

Inquiry into airport charges at Heathrow and Gatwick airports

Issues statement

1. Under section 43 of the Airports Act 1986, the Civil Aviation Authority (CAA) is required every five years to modify the conditions setting the maximum level of airport charges at designated airports, including Heathrow and Gatwick airports, following a reference to and report by the CC. (The CAA can extend that period by one year, as it has done for the other two designated airports, Manchester and Stansted, given the review to be carried out by the Department for Transport (DfT) of whether those airports should be de-designated.) The terms of reference of our current inquiry, sent to us on 30 March 2007, require us to consider:
 - (a) what are the maximum amounts that should be capable of being levied by Heathrow Airport Ltd and Gatwick Airport Ltd by way of airport charges during the period of five years beginning on 1 April 2008 (2008/9 to 2012/13, the fifth quinquennium, ie five-yearly period of regulation of the airports, referred to as Q5);
 - (b) whether the two companies have at any time during the period beginning with 28 February 2002 (the date of the previous reference to us of these airports) and ending with the date of this reference pursued:
 - (i) in relation to any airport charges levied by them at the airports; or
 - (ii) in relation to any operational activities carried on by them at the airports and relating to the airports; or
 - (iii) in relation to the granting of a right by virtue of which any operational activities relating to the airports 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 has at any time during the period beginning with 28 February 2002 (the date of the previous reference) and ending with the date of this reference pursued:
 - (i) in relation to any operational activities carried on by it and relating to the airports; or
 - (ii) in relation to the granting of a right by virtue of which any operational activities relating to the airports 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 falling 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 airports or by the modification of any conditions already in force in relation to the airports.

We are required to report by 29 September 2007.

2. This issues statement summarizes the main issues to be considered in the remaining stages of the inquiry, in order to give any interested parties the opportunity to provide any further comments, not only on this document but also on any of the material on our website. We are also currently carrying out an inquiry into a reference sent to us by the Office of Fair Trading (OFT) on 29 March 2007 under section 131 of the Enterprise Act 2002 into the supply of airport services in the UK by BAA, and on which we are required to report by 28 March 2009 (though intend to report somewhat earlier). We intend to issue a separate issues statement outlining our current view of the main issues in that market inquiry in the next few weeks.
3. BAA Ltd owns all the issued share capital of Heathrow Airport Limited and Gatwick Airport Limited, and also operates through wholly owned subsidiaries airports at Aberdeen, Edinburgh, Glasgow, Southampton and Stansted. Since our 2002 report, BAA plc (now BAA Ltd) has been acquired by Airport Development and Investment Ltd (ADI). ADI is a wholly owned subsidiary of FGP Topco Ltd, in which Grupo Ferrovial S.A. (Ferrovial) has a majority holding.
4. We have received a considerable volume of evidence from the CAA, BAA, airlines and others. Much of this evidence is set out on the CAA's website for the quinquennial review (<http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=67>) and our own website for this inquiry (<http://www.competition-commission.org.uk/inquiries/ref2007/heathrow/index.htm>).
5. There is a wide variation in suggestions put to us for the maximum level of airport charges in Q5.
 - (a) When making the reference, the CAA also sent us a document ('Airport Price Control Review—CAA recommendations to the CC for Heathrow and Gatwick Airports') with a recommendation that we should consider indicative ranges for the maximum annual rate of increase in airport charges of between RPI + 4 (that is, 4 per cent a year above the increase in the retail price index (RPI)) and RPI + 8 at Heathrow, and between RPI – 2 and RPI + 2 at Gatwick. The maximum level of airport charges per passenger would on that basis increase from £9.05 at Heathrow in 2007/08 to between £11.50 and £13.80 in 2012/13, the end of the five-year period for which charges have to be set (an increase of between 27 and 52 per cent over five years). Airport charges at Gatwick, £4.79 per passenger in 2007/08, would be between £4.50 and £5.50 in 2012/13 (a range from a 6 per cent reduction to a 15 per cent increase over five years). (These and other figures in this statement are at 2006/7 prices unless stated otherwise)
 - (b) In its submission to us in May 2007, BAA put forward a yield per passenger in 2012/13 of £17.97 at Heathrow (an increase of 98 per cent over five years) and £6.77 at Gatwick (an increase of 41 per cent over five years). This includes an opening adjustment at the start of the control period of £2.02 per passenger at Heathrow and 56p per passenger at Gatwick;
 - (c) Among the evidence of other parties we received, BA argued for a reduction in charges at both airports, with a formula of RPI – 1.5 at Heathrow and RPI – 4.4 at Gatwick.

The above suggestions for the maximum level of charges are themselves subject to the ongoing process of Constructive Engagement between BAA and the airlines, a process instituted by the CAA wherein the airport and airline users could discuss and, if possible, agree issues such as volume and capacity requirements; capital

projects; the nature and level of service outputs; service quality incentives; and the nature and level of the facilities/infrastructure outputs. By mid-July 2007, Constructive Engagement is expected to produce a final report to the CAA on traffic forecasts, capital expenditure and service quality regulation, indicating the areas in which the CAA and the airlines represented agree and those where they have agreed to differ. Some of the airlines at Heathrow and Gatwick are not represented in this work.

6. The issues in our review of airport charges at Heathrow and Gatwick airports fall into three main categories:

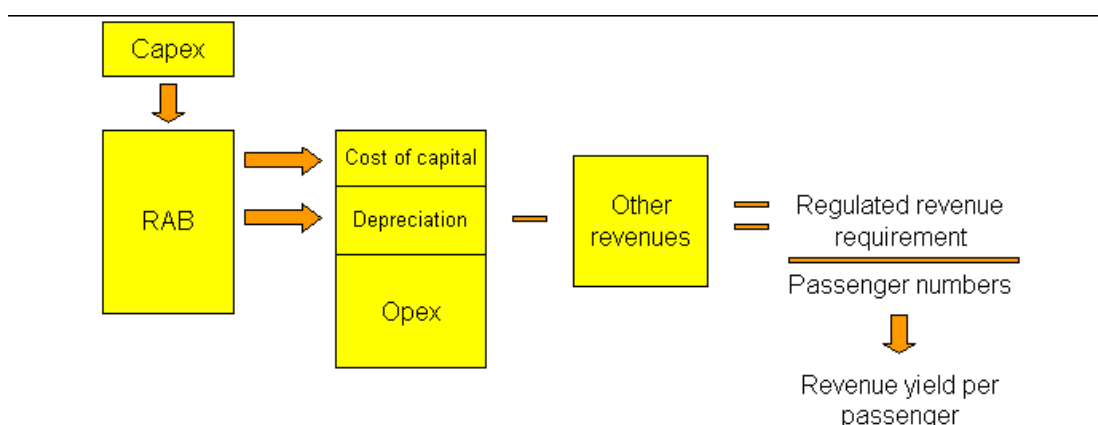
- (a) Those relevant to the structure of the price control.
- (b) Those relevant to the maximum level of charges as determined by the charging formulae. The maximum level of charges is intended to provide a reasonable return on new and existing assets—in particular to allow new investment to earn the cost of capital necessary for such investment to be carried out—after allowing for regulatory depreciation, forecast operating costs and the income expected to be generated from other activities. Figure 1 from the CAA submission to us illustrates the ‘building blocks’ of such an approach, showing the interrelationship of the seven main issues that need to be considered in deriving the required revenue yield per passenger:
 - (i) capital expenditure;
 - (ii) regulatory asset base;
 - (iii) cost of capital;
 - (iv) depreciation;
 - (v) operating expenditure;
 - (vi) other revenues; and
 - (vii) traffic forecasts.

