude given the price caps set for Stansted in the past, yet it has consistently entered into arrangements where its net yields are far lower than the maximum that they could theoretically have achieved. Secondly, this is likely to reflect the market conditions faced. It is in part because the low frills operators operate in a price sensitive market that substantial rises are unlikely to be profitable for BAA, since the potential loss of passenger numbers would be substantial. This is further supported by the observation of the Competition

¹⁴⁷ CAA (January 2003b), Transcript Wednesday 29 January 2003, Minutes of meeting re Proposals of November 2002 Price Caps for BAA London Airports for 2003 – 2008 on Wednesday 29 January 2003

¹⁴⁸ CAA (January 2003d), Transcript Friday 31 January 2003, Minutes of meeting re Proposals of November 2002 Price Caps for BAA London Airports for 2003 – 2008 on Friday 31 January 2003

¹⁴⁹ *Ibid.*

Commission¹⁵⁰ that “Discount arrangements at Stansted could, in our view be regarded as one of the few examples of competitive pressure on airport charges [...]” Thirdly, there is significant user concentration at Stansted, with the three respondents accounting for the large majority of passenger throughput at the airport. easyJet has its base at Luton, providing for further scope for negotiating leverage.

- 5.32 In relation to the particular concerns expressed by the respondents, the CAA is not convinced that the increase in the cap on gross yields from £4.44 per passenger to £4.89 per passenger in 2003/4 prices will make a material difference to the actual charges faced since both caps are well above the net yields currently generated.
- 5.33 In the view of the CAA, Stansted’s charges will continue to reflect market imperatives over Q4 and the cap will not affect the actual net yields achieved. This provides BAA with strong incentives to deliver its services efficiently. The CAA believes that a tightly constraining cap, as suggested by the respondents, may actually serve to dilute these incentives since the incentives provided by price cap regulation are likely to be weaker than the incentives provided by normal commercial operation. The CAA approach is consistent with its statutory objectives including that of imposing minimum restrictions.
- 5.34 As set out in its proposals, in the absence of compelling evidence the CAA does not accept that Gatwick has any particular relevance as the benchmark for setting Stansted’s charges, and that the cap at Stansted should be determined by reference to its costs, assets and market position.
- 5.35 Having considered the evidence submitted, the CAA¹⁵¹ confirms its proposal to adopt a higher cap for Stansted than recommended by the Competition Commission.

Conclusion

- 5.36 The CAA confirms its November 2002 proposal for Heathrow, of a starting maximum initial yield for 2003/4 of £6.48 per passenger, to be adjusted by RPI+6.5% per annum for the remainder of Q4. The detailed price cap condition for Heathrow is presented in Annex 9.1.
- 5.37 The CAA confirms its November 2002 proposal for Gatwick and concludes that the price cap at Gatwick should be a maximum initial yield of £4.32 per

¹⁵⁰ Competition Commission (2002), BAA plc. A report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd), paragraph 2.303

¹⁵¹ CAA (November 2002), Heathrow, Gatwick and Stansted Airports, CAA Proposals for Consultation, paragraph 2.21 to 2.31

passenger to be maintained in real terms at RPI+0% per annum for the remainder of Q4. The detailed price cap condition for Gatwick is presented in Annex 9.2.

- 5.38 The CAA confirms its November 2002 proposal for Stansted to continue in real terms with the level of gross yields permitted under the cap for 2002/3, leading to a starting maximum initial gross yield of £4.89 per passenger to be maintained in real terms with an adjustment of RPI+0% per annum for the remaining years of Q4. The detailed price cap condition for Stansted is presented in Annex 9.3.
- 5.39 The CAA is satisfied that these decisions are best calculated to meet the CAA's statutory objectives under the Act. Following Competition Commission advice the price caps reflect full allowance for assets in the course of construction, a cost of capital of 7.75% pre-tax real at each airport, and revenue advancement at Heathrow to permit a smooth price profile.
- 5.40 The following table compares the expected maximum yields for each year in Q4 compared to the expected yields for 2002/3 for Heathrow and Gatwick and the maximum allowable yield at Stansted for 2002/3 adjusted to the new basis for airport charges. The details of the adjustments made are set out in Annex 7.

