

# 14 Views of BAA

## Contents

	<i>Page</i>
Introduction.....	459
The general approach.....	459
Systems approach.....	460
The single till or dual till.....	461
Effect on resource allocation.....	464
Effect on investment.....	464
Commercial activities.....	467
Effect on BAA's overall profitability and regulatory consistency.....	469
Incentives under the single till.....	470
Price path commitment.....	470
Recovery of under-investment.....	471
Assets in the course of construction.....	472
S factor.....	473
Q factor.....	474
Default price cap, treatment of discounts and non-passenger flight and volume term.....	475
Specific issues relevant to setting of X.....	475
Passenger forecasts.....	475
Cost of capital.....	476
Regulatory asset base.....	478
Investment programme.....	479
Operating costs.....	479
Proposed value of X.....	480
Public interest issues.....	482
Investment.....	482
Interim review.....	482
Specific complaints.....	482
Systemic under-investment.....	486
Response to 11 September 2001.....	486
Consultation.....	487
Connectivity.....	489
T5 occupancy.....	490
Little America.....	490
Alternative approaches to investment and consultation.....	491
Service standards.....	492
Specific complaints.....	492
Service level agreements.....	496
Generic standards.....	496
Planning standards.....	499
Comments on BA's detailed proposals.....	500
Conditions of use.....	501
Airport charging issues.....	502
Peak pricing.....	502
Aircraft parking charges.....	502
Pricing at Stansted.....	502
Non-regulated charges.....	502
Ground handling.....	502

Check-in desk charges .....	504
Rents .....	505
Waste .....	506
Staff car parking.....	507
FEGP.....	507
Water and sewerage.....	508
Wayleaves.....	508
Fuel fees.....	508
Extending the scope of regulated charges.....	509
Specified activities.....	510
Other complaints.....	511
Charges to disabled passengers.....	511
Car hire .....	512
General aviation.....	513
Taxis .....	513
VAT refunds.....	514
Fire training.....	515
Travel agent outlets.....	515
Separation of ownership of the three airports .....	516

## Introduction

14.1. This chapter summarizes the views of BAA on the general approach to the setting of charges; the more specific factors relevant to the setting of X; and, finally, public interest issues with particular reference to complaints raised by other parties and summarized in Chapters 12 and 13. BAA's initial submission to the CC, on which parts of this chapter are based, is reproduced on the CC's web site. BAA also provided us with extensive information and attended a number of hearings, to which we refer in other chapters in this report.

## The general approach

14.2. At the outset of the inquiry, BAA said that the CC was presented with a broad choice. It might adopt a narrow 'traditional' view of seeking the lowest possible prices consistent with providing a minimum incentive to invest and maintain service quality. This was the approach adopted most clearly in the transport sector for Railtrack and NATS; the results spoke for themselves. The adverse consequences of imposing the tightest possible controls were felt not just by the regulated company, but most critically by the end consumer.

14.3. There were particular reasons why this approach was too narrow for the airports industry. Planning restrictions and the slot allocation system meant that busy and well-located airports, such as Heathrow, possessed a unique economic value, or 'rent'. This rent may be shared between airlines and airports, but would not naturally flow to passengers so long as demand exceeded capacity. The general rule was that if airport charges were set low, so that airlines took all the rent, there was a real danger of lower airport investment, leading to lower capacity, resulting in higher fares and lower output. If charges were higher, the airport would have greater incentives to add capacity, facilitating a bigger and more competitive airline industry, leading to lower prices and to greater choice for passengers.

14.4. Higher airport charges (which were currently very low by international standards) may therefore serve consumers better than lower prices would. This issue was compounded by the fact that marginal costs at airports were on a sharply rising curve, and were already higher than average costs. Prices which gave an apparently reasonable return on existing assets were too low to give appropriate price signals for investment. The problems associated with narrow minimum-price regulation were exacerbated by the highly dynamic nature of the industry. Airline strategies and passenger preferences changed over short timescales, leading to continuous evolution of capital and operating programmes. A fixed minimum price effectively capped the ability of airports to respond to change of this kind.