Consideration may also be necessary of any profiling of airport charges to generate the expected revenue requirement over an appropriate time period.

- (c) Public interest issues.

FIGURE 1

The standard regulatory building block approach



Source: CAA.

(a) Structure of price control

7. Two general issues as to regulatory approach were considered in our previous reports, but have given rise to little disagreement in the current inquiry.

(a) Firstly, whether airport charges for the two airports should be set on the basis of each individual airport or on a system basis. This relates not only to the charging formulae adopted—whether the formulae should be based on airport charges at each airport or charges averaged over the two or even three London area airports; but also whether charges for individual airports should be set only on the basis of returns at that airport or should also have regard to returns for the two or three airports combined, with an element of cross-subsidy between them. During the 2002 review, the CAA adopted the individual airport approach, although the CC had recommended that the former system approach should be maintained, partly due to concern about the financing of additional runways at Stansted which may have been necessary due to constraints on runway development elsewhere. The Government subsequently supported runway development at both Heathrow (provided certain environmental and planning conditions are met) and Stansted. All airlines from whom we heard as well as the CAA argued strongly in favour of the individual airport approach, and we are also proceeding with our analysis on that basis.

(b) Secondly, whether airport charges should be set on a single till basis, after taking into account revenues from commercial activities; or a dual till basis in which airport charges are required to cover aeronautical cost without taking commercial revenues and costs into account. This issue was extensively considered by the CC in the last review, following which the CAA accepted the CC’s recommendation to continue to adopt the single-till approach. Most parties in the current inquiry have argued strongly that the single till should be maintained and we are likely to recommend doing so, although BAA has suggested that aspects of this issue could be considered further in the market inquiry.

8. There are some issues in relation to the RPI–X form of regulation we may need to consider, but with little disagreement between the parties from whom we have heard on most of them:

- (a) whether regulation should continue to be by means of the RPI–X approach, setting a price cap for five years and giving the company the incentive to outperform by, for example, delivering the required service at lower cost than had been forecast in the price determination; rather than, for example, setting airport charges to ensure they cover costs and no more than a specified rate of return. One airline argued that the RPI–X approach as implemented for BAA, through a revenue yield term, results in a bias in favour of growth and against service quality; but we would currently regard this more as a reason to reinforce provisions for service quality rather than to depart from the RPI–X approach;
 - (b) whether regulation should be on the basis of revenue yield—ie £ per passenger—rather than a ‘tariff basket’, ie a weighted average increase of all elements of the airport charging structure. Although this has been an issue in some previous Airports Act inquiries, we have received no suggestions that the revenue yield approach should not be continued and are unlikely to recommend otherwise; and
 - (c) the treatment of non-passenger flights. Since the revenue yield approach is calculated only with reference to number of passengers, separate treatment is necessary of non-passenger flights. These are currently excluded from the regulated yield, but subject to the requirement that the charges applied to such flights (eg for landing) should be the same as for passenger aircraft. Subject to any further evidence we may receive, this approach is generally not in dispute.
9. There are, however, a number of more detailed issues as to the workings of the RPI–X formula:
- (a) Whether there should be a volume term for differences between the actual number of passengers at each airport in any year and the numbers expected when the airport charges formula was set. The appropriate size of X, and the subsequent outturn, is sensitive to the traffic forecasts used which affect not only the revenue from airport charges but also revenue from commercial activities. In previous reports, we have discussed whether, in view of the uncertainties about traffic growth, there should be a volume term in the formula, but considered that there would not be any significant advantage from doing so; we have heard no arguments in favour of a volume term in this inquiry. Such a term might result in higher prices during a downturn, as airlines would be hit not only by lower passenger numbers but also by higher prices;
 - (b) Incentives for efficiency in operating expenditure. The RPI–X formula gives some incentive to reduce operating costs. However, the incentive is largest at the beginning of the five-yearly period and declines during it, since the resulting lower operating costs are taken into account in setting X for the subsequent period. The CAA raised the option of an ‘Opex roll-over’ which would allow the company in such cases to continue to receive the benefits of operating expenditure reductions in the subsequent review. BAA could, for example, be allowed to retain the benefit of cost savings for a full period of five years, regardless of when it made them during the regulatory cycle. One airline argued against that approach, suggesting that the formula should itself be set on the basis of a ‘real opex challenge’. Such an approach might, however, increase significantly the complexity of the price control, and would be likely to require difficult accounting judgements to implement it;
 - (c) Investment incentives. As noted in Figure 1, an assumed level of capital expenditure (issues relating to which are set out further below) is a main input

into determining the size of X. But other measures may be necessary to ensure appropriate investment is carried out:

- (i) 'Triggers': including how many should there be and what impact should they have on X or on BAA? In our 2002 report, we recommended a number of triggers relating airport charges to progress in achieving investment milestones on particular capital projects, notably on Terminal 5 at Heathrow. In Q4, five triggers were adopted at Heathrow; in each case, failure to achieve the relevant investment milestone on time would reduce the value of X by 1/6th per cent for each month that the project is delayed, and by 2 per cent a year thereafter. We also recommended one trigger linked to Pier 6 at Gatwick, set at 1/12th per cent for each month that the project is delayed and by 1 per cent a year thereafter. (However, we acknowledged that the effect of the triggers could prove significantly less than the cost savings to BAA, or extra costs to airlines, from any protracted delay to the projects.) Triggers for Q5 are currently being discussed as part of Constructive Engagement; one airline, for example, suggested 11 possible triggers to us. We understand Constructive Engagement at Heathrow has recently produced agreement on the principles for capital investment triggers for Q5, and work is continuing to produce a manageable list.
 - (ii) One airline suggested to us that triggers should not necessarily be used to reduce the overall level of airport charges but to reduce charges to those users adversely affected by any delay to particular projects. Arguments against that approach put to us are that it could require a difficult judgement, particular developments benefiting not only users of a particular facility but other users, for example in reducing congestion elsewhere and freeing capacity to allow their traffic to grow; also that it may be more difficult to include user-specific triggers in the charging formula.
 - (iii) There is currently no other mechanism to relate charges to investment, or to require BAA to invest either in particular projects or the aggregate amounts assumed in setting X. We recognize, however, that such a requirement could itself have disadvantages. In a draft statement of regulatory policy, included in its submission to us, dealing with the risks of particular financial arrangements (to which we refer further below), the CAA said that it would expect at its Q6 review to identify whether (and the extent to which) the level of investment had fallen short of that which might reasonably have been expected to have taken place had the airports adopted financial arrangements consistent with those assumed in setting the price control in Q5. If the CAA had reasonable grounds at that time to suspect a significant divergence due to financial causes as opposed to operational or business reasons, it would expect to scrutinize in more detail the execution of the investment programmes of the two airports with a view to making retrospective adjustments for divergences between overall outturn and projected capital expenditure that could not be fully justified.
 - (iv) One airline told us that it regarded such a five-year mechanism as inadequate, and suggested an annual progress review mechanism to include changes in capital expenditure plans and issues other than capital expenditure.
- (d) Security cost pass through. The CAA has proposed to increase the pass through of additional costs (above a de minimis level) of meeting additional security requirements in Q5 from 75 to 90 per cent of the additional costs incurred. (In the last review, the CC suggested it be maintained at the former 95 per cent).