Expected Maximum Revenue Yield per Passenger at Constant (2003/04) Prices¹⁵²

	2002/3 ¹⁵³	2003/4	2004/5	2005/6	2006/7	2007/8
Heathrow	£6.13	£6.48	£6.89	£7.33	£7.80	£8.29
Gatwick	£4.32	£4.32	£4.32	£4.32	£4.32	£4.32
Stansted	£4.93	£4.89	£4.89	£4.89	£4.89	£4.89

¹⁵² These figures are indicative and will depend on the outturn rate of inflation. This is because the price cap has the form RPI+x rather (1+RPI).x . The rate of inflation assumed is 2.5% p.a

¹⁵³ The figures for Heathrow and Gatwick are the expected actual gross yields adjusted to the new basis from the Competition Commission Report table 10.7. The figure for Stansted is the maximum

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6. Future regulatory policy

Introduction

- 6.1 The CAA raised a number of points of future regulatory policy in its November 2002 proposals document, some of which attracted comment from users. These points are summarised in chapter 2 of this decision document. Responses on some of these issues are addressed below.
- 6.2 The CAA's consideration of current regulatory policy is translated into price caps set by the CAA for the BAA London airports in this decision document. There were several regulatory issues, which may affect BAA's behaviour over Q4 but will only influence regulatory decisions in subsequent price cap reviews. While regulators in the future must make decisions to meet the statute it is useful for the CAA to outline its current views on these matters to minimise regulatory uncertainty.

Starting RAB and roll forward to Q5

- 6.3 BAA raised a number of objections to the Competition Commission's determination of the starting RAB for Q4 and the CAA's acceptance of that determination. BAA argued that the RAB should mirror the historic cost asset base in the airport statutory accounts with gross asset values and depreciation uplifted by RPI, that accounting policy changes should be confined to those incorporated in the statutory accounts, and that this would be supported by full disclosure of BAA's calculations to the CAA and to users. BAA was particularly disappointed with the Competition Commission's treatment of net current liabilities. BAA¹⁵⁴ was 'puzzled' by the CAA's proposal to adopt forecast, rather than actual, depreciation in the roll forward of the RAB to Q5, and appeared to object to the notion that using actual depreciation would encourage regulated companies to 'game' and that projected depreciation could give distorted investment incentives in order to meet user or statutory requirements.
- 6.4 British Airways¹⁵⁵ argued that if the advancement of revenues from Q5 to Q4 was adopted, it should be clearly accounted for to as to be credited to users in Q5, rather than being absorbed through a reduction in the BAA regulatory asset base as proposed by the CAA.

¹⁵⁴ BAA (January 2003a), BAA Response January 2003 to CAA Preliminary Proposals November 2002 CAA/352, paragraphs 4.2.1 to 4.2.5

¹⁵⁵ British Airways (January 2003), Response to the CAA Proposed Q4 Decision for BAA's London Airports, paragraph 1.23