14.5. BAA therefore supported the CAA's broader interpretation of its duties as best met by seeking maximum economic welfare overall. It agreed that this would be achieved by prices which:

- (a) achieved dynamic efficiency, by encouraging additional investment when demand exceeds supply. Investment was currently the core issue for the business, with almost a united view among BAA and the airlines that more investment was needed;
- (b) contributed to allocative efficiency by helping existing capacity to be taken up by those airlines which valued it most highly; and
- (c) provided for productive efficiency by encouraging efficiency and innovation in management.

14.6. BAA also believed that the level of riskiness of investment it faced was now accelerating. Principle components were:

- (a) T5 represented the commitment of almost £4 billion to an extremely complex and protracted project, combining engineering and construction risk, and major systems risk, all of which had historically led to major cost overruns and delays to infrastructure projects in the UK.
- (b) In the case of T5, the risk was compounded by the heavily deferred nature of the returns, as the project was remunerated from gradual traffic build up after 2008. This in turn was dependent on airlines using sufficiently large aircraft to deliver sufficient passengers for the runway, given the 480,000 ATM limit which would bite on the opening of T5. These risks would be at their most

acute in the period 2005 to 2008, when the major expenditure would have been committed, before the project was completed, and before the traffic base had emerged.

- (c) BAA's other investments were also subject to major risk, including the vulnerability of Gatwick, and Stansted's continued growth being built on a base of only three airlines.
- (d) Security was a continuing and growing risk, both in terms of its cost impact and the effect of security crises on passenger demand. This risk would be exacerbated by the CAA's proposal to remove the security element from the price formula. This was a change in regulatory risk which had not been captured in the cost of capital calculations.
- (e) The increasing burden of compliance in other areas, including environmental controls, policing, fire cover and the like, also presented significant risk in an environment of fixed prices.
- (f) The retail part of the business had its own, increasing risk, including the real threat that the World Health Organization would succeed in having duty-free sales of tobacco banned; bureau de change earnings being massively cut if the UK joined the Euro; and extension of the size of the EC further reducing the scope for duty- and tax-free sales.
- (g) Regulatory risk overall had been significantly increased by the major changes to the regulatory environment proposed by the CAA. Key elements were the increased risk of assets being stranded at Stansted in particular; the risk to profits from the Q factor proposals; the vulnerability of the PPC to subsequent regulatory reviews; and the increased risk of a challenge under the International Obligations arising from the discontinuation of the system approach and the weakening of the long-term link between cost and prices.

### ***Systems approach***

14.7. BAA argued that, given the range of possible airport locations for new runways in the medium term, and the likelihood of annual fine tuning and rebalancing of the CIP between the airports as airline priorities changed in the short term, it was vital that any price formula did not create rigidity in the investment incentives at each airport. This was best achieved by the application of an overall system price formula, possibly in combination with overlapping individual airport sub-formulae, as the basis of control. This would allow the relative levels of airport charges at each airport to be set to reflect evolving relative levels of demand, and investment requirements, within a total revenue constraint. This would also eliminate the magnified forecasting error inherent in separately calculated values of X for each airport, since the variability of system-wide numbers was lower than that for individual airports.

14.8. An approach of this kind would avoid the economic pitfalls likely to result from the CAA's stand-alone approach. In simple terms, the use of a strict stand-alone approach, based on five-year returns linked to the cost of capital, would, in the long term, tend to produce the lowest charges at the most highly-valued, busiest, congested locations, with the greatest investment needs. This was the result of dividing fixed costs by large traffic volumes. Such an outcome would be perverse, leading to falling charges at Heathrow and rising charges at Stansted. It was only avoided in the CAA's proposals for Q4 by the judicious use of profiling devices. In the long term it was only prevented by the PPC, discussed below.

14.9. Underlying BAA's difficulty with a strict stand-alone approach was the market analysis (or absence of such an analysis) which underlay it. The CAA saw each airport as a separate market, and demand for each airport and the costs of expansion as being specific to that location. This was inherently inconsistent with its approach to demand forecasting, which, like BAA's, was driven by the allocation of overspill from Heathrow. This in turn was inconsistent with the CAA's discussion of slot valuation at Gatwick which failed to recognize that the value of slots at Gatwick was driven by the restriction of capacity at Heathrow. (The same omission applied to the CAA's analysis of Stansted.) The final paradox was then provided by the last paragraph of the CAA's overview (ie CAA proposals to us in February 2002), which hinted at the benefits of 'effective competition' between airports, a concept wholly at odds with the notion that each airport was a separate market, with a separate unique level of demand.