One airline has supported this (and increasing the de minimis amount by RPI), although others have preferred no increase. Significant changes in the security situation have continued to occur during Q4, including the additional DfT and EU security requirements, the costs of which will, however, receive particular scrutiny during our inquiry.

- (e) The correction factor. Over- or under-recovery of the permitted yield is currently subject to a subsequent correction factor, but applied on a £ per passenger basis, which may benefit the airports if the number of passengers has increased. The CAA proposed the correction factor be amended to recovery of an absolute amount; we are not aware of any objection to that or reasons not to do so. This change has attracted support from those who commented.
- (f) Treatment of discounts. In calculating revenue yield, airport charges are treated before any reduction of discounts (otherwise, discounts to one airline could be financed by higher charges to other airlines). The CAA proposed to retain this approach; we are not aware of any objections to that or reason not to do so.
- (g) Alternative to RPI. One airline also suggested substituting the Consumer Price Index (CPI) for the current use of the RPI. There was no support for this innovation from the CAA or other airlines and there is no regulatory precedent in the UK for changing index, though most sector regulators have examined the issue at some point. Most sector regulators have concluded that the value of continuing to base controls on RPI is, firstly, that precedent favours RPI, and secondly that significant cost items of regulated companies, such as index linked bonds which are used to calculate the cost of capital and wage settlements, are generally linked to RPI.

10. As to the scope of airport charges which are to be regulated:

- (a) Outbound baggage infrastructure and operating costs are currently not included in airport charges but recovered through other charges such as check-in desk rentals; in contrast, inbound baggage costs are treated as part of airport charges. CAA recommended that all baggage infrastructure costs should be treated as part of airport charges, but not operating expenditure. One airline argued to us that this would impact unduly on short-haul operators whose passengers had less hold baggage, although another disputed this, particularly following recent restrictions on the amount of cabin baggage. The first operator also believed it would be further disadvantaged having already financed improvements to the baggage infrastructure it used.
- (b) CAA have also suggested that the current fuel turnover levy be discontinued and the amounts previously raised be recovered from airport charges; one airline said that it was surprised by this since there had been no consultation on it.
- (c) Provision may also be necessary for airport air traffic control charges to be included in airport charges should the DfT decide to discontinue separate charges for this service.

Capital expenditure

11. For the purpose of its recommendations to us, the CAA adopted the BAA's then current projections of total capital expenditure in Q5 of £2,839 million at Heathrow, and of £422 million at Gatwick (at 2006/07 prices and before allowing for construction inflation), but subject to revision (as a result, for example, of continuing Constructive Engagement discussions between BAA and the airlines) both of the projects to be

undertaken and their costs. BAA in its submission to us projected capital expenditure of £2,844 million at Heathrow and £421 million at Gatwick in Q5 (at comparable 2006/7 prices), but subject to the possibility of some additional expenditure at both airports (its submission indicating a possible additional expenditure of £200 million to £300 million at Gatwick) and to a satisfactory outcome of the regulatory review. BA, however, suggested X could be reduced by 0.25 at Heathrow by improving the efficiency of BAA's capital expenditure; it noted that additional capital expenditure could increase X by 1.2 at Gatwick, but this would be offset by the effect of higher passenger growth which the increased capital expenditure would support.

12. It is clearly important that constructive engagement between BAA and the airlines resolve uncertainty as to the projects to be undertaken, although we recognize that certain details of the schemes will require continuing discussion as the projects develop. Agreement between BAA and the airlines is a far preferable basis for deciding the investment programme than relying on the judgement of ourselves or the CAA. The main issues raised with us are:
- (a) The Heathrow East Terminal (HET) development. While airlines supported HET in principle to give competitive equivalence between airlines that would otherwise use the current Terminals 1 and 2 (which would be replaced by HET) and BA which will use Terminal 5, there were concerns from some airlines that, as of mid-May, they had still seen no detailed costing or business case on HET. But we understand there is now a large measure of agreement on this scheme.
 - (b) Automated baggage connectivity between Terminal 5 and the Central Terminal area was previously opposed by some airlines but strongly supported by BA and its oneworld partners for the purposes of connections between Terminal 5 and Terminal 3, out of which BA and its alliance will continue to operate. But again we understand there is now a large measure of agreement on this scheme.
 - (c) Complaints of insufficient investment in BAA's Capital Investment Programme (CIP) in Terminals 3 and 4 and insufficient investment in additional pier service and stand provision, but we understand these issues have also been largely dealt with in the updated CIP.
 - (d) Suggestions that BAA had originally planned insufficient investment at Gatwick; but with subsequent concerns also about a significant increase, to about £750 million, it later proposed during the course of our inquiry, initially with little consultation or detailed supporting material.
 - (e) Other more general criticisms of BAA's consultation process put to us concerning inadequate involvement of airlines in the initial stages of considering options for projects and the resource-intensive nature of BAA's consultation process more generally, especially for smaller airlines with limited resources and without membership in one of the alliances.
 - (f) BAA's public statements that it would not undertake some of its investment programme, including HET and other additional capital expenditure at both airports, if the regulatory settlement was based on what BAA regarded as an inadequate cost of capital; and how, in such an event, this should be taken into account in setting X. (In its submission to us, for example, BAA suggested the investment programme at Heathrow could be reduced to as little as £500 million). There appear to be three options: recommendation of clawback of unspent allowances at the Q6 review; a variable X dependent on whether BAA undertakes the investment; or enhanced capital expenditure triggers, contingent on whether the promised developments are undertaken.