- 6.5 The CAA did not accept BAA's arguments on the issue of net current liabilities before and during the review by the Competition Commission and does not do so now. The CAA concurs with the Competition Commission's view¹⁵⁶ that BAA's approach would not be consistent with the MMC's 1996 report and the CAA's subsequent decision and its adoption might be expected to generate regulatory uncertainty and damage incentives
- 6.6 More generally the CAA agrees with the Competition Commission that it is not appropriate to set the RAB equal to the value of its assets in its statutory accounts up-lifted by RPI. The notion that the RAB acts as a unit of regulatory value and as such need not correspond to statutory asset values is widely accepted in UK regulation and is one that the CAA firmly endorses.
- 6.7 This view has also influenced the CAA's perspective on whether actual or projected depreciation should be adopted in rolling forward the RAB. If the objective was to mirror the assets in the statutory accounts then clearly use of projected depreciation could result in a significant divergence. Under the CAA's view that there is no need for correspondence between the two value assessments this does not provide a rationale for using actual depreciation. The CAA believes that actual depreciation does provide scope for 'gaming' although it accepts that there is no evidence of such behaviour to date.¹⁵⁷ The CAA does not believe that investment incentives would be undesirably distorted by the use of projected depreciation. Indeed the use of actual depreciation provides distorted incentives to adopt capital expenditure projects with lower depreciation profiles in order to enhance the RAB at the next review for example, by delaying the commissioning of a project.. Use of projected depreciation is incentive neutral in this respect. The CAA therefore confirms that it will roll forward the RAB to Q5 on the basis of the projected depreciation underpinning the Q4 price cap determination.
- 6.8 The CAA believes that regulatory certainty and transparency will be enhanced if the advancement of revenue at Heathrow from Q5 to Q4 is included as part of this projection. The CAA does not propose to adopt British Airways' suggestion that it should be treated as an explicit credit to users in Q5, rather than through a reduction in the RAB. However, in order to improve transparency the CAA has separately identified the pricing profile adjustment element of the depreciation projection in Annex 5. The CAA intends that the precedent set at this review be followed, with the advancement being notionally 'unwound' over Q5. This is

¹⁵⁶ Competition Commission (2002), BAA plc. A report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd, and Stansted Airport Ltd), paragraph 10.24

¹⁵⁷ Over Q3, BAA's actual depreciation was significantly higher than projected depreciation in consequence of the delay to Terminal 5. BAA could have been somewhat better off now if the depreciation projected at the 1996 review had been used in the roll forward, although this is counterbalanced by the claw-back of capital expenditure underspend in Q3 which the Competition Commission assessed as being significantly lower than the CAA, partly because it used actual depreciation to arrive at their assessment

without prejudice to the other matters that may be taken into account in determining the appropriate profiling of returns in Q5 and beyond. The inter-period profiling at Stansted, whereby Stansted is expected to earn less than its cost of capital over Q4, will also be recognised through an explicit reduction in depreciation over Q4. There is no inter-period profiling of returns for Gatwick

- 6.9 The CAA agrees that it is highly desirable to have as much certainty as possible for the basis of the RAB roll forward and that this basis should be reflected in BAA's regulatory accounts. Annex 6 sets out the basis for the RAB roll forward to Q5, together with the definitive statement of the starting RAB and projected depreciation for each airport.

Future regulatory policy on claw-backs

- 6.10 BAA said that given the partial claw-back of capital expenditure underspend in Q3, regulatory uncertainty was increased if no guidance is given on the treatment of claw-backs in future. The CAA cannot give definitive guidance on this matter. However, the CAA's general policy is that claw-backs are highly undesirable and undermine the incentive properties of price cap regulation. The claw-backs in Q3 should be viewed as a 'one-off' in the extreme circumstance where the key element of the capital expenditure plan was delayed due to an unexpected delay in obtaining planning permission for Terminal 5. The CAA notes that the regulatory settlement contained in this decision document for Q4 reflects BAA's investment programme including the construction of Terminal 5. There are strong expectations about the delivery of this programme that must be realised unless there are major changes in the views about the future. However, providing BAA follows best practice management and operates pro-actively the enhanced information disclosure and consultation agreement, consulting effectively with well-informed users, the CAA sees no good reason for disallowing capital expenditure at the next review. Nor would the CAA expect to adopt claw-backs where BAA had managed to significantly outperform expectations and thereby earn returns in excess of its cost of capital. Correspondingly, the CAA would not expect to recompense BAA if it under-performs against regulatory projections. This is consistent with the view of the Competition Commission¹⁵⁸ that the circumstances surrounding the Q3 claw-back were "exceptional".