14.10. As to whether there were any detriments from the system approach, prices at Stansted were above marginal cost and below marginal cost at Heathrow; and so in economic terms cross-subsidy of Stansted did not currently arise. Indeed investment at Stansted up to between 30 mppa and 35 mppa was justified at Stansted's current level of charges given its low long-run marginal costs. The primary beneficiaries of that investment, however, were the airlines, which were paying below marginal cost at Heathrow since airlines were accommodated at Stansted which would have liked to compete with the Heathrow airlines but were excluded by the slot allocation system, enabling Heathrow airlines to keep the preferential access to slots at below market prices and providing extra capacity for them. It was also open to Heathrow airlines to move to Stansted to benefit from Stansted prices if they wished. Differences in rates of return, however, were to be expected given the different maturity of the airports. There had been a series of examinations by the CAA and the EC of the marketing of Stansted. BAA had shown this was to maximize profitability, but BAA also had to ensure its future investments were profitable, as a result of which it was careful not to invest too early, but 'nearly too late'. Hence, increases in the lounge and satellite at Stansted needed to handle between 8 mppa and 15 mppa only came on stream as throughput was about to exceed 15 mppa.

14.11. The real issue as BAA saw it was that the system cap maintained flexibility for Government in the longer term for location of a new runway at that location. The next runway would be designed to meet growth in demand for the London system as a whole: if the burden fell only on the consumer at, say, Stansted, that would be a significant disincentive to the provision of a new runway of that location. In effect it would require Stansted airlines to pay the price of not being at Heathrow, as well as the costs of developing Stansted. It would also be very difficult to reverse any decision that airports should be regulated on a stand-alone basis.

14.12. BAA said that its advocacy of an approach to pricing at the overall London airports level was not a mechanism for obtaining a more generous price formula; it was not asking the CC to recommend a formula more generous than the CAA's proposal for Q4. Its concern was to set out a basis for charging which was flexible and durable enough to continue to produce efficient and economic outcomes for the London area in the long term.

### ***The single till or dual till***

14.13. The CAA was to be credited in BAA's view for addressing the issue of the definition of the regulatory domain head on, from first principles, and taking account of developing international thinking and precedent. In 1996, the MMC had noted that the single till had perverse characteristics (see paragraph 2.22); the CAA had taken this forward, and had defined the domain more narrowly to encompass only those activities where the airport enjoyed market power and a capacity bottleneck existed. Subject to one important exception, and some technical concerns on the method of calculation, BAA supported the CAA's approach. The proposed domain (described by the CAA as the RRCB) had the following advantages:

- (a) it eliminated the distortion to investment incentives for non-aeronautical activities inherent in the single till;
- (b) it unbundled prices in accordance with sound economic principles and regulatory practice; and
- (c) it allowed the airport operator to identify the returns associated with aeronautical investments, and incentivized such investment, even where there was no associated commercial income.

This would be in the interests of airport users, including those who may not yet exist, but may be important contributors to the competitive market in future, and whose prime interest was that there should be enough capacity for there to be a dynamic and competitive airline market. Air passengers were also best served by a large competitive dynamic industry: hence focusing on long-term investment needs was highly relevant to the reasonable interest of users.

14.14. In as much as, other things being equal, the RRCB might lead to higher average airport charges, it also brought two public welfare benefits:

- (a) it increased the general incentive to invest in additions to capacity and service quality, which would in turn lead to more choice and lower prices for air passengers; and

- (b) it contributed to improved allocation of existing scarce capacity (to the degree that demand elasticity was above zero), in the absence of an efficient slot market.

14.15. BAA believed that the dual till was compatible with international obligations. Many other international airports—for example, Sydney and other Australian airports, some seven of the top ten US airports (which adopted a compensatory basis, akin to the dual till) and certain European airports (Frankfurt, Zurich, Hamburg)—had also now gone down versions of the dual-till route, confirming the lack of international obligation to maintain the single-till approach. (It was, however, often difficult to say whether a particular approach was dual till or single till, since most airports in Europe did not have formal price control.) The use of the dual till by US airports was one reason the US Government would be unlikely to take action were the dual till to be adopted in the UK.