- (g) The appropriate treatment of any preparatory expenditure on mixed mode operation or Runway 3 and associated terminal facilities at Heathrow, for which there is currently no provision in BAA's capital programme. BA and other Heathrow airlines strongly support such schemes, on which the DfT is to consult in autumn 2007. One approach we saw suggested was to create a process to amend the yield to reflect the impact of developing mixed mode or runway 3 options in Q5; an alternative approach would be to include such expenditure in the Regulated Asset Base for Q6.
13. We will also need to consider issues in relation to BAA's project costs:
- (a) The Currie & Brown report commissioned by CAA suggested relatively limited scope for efficiency savings, at about 5 per cent, which BAA has said are now built into its project costings.
- (b) The airlines have also criticised the scale of on-costs (design and management costs) and of risks of costings of individual projects being exceeded (for which BAA includes a provision for 'risk allowances' over and above the estimated base costs). The Currie & Brown report suggested savings of between 1 and 2 per cent for on-costs and scope for refinement of the current approach to risk management, but suggested that BAA's typical risk allowance of about 25 per cent was broadly in line with its peer groups. It also noted the proposal of some airlines that the amount of risk held at project level be reduced and funds be retained at capital investment portfolio level on the basis that costs might otherwise be overstated against the likely outcome.
- (c) We also received criticism of inadequate information in the CIP to support the estimated project costs, with cost breakdowns provided only for one half of the major projects, and the on-cost and risk allowances not explained.
- (d) The CAA submission to us also drew attention to uncertainty over the assumed level of construction price inflation during Q5, assumed by BAA as 2 per cent above growth in RPI, which some airlines said was a higher rate than some other forecasts. This poses three questions: whether an allowance for construction price inflation is appropriate; if so whether that allowance should be based on RPI; and what the variance should be from whatever generic inflation index chosen.

Regulatory asset base

14. The mechanism for rolling forward the RAB was set out as part of the CAA's price control decision for Q4. We are not aware of any major methodological dispute, but the following detailed issues will need to be considered:
- (a) On the treatment of asset disposals:
- (i) whether these should generally be valued at market value at the time of sale, or otherwise;
- (ii) the valuation of the transfer of property interests from the airport operating companies (HAL and GAL) to BAA partnership and the subsequent transfer to the joint venture known as Airport Property Partnership (APP) or to any other joint ventures and the implications of any onward sale by any joint venture;

- (iii) a specific question raised by CAA as to how the hotel site at Terminal 5 should be valued; BAA has argued this should not be at market value since income from hotels has previously been treated as outside the scope of the single till. We will wish to consider the apportionment of land to and the valuation of that and any similar sites sold;
 - (iv) the treatment of any tax arising on asset disposals (given the use of a pre-tax cost of capital);
 - (v) whether BAA was entitled to a return on property assets disposed of early in Q4;
 - (vi) uncertainty raised by BA as to how the sale and leaseback of electricity infrastructure in the 1990s affected the RAB; and
 - (vii) the use of projected rather than actual depreciation in rolling forward the RAB. BAA noted in its submission to us that the higher than forecast capital expenditure at Heathrow results in projected depreciation used in adjusting the RAB being lower than actual depreciation, hence increases the opening RAB. At Gatwick, lower than expected investment at Gatwick results in projected depreciation being higher than actual depreciation, reducing the opening RAB.
- (b) The appropriate treatment of asset write-offs, the CAA currently being inclined to continue to allow write-offs without a reduction in the RAB; to do otherwise, it argued, could provide a disincentive to upgrade facilities.
 - (c) The suggestion of one airline that there should be an adjustment for under-investment at Gatwick in Q4 compared with that which was expected when the charging formula for Q4 was set (ie subtraction of the return allowed on investment which did not take place).
 - (d) The suggestion of some airlines that the value of the RAB should be adjusted for previous excess investment costs, including those suggested by the Currie & Brown study and what one airline referred to as the excess costs of Terminal 5 compared with the industry norm; CAA argued against this.

Cost of capital

15. Cost of capital is one of the main issues we have to consider:

- (a) In our previous report, the CC estimated a real, pre-tax cost of capital of 7.75 per cent for the three BAA London airports; the CAA adopted a 7.75 per cent cost of capital at Heathrow and Gatwick, based on a somewhat different approach to that used by the CC.
- (b) In its recommendation to us, the CAA presented provisional estimates of a real, pre-tax cost of capital at Heathrow of between 5.9 and 6.2 per cent, and at Gatwick of between 6.3 and 6.7 per cent. For the purposes of modelling the illustrative price cap, it used the figures at the top end of the range, 6.2 per cent at Heathrow and 6.7 per cent at Gatwick.
- (c) BAA in its submission to us submitted a range for the real pre-tax cost of capital of 7.25 to 8.25 per cent; the mid-point of the range estimated by its consultants OXERA was about 7.6 per cent at Heathrow and 7.8 per cent at Gatwick.

- (d) Among other estimates we saw were those of Cambridge Economic Policy Associates (CEPA) who advised BA. CEPA considered revenues should be set on a post-tax basis, but estimated the most likely pre-tax equivalent figures for BAA as between 5.6 and 6.1 per cent depending on the taxation rates assumed (the figures would be somewhat lower if an automatic adjustment mechanism in relation to the cost of debt were introduced).
 - (e) CAA also noted that the value of X was very sensitive to the figure adopted for the cost of capital; it estimated that a 0.25 per cent variation in cost of capital would lead to a 1 percentage point change in X at Heathrow and 0.7 per cent at Gatwick; the difference in the high end of the CAA and BAA estimate of cost of capital would therefore affect X by 4.9 percentage points at Heathrow and 3 percentage points at Gatwick.
 - (f) Using the low end of the CAA's range rather than the high end reduces the X by 1.2 percentage points at Heathrow and 1.1 at Gatwick, if the CAA's cost assumptions and RAB forecasts are used.
16. Most of the issues relevant to estimating the cost of capital relate to the components of the Capital Asset Pricing Model, a widely used methodology for this purpose; namely, the appropriate:
- (a) risk free rate;
 - (b) debt premium;
 - (c) equity risk premium;
 - (d) asset and equity beta (including any effect of gearing on the equity beta);
 - (e) debt beta;
 - (f) treatment of taxation; and
 - (g) appropriate level of gearing (including whether a nominal level should be used as by the CAA and in our previous report, or whether we should use actual levels, or should be looking for the most efficient level of gearing).

The recent estimates of BAA, CAA and BA, and of the CC in the last review, of each of these components is shown in Appendix A.

17. Other issues to be considered are:
- (a) whether other models for estimating the cost of capital should also be considered, our current view being not to pursue other models;
 - (b) whether the price bid by Ferrovial/ADI for BAA relative to its former market value and/or the regulated asset value of its regulated airports has implications for the cost of capital;
 - (c) different costs of capital for different airports;
 - (d) whether we should use the post-tax rather than the pre-tax cost of capital;
 - (e) whether we should take account of refinancing costs;

- (f) whether we should consider a 'split' cost of capital applying at a different rate to existing and new assets respectively;
- (g) whether there should be any indexation of cost of capital for changes in debt costs;
- (h) whether and, if so, how we should allow for any asymmetric risk: ie whether given the uncertainties in the estimates of cost of capital, the disadvantages of understating the cost of capital, thereby deterring investment, may exceed the disadvantages of overstating the cost of capital. Airlines from whom we heard argued against doing so; and
- (i) the implications of any apparent inconsistency in the cost of capital at different reviews, for example on incentives to invest.