Section 41 and wider role of the CAA

- 6.11 Users and BAA made a range of comments about the processes and policies for implementing section 41 of the Act and the wider role that they considered the CAA should take. As set out in its proposals paper, the CAA intends to consult

¹⁵⁸ Competition Commission (October 2002), BAA plc. A report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd), paragraph 2.260

on these matters and will do so separately from this decision. The comments made will inform the CAA's consultation.

Non-regulated charges

- 6.12 In its report the Competition Commission discussed a number of issues raised with it concerning separate charges levied by BAA for facilities necessary for airlines to operate at airports that fall within the definition of relevant activities for the purposes of the Act but which are not included within the airport charges that are subject to a statutory price cap. The Competition Commission noted some of these charges are for "specified activities" in respect of which, under conditions imposed by the CAA following the 1991 reference, the airports have to provide information on revenues, costs and profits. The Commission recommended that existing transparency arrangements should continue and the 1991 conditions are repeated, for completeness, at Annex 8.
- 6.13 While the Competition Commission did not make any public interest findings with regard to non-regulated charges it did recommend that the CAA adopt the suggestion of BAA of an undertaking to limit the increase in revenues per passenger from such charges to RPI. In the absence of a formal public interest finding the CAA cannot impose conditions upon the airports neither can it enforce any undertakings given by BAA. The CAA could only intervene between reviews following an investigation under section 41 of the Act.
- 6.14 The CAA, however, invited views from BAA on whether it is prepared to confirm such an undertaking and from users on whether an undertaking from BAA in the terms proposed would help address their concerns. BAA restated its willingness to introduce a voluntary revenue cap for non-regulated charges whereby:
- the cap is based on revenue per passenger;
 - the allowable yield would be uplifted annually by RPI;
 - total revenue would also rise where additional capital expenditure was invested;
 - only quasi-monopoly activities would be covered.
- 6.15 Users generally welcomed the suggestion for a voluntary cap linked to RPI but would be looking for a number of additional commitments from BAA:
- full cost-transparency to be provided for non-regulated charges;
 - the cap not to be expressed on a per passenger basis;
 - prices should be reduced by less than RPI where supply costs rise by less than RPI;

- no new charges should be introduced in Q4 without the agreement of users;
 - BAA should not reduce the scope of services or facilities currently covered by non-regulated charges without the prior agreement of users;
 - there should be a compensation mechanism in respect of failures in service provision.
- 6.16 BAA has indicated that it is ready to discuss further with users the treatment of non-regulated charges. As noted earlier the CAA cannot prescribe the terms of any undertaking, neither can it enforce any undertaking that may be given. However, it would regard the treatment of non-regulated charges as falling within the general scope of enhanced information disclosure. Agreement between airports and their users on these important issues should also limit the prospect of recourse to avenues of redress such as section 41 of the Act (where relevant) and the Competition Act. In addition, as noted by the Competition Commission, should the introduction of a voluntary undertaking prove unsuccessful, there remains the option for Q5 of creating a direct link between non-airport charges and the price cap.
- 6.17 In some responses users appeared to be inviting the CAA in effect to overturn the Competition Commission and make public interest findings of its own, for example in the area of property. This is not open to the CAA under the Act. However, where appropriate, the CAA will be prepared to use its powers under section 73 of the Act to obtain information from the airports in pursuit of its section 39 objectives.

BAA Financial Policy

- 6.18 As noted in chapter 4 above the CAA does not accept BAA's view that it should be given some regulatory protection if it was to approach critical levels of interest cover through no particular fault of its own. Given this price cap decision and this set of regulatory policies, the adoption of particular financing arrangements is the responsibility of BAA. BAA and its financiers should be held accountable for these decisions: users should not be expected to carry these risks. Price caps will be set on the basis of regulatory fundamentals, and not in order to accommodate any particular financing arrangement adopted. The CAA expects this general approach would also apply to any application for an interim review of the price caps.

Aerodrome Congestion

- 6.19 The CAA will monitor BAA's performance on aerodrome delays both in terms of assessing the effectiveness of the service quality term addressing this issue and the air traffic movement incentive, when in effect.