14.16. As to whether the dual-till approach should be applied to all three airports, BAA believed that to treat the airports as a single airport system within a dual-till framework was consistent with the ICAO and Bermuda 2. Within the revenue total, therefore, charges at individual airports should be set to reflect their individual role in the system, hence a dual-till approach could lead to charges at Stansted being capped nearer a single-till level. If the CC were to depart from the system approach, it should determine the dual-till question separately for each airport, including the exclusion of commercial activities provided in the competitive market and the high emphasis placed on investment incentives.

14.17. As to airline arguments that one could not at a conceptual level distinguish between the commercial and aeronautical activities, these could not be regarded as joint products; there was no fixed proportion between the two, and an airport could be produced with very little commercial activity or income. The bringing of passengers to the airport by airlines was a necessary, but not sufficient condition for the generation of commercial income: passengers themselves brought no commercial income, but what did so was BAA's ability to offer products and services which passengers wanted to buy. They were therefore an additional revenue stream, which BAA had maximized on the basis of its entrepreneurial skills. On this, many passengers regarded BAA airports as being among the best for commercial activity. At congested airports, the level of complementarity between the two activities was also low, because if airport charges were reduced, the number of passengers and commercial income would not be increased (indeed, if airport charges increased, the result could be operation by larger aircraft, increasing rather than reducing the number of passengers and commercial income—a negative complementarity). At uncongested airports on the other hand, if there was complementarity, it would be in the airport operators' interest to charge less than allowed under the dual till.

14.18. BAA acknowledged that in appraising investments in aeronautical facilities, likely commercial revenues would be taken into account and previously it had been possible to justify projects on that basis, even though any high commercial return would in effect be taken away at the next quinquennial review: but that approach was now more difficult with the increase in marginal costs. Hence—as discussed further below—BAA was now looking for an approach which increased the level of investment incentive, and allowed individual managers bringing forward aeronautical investments to identify the returns.

14.19. As to practicalities of the separation of commercial and aeronautical activities and cost allocation, which the CC in its July statement on the dual till (reproduced at Appendix 2.3) argued was difficult, the task was found possible when the Government required BAA to separate these activities for accounting purposes in 1967 and renewed the requirements in 1986. BAA auditors had found it possible to separate these activities, as had overseas administrations and airport authorities. Extensive work had also been carried out with the CAA on this. The CC itself found no difficulty in such separation when it imposed the requirement to report separately on the specified activities. As to the possible objection that there were common costs in the provision of aeronautical and retail facilities and that BAA would have an incentive to pass common costs through aeronautical facilities and to get revenues out of the retail side, this was the essence of ring-fencing in other utilities.

14.20. The CC's argument was also fallacious in principle, confusing joint goods, where cost allocation was indeed a problem, and related products. The key point was that whilst commercial activities could not be provided without aeronautical activities, the converse was not true and the cost could be identified separately; commercial activities were incremental and the incremental cost should be capable of identification. There would of course always be issues of overhead allocation, any answer would be approximate but robust, and the regulated company may expect to get the worst of any rough justice: but that was no reason for the CC to prefer to be absolutely wrong.

14.21. On arguments that, to estimate the appropriate division of costs, it would be necessary to consider how terminal buildings would be constructed with and without commercial facilities, BAA said that it had done work on that and the cost difference was quite small. The marginal cost of providing retail activities was low, retail floor space accounting for 8 to 10 per cent of T5, but the impact net of what circulation and seating would be required without retail would be a lower figure.

14.22. However, BAA disagreed with the CAA on the proposal to exclude surface access from the RRCB. The CAA excluded not just rail schemes, but also all roads, from the RRCB. The Heathrow Express project was excluded, despite the fact that the 1991 formula settlement from the CAA was heavily conditional on BAA pursuing this project and Heathrow Express was, in effect, a condition precedent to getting T5. The only projects included by the CAA were the Heathrow Express and Piccadilly Line extensions to T5, on the grounds that these were conditions of the T5 consent. To require projects to be planning conditions in order to be included in the aeronautical till would discourage the process of trying to reach accommodation with local authorities constructively on surface access schemes, rather than further protracting the more confrontational planning process. It appeared that the CAA envisaged that the solution lay in road pricing, although BAA was not currently legally empowered to road price, and a road-pricing technology had not yet been defined for airports. Until these problems were resolved, the exclusion of roads and railways from the RRCB removed from BAA the incentive to push forward with imaginative schemes to improve airport access capacity, reduce travellers' delays and add to service quality.

