

OFT Market Study of UK Airports

Submission by Legal & General Assurance Society Ltd and Hines UK Ltd

Summary

- 1 Legal & General Assurance Society Limited ('L&G') and Hines UK Limited ('Hines UK') welcome the decision by the Office of Fair Trading ('OFT') to undertake a market study of UK airports and the opportunity it provides for them to set out their concerns over the manner in which BAA plc ('BAA') operates its airports. In particular, L&G and Hines UK are concerned over the extent to which BAA is able to exploit its near monopoly in the ownership and operation of airports within South East England when acquiring and developing land at those airports, whether for operational use or for commercial activities that are ancillary to airport operation.

- 2 We consider that BAA's ability to influence the development of commercial facilities at its airports in its favour places competing developers, such as L&G and Hines UK, at an unfair competitive disadvantage and is likely to result in BAA developments being less economically efficient, less cost effective or quite simply not as good as rival proposals that could otherwise be developed. We are also concerned that BAA is able to use its statutory compulsory purchase powers to acquire land for commercial development, as well as for its operational needs, to the exclusion of alternative users of that land. We believe that this situation gives rise to significant consumer detriment and that it should be remedied by BAA being prevented from undertaking developments beyond the core operational needs of those airports it continues to own or, at the very least, by opening up the development process to competition through the imposition of an obligation on BAA to treat rival proposals to develop land within or next to its airports on equal terms to its own proposals. Given the scope for conflicts of interest in such an arrangement, this obligation should be policed by a neutral third party. We also maintain that BAA's ability to acquire land using its compulsory purchase powers¹ should be more tightly constrained, so as to subject all such acquisitions to a more stringent public interest test and to limit them to those acquisitions required to meet its strictly operational needs only.

¹ Under section 59 of the Airports Act 1986.

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Parties

L&G

- 3 L&G is the main operating subsidiary of the Legal & General Group plc, a UK based investment company which is listed on the London Stock Exchange. Established in 1836, L&G is now the largest fund manager in the UK, with a total of £208 billion in funds under management and revenues of £31 billion in the financial year ended 31 December 2005. L&G's principal businesses are the provision of long term insurance, savings and investment products; investment management; the provision of general insurance products; and the provision of mortgage advice. Most of these activities are underpinned by L&G's extensive investment holdings. As well as financial investments, which make up the bulk of L&G's holdings, L&G also invests directly in property, both in the UK and overseas. In the 2005 financial year, L&G generated revenues of £838 million from its property holdings, out of total investment income of £26,931 million.

Hines UK

- 4 Hines UK is part of the Hines group, a privately owned, international real estate firm which has been in existence for nearly 50 years. The Hines group has a presence in more than 85 cities around the globe and investor relationships with many of the world's largest financial institutions. It has offices in 15 countries, with regional offices in Atlanta, Chicago, Houston (US headquarters), London (European headquarters), New York and San Francisco, as well as 65 other US cities. The Hines group portfolio of projects completed and underway consists of almost 900 properties worldwide, including skyscrapers, corporate headquarters, mixed-use centres, industrial parks, medical facilities and resort and residential communities. The Hines group currently controls assets valued at approximately \$12.5 billion. The Hines group's UK business was established in 2000, with an initial focus on airport developments.

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Detailed Explanation

Factual background

- 6 At the most basic level, BAA's business rests on its ownership of the land on which its airports are sited. This land may be used directly for an airport's operational activities, such as runways, taxiways, aircraft stands and terminal buildings, or for ancillary activities, such as hangars and aircraft servicing facilities, cargo storage and handling facilities, hotels, car parking, access roads and office space. In addition, BAA holds a large quantity of undeveloped land. While this land is located primarily within airport perimeter fences, BAA also owns some land in the vicinity of its airports.
- 7 Since its privatisation, BAA has sought to exploit the value of its land holdings to cross-subsidise its core operational activities. It acquired a property company, Lynton plc, in 1988 specifically for this purpose, subsequently re-launching the company as BAA Lynton in 1997. BAA Lynton also helped BAA as a whole to improve its procurement and development strategies and processes. In March 2000, BAA sold its interest in eight hotels located at its airports to a newly created fund, known as the Airport Hotels Partnership ('AHP'), producing net cash of £187 million (see **Annex 1**). A ninth hotel was added in September 2004, when BAA Lynton completed a new 500 bed, four star Radisson SAS hotel at Stansted. BAA Lynton was appointed to manage the assets of the fund and retains a right to buy back the assets after a certain period, as well as to acquire land that may be required for operational purposes. While the fund originally had a number of investors, including BAA itself, in February 2006 the Arora Family Trust acquired 100 per cent of the fund for over £300 million. BAA Lynton has recently confirmed

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that it has appointed Arora International the contract to build and operate a new five star Sofitel hotel at Heathrow airport's Terminal 5 (see **Annex 2**).