Surface access projects and regulated airport charges

6.20 As there was no adverse comment from interested parties on the treatment of surface access projects, with a continued single till approach, the CAA confirms that it expects the designated BAA airports to provide a clear demonstration that significant new surface access projects that are proposed to be funded in part by regulated airport charges can be expected to generate benefits in excess of their costs in terms of the Act's objectives compared to the next best alternative, before that part of the project's costs are incorporated in the cost basis for the purpose of setting regulated airport charges.

CAA long-term regulatory approach

6.21 The CAA considers that regulatory decisions that provide for the greatest likelihood of additional capacity, at desired service quality levels, being delivered where it is valued most are in most instances best calculated to meet its statutory objectives, and that regulation is likely to be most effective when it is founded upon credible incentives established by sustainable regulatory policies. The CAA would continue to review for the future the prospects for output based incentives linked to their incremental value and incremental cost.

6.22 The potential costs of initiating new runway capacity were explicitly excluded from this decision, with the CAA willing to consider proposals from BAA as to how any such investments should be handled consistent with the Act.

6.23 The CAA will continue to work with market participants to assist better longer-term strategic engagements between the airports and users. The CAA considers that the case for moving to a dual till in future would be substantially stronger if the airports were better able to demonstrate the potential benefits that it could bring, and considers that the dual till is one of a range of possible mechanisms for providing enhanced investment incentives and that superior options to both the single till or dual till could be considered.

Conclusion

6.24 To aid longer-term regulatory certainty in this decision document the CAA specifies the initial RAB for Q4 and the adjustment process over Q4 via the use of projected depreciation. The CAA's strong preference is for future claw-backs to be avoided to maximise the incentive properties of price cap regulation but ultimately this will be determined by BAA performance against its plan, which will form the basis for the CAA's Q5 decision. The CAA will review the operation of section 41 of the Act. The CAA considers decisions concerning the financial structure of BAA to be BAA's responsibility with BAA being remunerated by this price cap to implement its plan and carry the risks of doing so. The CAA will monitor BAA's performance in respect of aerodrome delays. BAA will have to satisfy the CAA in terms of the net benefits against the Act's

objectives of new surface access projects that are being proposed for funding by airlines via regulated airport charges. The CAA re-iterates its commitment to incentive-based regulation and will encourage more effective inter-action between airlines and BAA.

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7. Public interest findings

Service quality

- 7.1 The Competition Commission made a public interest finding that in failing to conduct themselves so as to make prices paid sufficiently reflect the level of service provided, Heathrow and Gatwick airports have pursued a course of conduct which may be expected to operate against the public interest¹⁵⁹. Under the Act, the CAA is obliged to implement a condition in the airports' permissions to levy charges in order to remedy the finding although the exact form of the remedy can vary from that recommended by the Competition Commission.
- 7.2 The CAA put forward for consultation a condition intended to remedy this public interest finding. This would require the airports to pay specified rebates to users in circumstances where the quality of service fails to meet specified standards. The CAA¹⁶⁰ also published on 14 February 2003 for separate consultation a first statement of standards and rebates which it is minded to bring into effect after this condition comes into effect.
- 7.3 BAA expressed its disappointment that the Competition Commission decided to make a public interest finding in this area and not to rely on a factor in the charge conditions themselves. It also set out the view that there were certain principles set out in the Competition Commission's report¹⁶¹, which were essential to the success of such a scheme. It set these out as follows:
- that the scheme should be designed and implemented in a way so that there should not be a significant financial impact on BAA unless the Company allows service to deteriorate significantly;¹⁶²
 - that the individual elements of airline and passenger standards should be assessed separately, with separate limits on the maximum rebate available for each element;¹⁶³

¹⁵⁹ Competition Commission (October 2002), BAA plc. A report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd), paragraph 2.560

¹⁶⁰ CAA (February 2003), Service Quality Proposals Specification of Standards and Rebates

¹⁶¹ BAA (January 2003a) BAA Response January 2003 to CAA Preliminary Proposals November 2002 CAA/352, paragraph 5.1.ii