Depreciation

18. We are not aware of any issues regarding BAA's calculation of Q5 depreciation; however, there is a doubling of the depreciation charge at Heathrow in Q5 relative to Q4, which feeds directly into the Q5 revenue requirement, and which arises largely from the anticipated completion of Terminal 5 at the beginning of the control period.

Operating costs

19. Following increases in BAA's operating cost projections since its submission to the CAA in September 2006, the difference between BAA's and CAA's recommendations of March 2007 also has a significant effect on the size of X.
- (a) CAA's initial proposals to us were for operating costs of £3,435 million over Q5 at Heathrow and £1,065 million at Gatwick.
 - (b) BAA's forecast in its submission to us was for operating costs of £3,910 million at Heathrow and £1,244 million at Gatwick.
 - (c) A number of airlines have argued there is more scope for cost reduction than assumed by CAA, noting in particular the achievement of substantial cost savings by themselves in the face of strong competitive pressures in the airline market for passengers and cargo. BA, for example, argued that more demanding assumptions on the potential for operating savings through Q5 would save a further 6 per cent on Q5 operating costs at Heathrow compared with the CAA recommendations, reducing X by 2.1 percentage points, and with scope for similar percentage savings at Gatwick.
20. The following are the main issues relating to operating costs:
- (a) Whether we should adopt the CAA's approach of estimating a trend baseline level of operating costs for the first years and then estimating costs in subsequent years by adjusting this baseline to reflect volume growth, efficiency improvements and one-off expenditure; or alternatively whether we should adopt BAA's approach of estimating all cost items on a bottom-up basis in each year. If we were to adopt the CAA's approach:
 - (i) what the baseline level of operating costs at each airport should be;
 - (ii) how costs in subsequent years should be adjusted to reflect volume growth;

- (iii) what annual rate of efficiency improvement should be assumed; and
 - (iv) what one-off costs should be allowed for separately.
- (b) BAA's manpower projections:
- (i) The Booz Allen Hamilton process benchmarking report for CAA identified at least some potential for efficiency and/or effectiveness improvement for all processes examined. For example, it suggested substantial scope for productivity improvements in passenger screening at central search at all Heathrow and Gatwick terminals of between 5 and 12 per cent by increased flexibility of rostering, and from reductions in levels of absenteeism, but acknowledged that subsequent changes in security processes meant that this quantitative assessment was no longer likely to be valid. Scope for improved efficiency was also found in other processes, including trolley management and airside and perimeter security.
 - (ii) The IDS study of employment costs for the CAA (see below) found that many staff were paid above the median rate for similar jobs in the relevant region. IDS also found that the average number of days lost per employee owing to sickness was significantly above the national average and that BAA's pension scheme was unusually generous.
 - (iii) The KPMG LLP report on the finance and facilities management costs of BAA concluded that the finance function was generally relatively efficient with salary costs broadly in line with market rates, but with scope for further savings of between zero and 6 per cent over the next few years. KPMG found that although BAA's facilities management was relatively efficient compared with its benchmark, there was scope for efficiency improvements of between 1 and 7 per cent of property costs.
 - (iv) Based on the evidence in these reports, the CAA allowed for 1 per cent a year efficiency improvements.
 - (v) BAA's bottom-up year-by-year projections include productivity improvements as a result of various change programmes but these are partly offset by additional security staff and other requirements, in particular a net cost increase resulting from the opening of Terminal 5 and the closing of Terminal 2.
 - (vi) Among airlines' criticisms are that the CAA has assumed a level of efficiency improvement below that assumed by other regulators; that the benchmarking studies suggest further scope for productivity improvement than assumed by the CAA; that BAA productivity trends are significantly worse than the airlines' own more significant improvements in productivity; and that there is scope for market testing and contracting out of more functions carried out in-house by BAA, including security processes.
 - (vii) Some airlines also objected to BAA's adoption of a higher standard for security queues (discussed further below) and the additional costs that would result.
- (c) The implications of current and projected pay levels. The IDS report for the CAA referred to above showed that security staff were paid at the upper quartile for jobs of similar weight within the relevant regional labour market; engineering technicians and senior managers between the median and upper quartile; and

administrative-type support staff and supervisory and managerial staff at the lower grades between the median and lower quartile. But it also noted that it would expect to see airport security staff at busy international airports to be at the upper part of the earnings distribution.

(d) On pensions:

- (i) whether the pension costs allowed should be on the basis of the anticipated service costs, or anticipated cash contributions to the pension fund each year or on the anticipated pension charge to the profit and loss account, which takes into account investment gains on fund assets and interest costs on fund liabilities.
- (ii) whether there should be an adjustment to the RAB for the Q3 pension fund contribution holiday, and, if so, how; and
- (iii) the treatment of any higher pension costs resulting from the revised investment strategy of the pension fund, and consequent increase in BAA's annual cash contributions, in the light of ADI's takeover of BAA and proposed leveraged structure.

A number of airlines have also commented on the terms of the pension fund compared with other schemes; the IDS report noted that the BAA accrual rate was significantly more generous than for most other schemes. The CAA has proposed for Q6 a more holistic approach to considering salary and pension costs.

(e) On other cost items:

- (i) CAA reduced BAA's initial projections for *utility costs* for the two airports from £630 million over Q5 as a whole to £543 million, based on the high range of a forecast commissioned from IPA; in its submission to us, BAA subsequently reduced its own forecasts due to a change in market conditions to within £19 million of those IPA estimates.
- (ii) Allocation of *centrally incurred costs*, including CAA adjustments, following the LECG report it commissioned, to the 'capping' by BAA of the allocation of central cost to particular businesses which increases the costs allocated to Heathrow and Gatwick; and removal of the BAA's 'mark-up' applied to central costs.
- (iii) *IT Costs*. Some airlines considered there was scope for contracting out parts of BAA's IT activities; the KPMG report commissioned by the CAA found the underlying costs of BAA's IT infrastructure operation to be in line with or better than benchmark averages.

Other incomes

21. The difference in view between BAA and CAA on other incomes had a relatively limited effect on X: about 1 percentage point. BA, however, argued that there was scope for a significant increase in retail revenues, above that assumed by CAA, which would reduce X from that recommended by CAA by 2.4 percentage points at Heathrow and 2.2 at Gatwick.