- 8 The creation of AHP was followed in December 2000 by the transfer of ten commercial properties to the Airport Industrial Limited Partnership, owned by Scottish Widows Investment Partnership and BAA, in return for £107 million in cash (see **Annex 3**). In addition to its ownership stake, BAA retained a role as property adviser to the partnership and retained management control of six properties that were located within its airports. As with AHP, BAA retains a right to re-acquire assets after a certain time or if it requires those assets for operational reasons.
- 9 In March 2005, BAA Lynton transferred certain commercial property assets (primarily cargo warehouses and offices) valued at over £800 million to a new 50:50 joint venture with Morley Fund Management, a specialist property fund manager (see **Annex 4**). Creation of the joint venture, known as the Airport Property Partnership ('APP'), led to £575 million in cash being returned to BAA. BAA Lynton's main role is now to manage and develop the assets held by APP, with Morley contributing its fund management expertise.
- 10 In addition to significant holdings of land and buildings at BAA's other airports, APP owns certain, as yet undeveloped, land within the Stansted Airport perimeter (approximately 20 acres at Taylors End and 10 acres at South Gate). In August 2005, BAA Lynton announced that it had obtained planning permission to develop 11 warehouse units at the Taylors End site, with a total floor area of 15,550 square meters (see **Annex 5**). L&G and Hines UK understand that BAA also owns land in the vicinity of Stansted Airport.
- 11 L&G owns approximately 750 acres of undeveloped land adjoining the Stansted Airport site, as indicated on the map provided at **Annex 6**. It acquired this land in 2001, pursuant to the arrangement with Hines UK summarised above, in anticipation of the future development of Stansted Airport and the surrounding Stansted/M11 area. Such development is expected to arise as a result of the airport's planned expansion and the decision by Government to direct future growth into this area, building on the improved transport infrastructure provided for the airport and related economic activity.
- 12 The planned development is centred on a new off-airport international business hub. L&G and Hines UK hope that such a development would meet the demand for premises from a broad range of potential occupiers who desire to locate their businesses at, or adjacent to, airports. Such businesses range from cargo or

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logistics groups actively involved in international air freight to a wide spectrum of office users, including major international companies, which will often wish to establish offices adjacent to airports to improve access for employees and customers alike.

- 13 An office location close to Stansted Airport is also likely to appeal to a range of other businesses looking to expand, including those involved in the Cambridge biotechnology sector. Given the planning constraints limiting development in the city of Cambridge, such businesses would be attracted to the area around Stansted Airport by the excellent communications to London and the international dimension an airport location offers, as well as top quality accommodation.
- 14 Due to airport user restrictions, much of the accommodation provided at Stansted Airport by BAA Lynton is not available to non-airport related companies. A general commerce park would provide both airport and non-airport users with a choice of accommodation, while taking advantage of the airport's position as a transport hub and concentrating new development where it is most sustainable.
- 15 BAA's preferred development option for the construction of a second runway at Stansted, located to the east of the present runway, would require more than half of L&G's Stansted land holding for the new runway itself and associated terminal and other operational infrastructure, as well as the related car parking and other ancillary uses. With this in mind, L&G and Hines UK have proposed an innovative development solution, under which L&G would give the necessary operational land to BAA and develop the ancillary commercial facilities (such as car parks) for BAA's benefit. To date, we have not received a response to this proposal from BAA. Instead, BAA has implied that it intends to use its statutory powers to obtain a compulsory purchase order to acquire the land owned by L&G, with the intention of using part of the land for non-operational purposes. Were BAA to follow this course, L&G could ultimately be forced to sell its land to BAA at a significantly discounted agricultural value. Such a value could well be far below the land's real current value and even further below its development value for BAA, which could be in the region of £1 million an acre.