¹⁶² Competition Commission (October 2002), BAA plc. A report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd), paragraph 2.477

¹⁶³ *Ibid*, paragraph 2.466

- that, for each individual element of service, BAA should be permitted to use good performance in one month to offset bad performance in another during the same year;¹⁶⁴
- that the Quality Service Monitor target, and indeed other, targets should be reasonable and achievable;¹⁶⁵
- that current measures of delay are insufficient for use in a rebate scheme and it is unlikely that an adequate scheme could be developed in less than two years;¹⁶⁶
- that additional work is needed to develop appropriate measures related to the serviceability of runways and taxiways, and to develop appropriate targets for pier service (and possibly other elements), and that these should be incorporated at a later date.¹⁶⁷

7.4 The Act requires the CAA to impose such conditions (or modify conditions already in force) as the CAA considers appropriate for modifying or preventing the adverse effects specified in the report. The CAA is also required to have regard to the recommendations made by the Competition Commission of the conditions or modifications to conditions, which would remedy the adverse effects and has done so. The CAA does not however interpret paragraph 2.477 of the Competition Commission's report as setting out a principle that any scheme should not impose a significant financial impact on BAA unless the service is allowed to deteriorate substantially but rather it is an observation that the standards that it had proposed would not imply a significant financial impact. Indeed the remainder of the paragraph emphasises the flexibility desirable for the CAA to implement such an untried approach. In any event, as is clear from the above, the CAA's duty is to remedy the effects of the course of action, which has or is expected to act against the public interest. This adverse effect is that prices do not reflect the quality of service provided to the extent that would occur in a competitive market.

7.5 None of the other respondents to this consultation has questioned the principle of dealing with the public interest issue through the proposed condition.

7.6 The standards of service conditions for Heathrow and Gatwick airports that the CAA has imposed are at Annex 10 to this document. The CAA intends to deal

¹⁶⁴ *Op cit*, paragraph 2.466 and Appendix 2.4 paragraphs 7 and 8

¹⁶⁵ *Ibid*, paragraph 2.475

¹⁶⁶ *Ibid*, paragraph 2.465

¹⁶⁷ *Ibid*, paragraphs 2.468 and 2.478

with the detailed points in respect of the specified standards and rebates as part of the separate consultation on that subject.

Taxis at Heathrow

- 7.7 The Competition Commission concluded that Heathrow Airports Ltd ('HAL') had pursued a course of conduct which operates and may be expected to operate against the public interest in that it imposed a levy - the HALT (Heathrow Airport Licensed Taxis Ltd) levy - on all taxi drivers picking up customers at Heathrow without first ascertaining, by tender or otherwise, such questions as whether all aspects of the service were in the interests of taxi drivers; whether they could be obtained at a lower price from a commercial provider; or whether a better service could be obtained from a commercial provider for the same price. The adverse effects of this conduct were that a levy had been imposed on taxi drivers without any basis for the regulatory authorities to determine whether the services provided by HALT were of benefit to taxi drivers (whether or not members of HALT) or represented value for money to them, and to passengers, or whether the methods used were currently cost-effective; and that taxi drivers (whether or not members of HALT) did not have the protection against excess charges that would be afforded if the services were provided under normal commercial arrangements or if BAA had taken the steps previously referred to.
- 7.8 The Competition Commission recommended that a condition should be imposed that would enable the CAA to give a direction preventing BAA collecting the HALT levy on a compulsory basis while the direction remained in force. The power would arise if at any time it appeared to the CAA that it was not in the public interest that the HALT levy should continue on a compulsory basis. For that purpose, the Competition Commission recommended that the CAA should invite BAA to produce evidence within six months that satisfied the CAA that the HALT service was of benefit to the taxi drivers who use Heathrow (whether or not members of HALT) and their passengers; that the benefits outweighed the costs of providing the service; and that the service could not be provided in a more efficient and cost-effective manner. The CAA should then in due course decide whether to give a direction under the condition. However, if the CAA was at any time minded to give a direction under the condition, it should consult HALT before coming to a final decision. If BAA produced evidence that satisfied the CAA that the HALT service was of benefit to the taxi drivers and their passengers, the CAA should from time to time, say every five years, invite BAA to provide evidence that that was still the case.
- 7.9 The CAA considered whether it should implement the condition as recommended by the Competition Commission. It saw no difficulty in proposing a condition which placed on HAL an obligation to report to the CAA within six months as described in the previous paragraph. The CAA did however have some doubts as to whether it could implement in the terms suggested by the Competition Commission the second part of the recommended condition,