22. BAA's performance in generating commercial revenues was significantly better in Q4 than expected at the time the current charging formula was set. On the future growth of commercial income:
- (a) BAA was reported in the CAA's December 2006 proposals as forecasting a decline in commercial revenues per passenger of 0.8 per cent a year.
 - (b) In a report to the CAA, Donaldsons suggested that commercial performance across the spectrum of commercial activities could offer an improvement of about 5 per cent. The CAA adopted commercial revenues per passenger some 4 per cent higher than BAA's projections: retail revenues per passenger declining during Q5 from £4.50 to £4.35 at Heathrow and from £4.14 to £3.97 at Gatwick (at 2006/7 prices) and total commercial revenues from £5.67 to £5.58 at Heathrow and from £4.84 to £4.65 at Gatwick.
 - (c) A number of airlines believed the CAA projections were too low. BA suggested using information available from its consultants, Pragma, that retail revenues at Heathrow (excluding bureau de change, car parking and property revenues) could increase from £3.30 per passenger to £3.78, rising to £3.86, per passenger. It argued that such increases could result from reductions in security processing times, leading to increased airside dwell times, increased retail space per passenger, the improved targeted retail offer in Terminal 5, and increasing longhaul/non-EU share of traffic.
 - (d) BAA did not accept Donaldsons' conclusions, also arguing that additional expectations of improved commercial revenue were unreasonable unless its incentives were to be improved by a relaxation of the single till constraints.
 - (e) The CAA submission to us also drew attention to concerns of one airline about the arrangements with World Duty Free, and whether they enabled BAA to enhance its return on the single till at each airport. We would also need to consider the implications of any possible sale of World Duty Free.
23. On non-regulated aeronautical revenues (ie charges to airlines excluded from the scope of the charging formula) the CAA's position in its submission to us was that the principles for non-regulated charges which had emerged from the Constructive Engagement discussions at Heathrow and Gatwick would provide adequate protection to users, in particular of transparent cost-based recovery of costs and with regular consultation with airlines. On that basis it adopted BAA's projections for non-regulated charges, subject to adjustment for utilities charges. BA said that CAA had told BAA and the airlines that they should also agree forecasts of non-regulated charges in constructive engagement, but agreement had still not been reached on such forecasts for Heathrow, and no forecasts had been shared with airlines at Gatwick.

Traffic forecasts

24. The divergence in the traffic forecasts we have seen is shown in Table 1.

TABLE 1 Traffic forecasts at Heathrow and Gatwick

	<i>Open skies assumed?</i>	<i>2008/09</i>	<i>2009/10</i>	<i>2010/11</i>	<i>2011/12</i>	<i>2012/13</i>
Heathrow (m pax/yr)						
CC 2002 projections	No	75.5	80.0	81.5	83.0	84.7
BAA 2005 projections	No	75.0	78.0	80.0	81.5	83.0
BAA Feb 2006 projections	No	74.0	75.7	77.5	79.5	81.5
BAA Feb 2006 projections	Yes	74.9	77.2	79.0	80.5	82.0
CAA CC Reference (Mar 2007)	No	71.7	73.2	74.8	76.4	78.5
BAA CC submission projections	Yes	70.6	72.8	74.2	75.3	77.2
CE Interim report, July 2007-IATA	Yes	72.6	74.5	75.9	77.3	78.8
Gatwick (m pax/yr)						
CC 2002 projections	No	40.0	40.5	41.0	41.5	42.0
BAA 2005 projections	No	37.0	38.0	38.5	39.5	40.0
BAA Feb 2006 projections	No	36.2	36.9	37.5	38.2	39.0
BAAFeb 2006 projections	Yes	35.8	36.1	36.5	37.2	38.0
CAA CC Reference (Mar 2007)	No	34.6	35.1	35.5	36.0	36.5
BAA CC submission projections	Yes	36.2	36.6	36.8	37.3	37.7
CE Interim report, July 2007 - IATA	Yes	36.2	36.6	37.0	37.5	38.2

Source:

25. CAA in its submission to us used traffic forecasts for Heathrow corresponding to those in BAA's regulatory submission of September 2006. It used somewhat lower forecasts for Gatwick. It stressed, however, that this was without endorsing such figures, given subsequent reductions in BAA's forecasts and continuing discussions between BAA and the airlines as part of Constructive Engagement.
- (a) BAA's May 2007 submission to the CC, including an initial 'simplistic' estimate of the effect of the recent Open Skies agreement, was for a somewhat lower traffic forecast than the CAA figures at Heathrow, somewhat higher at Gatwick.
- (b) All airlines from which we heard were critical of the reductions in BAA's Heathrow forecasts (before the effect of Open Skies). Among BA's arguments were that the adjustments made to BAA's forecasts for economic and other factors were not appropriate given the excess demand to use Heathrow; and that the most recent forecasts understated long-haul growth at Heathrow, and had inaccurate fleet mix and unduly conservative load factor assumptions. It said that use of the Constructive Engagement 'low case' would reduce X by 0.5 percentage points. We understand there remains a substantial difference of view on Heathrow traffic forecasts.
- (c) We understand that there is only limited disagreement on Gatwick traffic forecasts.

Profiling

26. The 'building blocks' set out in Figure 1 show how the total revenue requirement could be derived so as to earn the appropriate cost of capital over an appropriate time period. But the profile of charges in individual years may require consideration of some further issues:
- (a) *Pre-funding*: Airlines have criticized the inclusion of assets in the course of construction (AICC) in the RAB, increasing charges before the assets become operational. The net present value of revenues from such an approach should not, however, exceed that of alternative approaches, while allowing for AICC

may reduce the uncertainty that charges will be sufficient to cover the cost of capital over the life of a project.

- (b) *Profiling within quinquennia*: The CAA proposals allow for an 'opening yield adjustment' of 41p per passenger at Heathrow and 28p at Gatwick to reflect the revised classification of some services within the regulatory framework, with the price cap then profiled to allow a smooth increase in charges through the quinquennium. BAA's proposals for an opening yield adjustment of £2.02 at Heathrow and £0.56 at Gatwick also allow for additional security and Terminal 5 costs, in order to avoid the need, on its assumptions, for a continuous price increase (of RPI+15) at Heathrow in Q5 with a subsequent reduction of prices in Q6.
- (c) *Profiling between quinquennia*. Charges in Q4 included some revenue brought forward from Q5 to avoid the need for a large step increase in charges in Q5. Airlines have argued against any further such revenue advancement, but we may need to consider the implications of any projections for Q6. It remains highly doubtful, however, whether any projections for X for Q6 are likely to be useful at this stage, given the uncertainties about capital expenditure programmes and in particular Runway 3 and Terminal 6 at Heathrow, or a second runway at Gatwick in Q7 if this proves impossible. The current projections for a negative X for Q6 for both airports will be overturned by any projects of this size.
- (d) Any implications of other financial constraints may also need to be considered.

Public interest issues

27. A wide range of public interest issues has been raised with us, particularly by airlines and other parties carrying out operational activities at the airport. There is, however, potentially some overlap of issues between this inquiry and the market inquiry, although the legal framework for the two inquiries is quite different. It is possible that some of these issues may prove to be more appropriately considered in the market inquiry (to the extent that they fall within the legal framework for and the scope of the terms of reference for that inquiry), for example if they do not fall within the terms of reference, or scope of any preferable possible remedies, under the Airports Act, or if they also apply to other BAA airports, or if our investigation into them would benefit from the longer time available to us under the market inquiry.