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Competition concerns

- 16 L&G and Hines UK are aware that the main focus of the OFT's market study, and potentially any market investigation reference to the Competition Commission ('CC'), is the scope for enhanced competition between and within airports in the provision of passenger handling services. We also note that the OFT is considering, in particular, the extent to which intervention by the OFT, and ultimately the CC, could produce significant consumer benefits in terms of "*timely and adequate investment in UK airports*" and "*a better value service to the UK traveling public*".² We would suggest that the way in which BAA acquires, holds and develops its land, as well as the financial return it receives through that development, is an important element of the overall competitive picture that should also be examined by the OFT.
- 17 As noted above, BAA's operation of an airport will require it to own, or at least control, certain operational assets within the airport perimeter, such as the runway, taxiways, aircraft stands, hangars and terminal facilities. For largely historical reasons, it has also owned all other land within the airport perimeter, which may be used for ancillary activities such as cargo handling and storage, offices, hotels, car parking and roadways, or lie undeveloped. As also noted above, certain of these assets have been transferred to various joint ventures. Nevertheless, BAA continues to manage these assets, via BAA Lynton's role as asset manager, and retains a clear economic interest in them, as well as a right to re-acquire them at a future date.
- 18 The history of BAA's property joint ventures shows that it is prepared to part with non-operational assets when financial circumstances favour this. Indeed, the experience with respect to the development of its new hotel at Heathrow shows that it is prepared to contract out the development of properties, as well as their ultimate ownership, where it does not have sufficient in-house expertise. It is also notable that BAA was rumoured to be considering selling off its car park business in the context of its defence of Ferrovial's ultimately successful hostile takeover of the company.³ This reinforces the point that there is nothing in principle to prevent

² OFT Chief Executive John Fingleton, quoted in OFT press release 109/06, 30 June 2006.

³ Such a move would have been consistent with BAA's regulatory policy concerning car parks. As recently as March 2006, BAA requested the CAA to "*consider removing [...] long term car parking [...] from the regulatory domain* [on the basis that this activity was provided in competition with others] [and] "*introducing a dual till approach for Stansted, as a framework for testing prices in advance of a final decision on the timing of the second runway investment* see *BAA Response to CAA Policy Issues Consultation Paper BAA/Q5/100* - Executive Summary, paragraph 11, page 5; Chapter 6: Scope of regulatory charges and the regulatory till, paragraphs 225 - 227, page 72; and Annex 3, Market information on commercial activities, pages 1 - 4; available at <http://www.caa.co.uk/docs/5/erqdocs/dec05/baa.pdf>.

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non-operational airport assets being developed, owned and operated by non-BAA entities.

- 19 While L&G and Hines UK understand that BAA is obliged under public procurement rules to put the development of "*airport or other terminal facilities*" to competitive tender,⁴ we note that this does not impinge on BAA's continuing ownership interest in such facilities. Furthermore, we understand that this obligation does not extend to the development of airport land for commercial purposes.
- 20 It is also important to note that BAA passes assets to the various investment funds only once they have been completed. This means that, except for new hotels, BAA Lynton is the default developer for all BAA land and therefore reaps the entire gain from the increase in value of the land developed.
- 21 L&G and Hines UK accept that BAA's continued operation of an airport requires it to have a certain degree of control over operational assets, except to the extent that specific circumstances could permit competition between assets within the same airport (most probably terminal and cargo facilities). As the OFT has noted, airports owned by BAA accounted for 92 per cent of passengers of London airports in 2005. Whilst L&G and Hines UK have not undertaken a detailed market definition exercise, we consider that both the supply and demand characteristics suggest that this constitutes a distinct market, on which BAA is super-dominant. We see no need why the market position enjoyed by BAA through its ownership of essential operational assets should extend to ancillary activities, however. Indeed, we would point to numerous examples, including in the United States, Germany and Italy, where outside companies have been brought in to undertake developments on airports.
- 22 BAA's unique position enables it to favour its own developments, whether on- or off-airport, whether of operational or ancillary facilities and whether the assets are held directly or via a joint venture. As a result, proposals from competing land owners to meet the same user requirements are not assessed on their merits. Given the conflict of interest between BAA's role as airport operator and its role as land owner and developer, we would suggest that it will inevitably favour its own 'in house' development proposals. This is likely to result in rival developments not being progressed, even if they are likely to prove more cost-effective, innovative, efficient and attractive to airport users. Such an outcome would give rise to a clear detriment to consumers.