namely that it could give a direction to HAL to cease the HALT levy on a compulsory basis if it thought that it was not in the public interest for the levy to continue. As far as directions are concerned, it was not clear that the CAA had powers of direction under the Act and, in any event, the CAA had doubts whether giving the proposed direction would satisfy the requirements of section 46(2) of the Act. The second issue was whether the CAA could itself make a public interest finding. Although when it makes a reference of a designated airport to the Competition Commission the CAA can express a view on whether an airport has acted against the public interest over the previous five years, the Act did not seem to give the CAA wider powers to make public interest findings which are reserved to the Competition Commission.

7.10 Given these concerns the CAA proposed a condition, which differed in detail from the Competition Commission's recommendation, but which the CAA believed would have an equivalent effect in remedying or preventing the adverse effects specified in the Competition Commission's report. Within six months of the condition coming into force HAL would have to provide evidence to the CAA of the kind described above. If following an analysis of that evidence the CAA was not satisfied that the relevant tests described by the Competition Commission are met then HAL should cease the compulsory HALT levy.

7.11 The CAA received a number of representations on its proposal from HALT and from individual taxi drivers and a representative organisation. These addressed a number of issues relating to HALT that went beyond the scope of the Competition Commission's public interest finding and the CAA's proposed condition. The CAA is therefore unable to take these into account. At a hearing held on 30 January 2003, attended by HALT, the London Cab Drivers Club, individual taxi drivers and BAA, the CAA invited views on the proposed condition. HALT and BAA were content with the condition as proposed. Taxi drivers made comments on two main aspects:

- the arrangements for consultation with the taxi market;
- references in the preamble to the proposed condition to a possible tendering of the services currently provided by HALT.

7.12 Taxi drivers were concerned that the condition as proposed would allow HALT and HAL to make representations as part of the process of review of the services provided by HALT but taxi drivers would not be able to. The CAA agrees that the views of taxi drivers expressed both through their representative organisations and individually will be important. It will therefore make it clear in the condition that taxi drivers will be able to make representations and that there should be a reasonable process by which their views are sought. The CAA does not believe that it should lay down the form of this process but it would expect HAL to take all reasonable steps to bring matters to the attention of taxi drivers.

- 7.13 The CAA wishes to make it clear that the condition it is proposing does not require HAL to put the HALT service (i.e. the provision of taxi information desks) out to competitive tender. However, in the light of comments made by the Competition Commission and BAA, tendering of the service would be a means of testing whether the service could be provided in a more efficient and cost-effective manner. The conditions of any such tender would be primarily for HAL to determine although it will no doubt have taken note of the concerns expressed by taxi drivers about the possible outcome and will wish to ensure that no conflicts of interest arise. The CAA does not propose to make any changes to the condition in this respect.
- 7.14 Having considered the arguments made at the hearing, and after seeking further comments from those who attended the hearing, the CAA has decided to impose the condition at Annex 11. The changes from the CAA's earlier proposal confirm the role of taxi drivers in the review process. Condition (a) has also been revised to allow for the interests of those who may use the HALT services but who do not subsequently use a taxi at Heathrow to be taken into account. There were no objections to these changes.