Issues raised by airlines

Issues arising from acquisition by Ferrovial

28. On the financial structure of BAA:
- (a) Some airlines expressed concern about the high degree of gearing of BAA following the ADL acquisition, including:
 - (i) airport charges being put at risk of being called upon to satisfy debts other than those directly incurred in the course of carrying on the airport business by their incorporation within the scope of the security provisions of financing arrangements covering an enlarged group;
 - (ii) reducing BAA's financial capacity to deal with shocks; and

- (iii) hence risking BAA's ability to provide benefits for airlines and the airports being run to maximize cash flow, reducing investment.
- (b) In February 2006, CAA notified the possibility of conditions to remedy adverse effects the CC might identify including any that might relate to or result from transactions. In its submission to us the CAA recognized that the CC would need to be satisfied that there had been a course of conduct *by an airport operator* that had operated or may be expected to operate against the public interest. But it also believed that in the light of other measures it proposed in its recommendations (including the development of adequate ex ante financial incentives and the process of ex-post review referred to in paragraph 9(c)(iii) above), further steps may be unnecessary and potentially undesirable.
- (c) Some airlines have continued to argue to us that further measures are necessary, including ring fencing of the regulated businesses and restrictions on the cashflow to outside those businesses.
- (d) BAA in its submission to us argued that the airlines' concerns were unfounded; it noted that an operational and financial ring-fence was being put around the three London airports and that its proposed refinancing would allow the full level of capital expenditure it had proposed, subject to a satisfactory regulatory settlement.

29. On other Ferrovial interests:

- (a) We have noted Ferrovial's other ground handling interests, about which some concern was expressed to us; we understand an airport operator is allowed to provide ground handling services under EU ground handling regulations but which also set out other requirements relating to the provision of ground handling services.
- (b) Concern was also raised with us about Ferrovial's construction interests and whether there could be transfer pricing implications; CAA in its submission argued that scrutiny of BAA's capital projects and investment plans by airlines, the CAA and ourselves may deter or detect the risk of any adverse behaviour.

Quality of service

30. Following an adverse finding in our last report, a service quality scheme was set up for both airports, based on each airport paying relatively small rebates to airlines when service fell below a defined standard in a particular terminal:

- (a) the scheme currently covers the following aspects of service: stand availability; jetty availability; pier service provision; fixed electrical ground power availability; people mover availability; inter-terminal transit availability (at Gatwick); security queues; arrivals baggage carousel availability; passenger measures based on BAA's Quality of Service Monitor (QSM) survey of passenger perception for departure seat availability, cleanliness, way-finding and flight information; and an aerodrome congestion term;
- (b) the scheme is currently subject to a cap of 3 per cent of airport charges in each terminal. This maximum is currently reached after six months of service quality failure;
- (c) it seems generally agreed that the scheme has focused management attention on these quality elements; standards have been generally achieved and

performance improved (as also shown by QSM survey results) but with the notable exceptions of pier service in Heathrow Terminal 4 and Gatwick North Terminal; and in security queuing following the introduction of new directives in 2006; and

- (d) despite the operation of the scheme, we have received strong criticisms of quality of service particularly at Heathrow, and suggestions from airlines that aspects of quality of service continue to operate against the public interest, particularly in relation to security queuing and some activities not currently included in the scheme. The OFT document accompanying the market reference also quoted figures showing both Heathrow and Gatwick ranked very poorly in passenger perception of quality of service compared with other airports.
31. Various CAA and airline proposals for modification to the service quality regime (SQR) are under discussion as part of constructive engagement. It is expected that some changes, including new quality measures will be agreed between BAA and the airlines, although we understand that differences may remain on the inclusion of some measures and on the level at which performance for many measures should be set (and any associated cost implications of these changes). Our ability to make enforceable recommendations may depend on whether a further adverse finding on BAA's performance under the current SQR is appropriate—at this stage we are uncertain whether it will be open to us to consider this. But quality of service is a key issue in the OFT's market inquiry reference and in airline complaints, particularly concerning security screening.
32. The issues are:
- (a) Changes to the scope of activities covered by SQR. Those being considered under constructive engagement include: adding transfer security queuing, staff security queuing, control post queuing, and aircraft manoeuvring (stand entry guidance systems). BAA want pier service removed, to which airlines object. One airline also suggested to us measures for cleanliness, tidiness, building maintenance and temperature control.
 - (b) How performance is measured:
 - (i) On services for passengers some airlines want to reduce reliance on QSM scores (Virgin citing the Terminal 3 car park as bringing the whole QSM scores into question) but others accept QSM scores as a basis for SQR incentives for services for passengers. On services for airlines, some airlines want to change some of the measures used to reflect performance both at peak times and on average, eg for the security queuing standard. (The existing measure may also show apparently acceptable average performance, even when long waiting times occur at early morning peak times.)
 - (ii) Proposals for changes to the targets include: multiple or single measures for passenger sensitive equipment serviceability; whether the measures for central search queuing should be absolute limits or performance that has to be met on 95 per cent of occasions measured; increases in the targets for jetty serviceability to 99 per cent, FEGP serviceability to 99 per cent, stand serviceability to 99 per cent, arrivals reclaim serviceability to 99 per cent, QSM score for departure lounge seating to 3.8, QSM score for cleanliness to 3.9, QSM score for wayfinding to 4.0, and QSM score for flight information to 4.2.

- (iii) In many of the cases, we understand that BAA may not object to the target being changed but considers that this will incur additional costs that will need to be allowed for in airport charges.
 - (iv) Some airlines have suggested a target based on overall passenger satisfaction, as measured by the comparative ASQ surveys, with the target of Heathrow reaching top 10 status. This is not supported by BAA, which believes such an overall measure would encompass not just BAA's operational responsibilities, but also operations managed by airlines and others.
 - (v) The CAA did not see any strong evidence to suggest the maximum failure under each element of the scheme should be reached after 12 months of failure, rather than after six months at present.
- (c) Increase amount at risk:
- (i) Airlines have suggested 7 per cent of BAA's revenues from airport charges should be at risk under the SQR, rather than the current 3 per cent which BAA considers more than sufficient.
 - (ii) Some airlines have also criticized the CAA's proposed reduced weighting for aerodrome delays.
- (d) Bonuses as well as rebates
- (i) CAA and BAA both proposed that good performance should be rewarded with a bonus increase in charges, which would need to be in the price cap formula. All the airlines that have commented objected to this, among the objections being that there would be no benefit to them from BAA doing better than the target and the effect on incentives. The issue of providing BAA with incentives for improvement over a range of different performance levels might be separable from the issue of whether bonuses as well as rebates should be paid. For example, a graduated rebate payable within a range of service levels would improve BAA's incentives (so that they were not completely dependent on hitting or not hitting a specific level of service) without requiring airlines to pay bonuses to BAA.
- (e) Suspension of system:
- (i) Airlines are highly critical of the CAA's decision to suspend the security queuing standards and rebates following changes in Government security requirements in August 2006 and propose that suspensions should require the agreement of the AOC.
- (f) Pier service:
- (i) This is a continued source of criticism from airlines who want the target to be set at 95 per cent of passengers being pier-served. BAA wants separate targets for each terminal for each year linked to capital projects.
- (g) Airline performance:
- (i) Its inclusion is resisted by airlines and supported by BAA.
33. We also received criticism of BAA's delay in implementing a baggage service level agreement at Gatwick.