⁴ See Schedule 1, Category 7, Part O of the Utilities Contracts Regulations 2006.

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- 23 We would also point to the iniquity of a situation where BAA is able to use its statutory compulsory purchase powers to acquire land "*for any purpose connected with the performance of [its] functions*"⁵ at its original, undeveloped value. While the extent of this power remains uncertain, it could extend to cover the acquisition of land for purely commercial purposes. Such an outcome would enable BAA to acquire land at a significantly discounted purchase price and subsequently capture the entire increase in value of commercial land, when it is ultimately transferred to a property joint venture, simply by virtue of its position as the airport operator. As well as providing an unfair financial benefit for BAA, this situation also creates a perverse incentive for BAA to increase the amount of land it acquires through these means, since the more land it can claim it needs, and therefore compulsorily purchase, the more it can subsequently develop and sell on at a massively inflated price.
- 24 We understand that the current model, under which BAA exploits its commercial activities to cross-subsidise airport operation, under the so-called single till arrangement, has been a feature of the regulatory regime since BAA was privatised. We believe that it is increasingly inappropriate and undesirable, due to the adverse consequences set out above.
- 25 We believe that BAA's ability to acquire land through compulsory purchase, and subsequently to exploit its land holdings for activities that are ancillary to an airport's operational requirements, is a structural feature of the UK airports market that relates to the manner in which BAA was privatised and is regulated. Furthermore, for the reasons set out above, we believe that this feature prevents, restricts or distorts competition in the UK. As a result, L&G and Hines UK maintain that the requirements for a market investigation reference to the CC under section 131 of the Enterprise Act 2002 are met. We would therefore request that the OFT refer the UK airports market to the CC and that any reference should request the CC to examine the impact on competition of this feature, in addition to any wider issues concerning competition between and within airports.

Remedies

- 26 While L&G and Hines UK consider that it is not appropriate to suggest detailed remedies at such an early stage of the investigative process, we believe that there is an overriding need for regulatory intervention to enable BAA and its competitors to distinguish more clearly between the operational requirements of an airport and

⁵ Section 59 of Airports Act 1986.

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its ancillary, and more commercially competitive, facilities, irrespective of whether those facilities are located on- or off-airport. Where development of ancillary facilities is concerned, proposals by BAA Lynton and those of rival developers should be assessed on their merits and on equal terms. While we do not rule out the possibility that BAA could undertake this assessment itself, we consider that the clear potential for conflicts of interest would require the process to be overseen by a neutral third party. Given the scope for protracted debate over whether a development decision by BAA did or did not favour an 'in-house' proposal, a preferable solution may well be to require BAA to either surrender ownership of, or control over, all land that is not directly required by it for the operation of its airports. In particular, L&G and Hines UK consider that the provision of commercial facilities such as car parking are not key operational needs and as such should be open to third party owners and providers. We would also maintain that the exercise of BAA's compulsory purchase powers for the acquisition of land should be made subject to a more stringent public interest test and be specifically limited to enable the purchase of land which is reasonably required for purely operational purposes only.

Contact details

27 L&G and Hines UK are happy to answer any questions the OFT may have on the contents of this submission and for a non-confidential version of this submission to be published on the OFT's website. In the event that the OFT wishes to contact L&G and Hines UK, details of the responsible people at each company are provided below:

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Chronology

Date	Event
July 1987	Listing of BAA
1988	Acquisition by BAA of Lynton plc
1991	Opening of new Stansted terminal
April 1997	Creation of BAA Lynton
2000	Hines group establishes UK presence
March 2000	Creation of Airport Hotels Partnership by BAA
December 2000	Creation of Airport Industrial Limited Partnership between BAA and Scottish Widows Investment Partnership
2001	Purchase of land near Stansted by L&G
September 2004	Completion and sale of Stansted Radisson SAS hotel
11 March 2005	Creation of Airport Property Partnership joint venture between BAA and Morley
February 2006	Airport Hotel Fund acquired by Arora Family Trust