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8. Other issues raised in responses

- 8.1 British Airways¹⁶⁸ expressed its disappointment that the Competition Commission had not made any public interest findings with respect to a number of concerns the airline had on property issues at Heathrow and Gatwick. buzz, easyJet and Ryanair¹⁶⁹ were disappointed that the Competition Commission had made no finding concerning fuel charges at Stansted. The CAA's locus in the reviews is limited to setting price caps for airport charges and remedying any public interest findings the Competition Commission made. Therefore, the CAA cannot deal with matters, which were not found to be against the public interest as part of this process. If the issues are about relevant activities (defined in section 36(1) of the Act) the CAA can impose conditions on the airport operator following an investigation under section 41 of the Act.
- 8.2 flybe¹⁷⁰ said that the costs of transfers should be paid for out of a separate charge levied only on transfer passengers. The Competition Commission made no finding on this issue, the summary (in the Competition Commission's report) of flybe's evidence to it does not mention the matter so it may not have been raised with the Competition Commission. Therefore the CAA also has no locus in this matter during the current process.
- 8.3 SAS¹⁷¹ asked that a separate factor be added to the price formulae covering Terminal 5. This would be one way of making the effect of Terminal 5 on charges more transparent, but it is not the only way. The CAA believes that adding an additional factor to the formulae would make them more complicated and is not warranted.
- 8.4 Mr Hooper¹⁷² requested that the CAA should delay setting the price caps until the Government's consultation on runway developments in the South East is completed. The Act allows the CAA to extend the period of the price caps once, and then only for one year. The CAA has already extended the caps for an additional year to ensure that the decision on the planning inquiry into Terminal 5 was made, so another extension is not possible.

¹⁶⁸ British Airways (10 January 2003), Responses to the CAA Proposed Q4 Decision for BAA's London Airports

¹⁶⁹ buss, easyJet and Ryanair (January 2003), CAA Proposals for Stansted Airport Charges 2003-8

¹⁷⁰ flybe (December 2002), Heathrow, Gatwick and Stansted Airports CAA Proposals for Consultation

¹⁷¹ SAS (January 2003), CAA proposal for BAA Airport Regulation 2003 – 2008

¹⁷² Mr Hooper (January 2003), Re: Proposals for landing charges at Heathrow, Gatwick and Stansted Airports

- 8.5 Mr Stevens suggested that BAA should be allowed to insure against the risk that air travel might be suddenly capped by international agreement to curb global warming and the costs should be passed on to airport users through airport charges. This is entirely a matter for BAA. The CAA has no powers to compel BAA to take out such an insurance policy and therefore cannot act on this suggestion.

9. CAA decision

9.1 The CAA has considered carefully all the written responses to the proposals it published in November 2002 and the points made at the oral hearings held in January 2003. For the reasons discussed in this document, the CAA has decided to implement those proposals other than in the following respects:

- the air traffic movement related incentive at Heathrow will not be implemented until the introduction of an aerodrome congestion term as part of the remedy to the adverse finding by the Competition Commission on service quality;
- a relaxation of the proposals in respect of the recovery of additional security costs at Heathrow, Gatwick and Stansted so that the hurdles apply against the total annualised spends of all new security requirements within Q4;
- minor amendments to the conditions following the adverse findings of the Competition Commission on service quality at Heathrow and Gatwick and on taxis at Heathrow.

9.2 In reaching the decisions on the price caps to apply at Heathrow, Gatwick and Stansted during Q4 as set out in this document the CAA has followed the recommendations of the Competition Commission and the policies that underlie them other than in the following respects:

- the recovery of additional security costs at Heathrow, Gatwick and Stansted;
- an air traffic movement related incentive at Heathrow;
- the level of the price cap at Stansted;
- 'stand-alone' regulation of each of the three airports rather than a system approach.

9.3 In accordance with sections 46(1) to (5) of the Airports Act 1986, the CAA hereby imposes the conditions in respect of Heathrow, Gatwick and Stansted Airports set out in Annexes 9 to 11 of this document. The CAA considers that the implementation of these conditions is best calculated to achieve the objectives of section 39 of the Act.

Civil Aviation Authority

28 February 2003

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