Other issues raised by airlines

34. A number of other public interest issues were raised with us by airlines:

- (a) Inadequate consultation, including:
 - (i) on capital expenditure, including lack of adequate or timely provision of information on project specific costs, on-costs and risk monies; on capital expenditure at Heathrow including HET, pier service provision in general and at Terminal 5 in particular, stand provision, the Eastern Apron development and the decision to adopt horizontal rather than vertical segregation of inbound and outbound passengers at Terminal 3 Pier 7; and on capital expenditure at Gatwick, including the recent significant increase in capital expenditure plans;
 - (ii) on management of security issues, including BAA's decision to improve the security queuing standards without consulting on the costs and benefits of doing so;
 - (iii) on non-regulated charges at Gatwick, where BAA had been slow in sharing forecasts with airlines; and
 - (iv) non-provision of information on commercial incomes.
- (b) Disposals of assets without consultation which could be required for future operational use.
- (c) Failure to plan adequately to increase facilities for fuel storage at Heathrow or make available the necessary land; and failure to coordinate an adequate response to the shortage of fuel supplies resulting from the Buncfield fire.
- (d) Lack of intra-airport competition, from separately owned terminals or in the development of new terminals or in competitive tendering for airport operation. Some airlines from whom we heard, however, did not believe there was scope for intra-airport competition, given the shortage of capacity at the airports.
- (e) Lack of differential charging (other than under the SQR scheme) between terminals to reflect different quality of service, for example between South and North Terminal at Gatwick, or, in future (and therefore possibly outside the scope of this inquiry) between Terminal 5 and Terminals 1 and 3 at Heathrow.
- (f) The flat rate structure of the runway charges, which, one airline argued, could disadvantage operators of short-haul aircraft and fail to reflect differences in the costs of handling larger aircraft, particularly the A380 when it operates at either airport.
- (g) Attempts by BAA to monopolize IT services at Heathrow, requiring airlines in some terminals to use BAA's IT services (such as CCTV and WIFI networks in Terminal 5) at charges in excess of market rates.
- (h) High charges by BAA for services to passengers of reduced mobility, BAA also insisting on taking them through its retail outlets.

Concerns from other parties

35. The following are the concerns raised with us by other parties:

- (a) *Heathrow taxis:* Complaints included the constitution of Heathrow Airport Licensed Taxis Limited (HALT) and its contract with BAA; a 20p levy on taxis using Heathrow for use of the Journeypay credit card payment system; and the cost of using Heathrow.
- (b) *Minibus charges:* We have received a large number of complaints about charges for use of Heathrow more than doubling.
- (c) *Park & ride issues:* Complaints concern charges for picking-up and setting down passengers being driven to and from independent off-airport car parks; the location of the stops required to be used; the prohibition on the use of the airport name; and the use of the BAA website to refer only to their own services and not those of competitors. The concerns relate to other BAA and some non-BAA airports as well as to Heathrow and Gatwick.
- (d) *Car hire arrangements:* Complaints (primarily in the context of the market inquiry) concern BAA's 'consolidation' of car hire activities and the charges for use of airport facilities, for Heathrow and Gatwick but also other BAA airports.
- (e) *Selection of goods stocked by World Duty Free:* We have received a complaint that BAA is not prepared to discuss stocking some alcoholic drinks in WDF outlets.
- (f) BAA's use of its compulsory purchase order powers to acquire land not required for operational use, but for developments which could be undertaken by other companies (including office developments and long-term car parking), and some of which could as a result be subsequently sold at a significant profit (although this may also be an issue for the market inquiry).
- (g) We have also received a number of complaints from users about poor quality of service and facilities; and the foreign exchange rates charged at the airports.

The components of WACC—estimates provided by CAA, BAA, BA and CC Q4

per cent

	CAA				BAA (stand alone)*				BA		CC Q4	
	Heathrow		Gatwick		Heathrow		Gatwick		Low	High	Low	High
	Low	High	Low	High	Low	High	Low	High				
Risk-free rate	2.0	2.0	2.0	2.0	1.75	2.5	1.75	2.5	2.0	2.5	2.5	2.75
Debt premium	<u>1.0</u>	<u>1.0</u>	<u>1.0</u>	<u>1.0</u>	<u>0.74</u>	<u>1.06</u>	<u>0.95</u>	<u>1.18</u>	<u>1.0</u>	<u>1.25</u>	<u>0.9</u>	<u>1.2</u>
Pre-tax cost of debt	<u>3.0</u>	<u>3.0</u>	<u>3.0</u>	<u>3.0</u>	<u>2.49</u>	<u>3.56</u>	<u>2.70</u>	<u>3.68</u>	<u>3.0</u>	<u>3.75</u>	<u>3.40</u>	<u>3.95</u>
Equity risk premium	4.5	4.5	4.5	4.5	3.50	5.0	3.50	5.0	5.0	5.0	2.5	4.5
Asset beta (number)	0.575	0.625	0.64	0.71	0.57	0.73	0.60	0.76	N/A	N/A	N/A	N/A
Equity beta† (number)	1.13	1.26	1.30	1.48	1.26	1.62	1.33	1.69	0.8	0.95	0.8	1.0
Assumed debt beta (number)	0.2	0.2	0.2	0.2	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Post tax cost of equity	7.1	7.7	7.8	8.7	6.17	10.61	6.42	10.94	6.0	7.25	4.5	7.25
Taxation	30	30	30	30	30	30	30	30	20	20	30	30
Pre tax cost of equity	<u>10.1</u>	<u>11.0</u>	<u>11.2</u>	<u>12.4</u>	<u>8.82</u>	<u>15.16</u>	<u>9.17</u>	<u>15.63</u>	<u>7.5</u>	<u>9.1</u>	<u>6.43</u>	<u>10.36</u>
Gearing‡	60	60	60	60	55	55	55	55	60	50	25	25
Pre-tax, real WACC	5.9	6.2	6.3	6.7	5.34	8.78	5.61	9.06	4.8	6.4	5.67	8.76
'Uplifts'		<u>N/A</u>		<u>N/A</u>		<u>0.5</u>		<u>0.5</u>		<u>N/A</u>		<u>0.5</u>
Point estimate		6.2		6.7		7.56		7.83		5.6		7.75

Source: CAA proposals, Oxera report (on behalf of BAA), CEPA July 2006 report (on behalf of BA) and CC's Q4 report.

*BAA estimates are on a 'bottom-up' basis for the two airports separately.

†BA assumes gearing of 55 per cent.

‡OXERA (for BAA) the WACC based on a notional uniform gearing of 55 per cent.