14.23. BAA therefore encouraged the CC to adopt the RRCB, but with surface access added until such time as road pricing was practically possible. This proposal was not a device for raising prices further in the next quinquennium, since it was not attempting to 'bid up' the CAA's formula proposal; its significance was in relation to the long-term investment climate it created for surface transport schemes. BAA believed that it would be inconsistent with previous regulatory practice to do otherwise. Consistent with this, BAA also suggested short-term car parks be included in the aeronautical till.

14.24. BAA also queried the CAA's assumption that all current liabilities should be deducted from aeronautical assets, rather than some allocated to commercial assets. It also argued that any adjustment for revenue advancement and under-investment should be allocated to both the commercial as well as to the aeronautical till. In consequence, BAA estimated regulatory fixed assets of aeronautical facilities of £3.1 billion compared with the CAA's estimate of £2.5 billion; of the difference, £410 million was attributed to advancement of revenue/capex adjustment, and £180 million to working capital.

14.25. BAA stressed, however, that while it wished to modify aspects of the CAA approach, it was not seeking higher revenue from airport charges than proposed by the CAA. Indeed, it was not seeking an immediate move to full dual-till prices, rather a lifting of the strict single-till cap and a clear signal of the move towards the dual till over a period of time. Although (as noted below) it also regarded smoothing of revenues between quinquennia as necessary, such 'money on the table' would have a much greater value if it was a demonstration of commitment to move to a dual till over the longer term, and to resolve the current perverse incentive of the single till in investment decisions, discussed further below. BAA did, however, see as feasible the CAA's suggestion that it could revert to the single till in future if BAA's performance was inadequate, although it was confident it would never operate in such a way as to bring that about.

14.26. BAA's main proposition was that the CC should no longer find itself bound strictly by the single till rate of return if other considerations, in particular the importance of investment, would otherwise lead us to a higher level of charges than under the single till: there could be a range of outcomes between the single till and dual till in the future. It also saw a strong argument that the cost of capital was not a fixed number, and no one knew quite what it was: alighting upon a single till cost of capital and setting charges to match that was as likely to give too low a level of charges as too high, with a 50 per cent risk of under-investment, whereas a priority for public welfare may be to ensure investment rather than minimize charges. The dual till provided a mechanism to reduce that risk by providing a cost base structure which demanded a higher level of charges.

14.27. Hence, BAA went along with the CAA's judgment in its February proposals to us, in recommending Heathrow's charges in Q4 be on a single-till rather than dual-till basis, in balancing off the ultimate level of charges and what was achievable in the shorter term: in practice, it believed it could not price fully up to the CAA's recommended cap at Gatwick or Stansted.

14.28. It acknowledged, however, that its main concern was to have the right level of airport charges—but the reasoning which underlay that was significant, and to set a price formula based on a dual till would send a clear message as to the future return and extent of regulation and provide a sounder and more sustainable basis than a single-till number which would be affected by future changes in commercial revenues. It would also tend to bring forward price increases so BAA was not as vulnerable to changes in capacity utilization.

#### *Effect on resource allocation*

14.29. BAA said that, although charges on aeronautical activities were lower under the single till than under the dual till, in the presence of capacity constraints and in the absence of auctioning of capacity, charges on aeronautical activities would have their main incidence on the profits of airlines, and it was unclear why they should be subsidized. (It showed us a number of papers on this point.) Indeed that would worsen allocative efficiency in the presence of capacity constraints.

14.30. Airlines were currently charging what the market would bear at Heathrow: not on the basis of their costs plus BAA's landing fees. Hence, the effect of an increase in charges (which would only be to European levels) would not be to increase fares at congested airports, but to weed out the least efficient, highest-cost providers. Slots operated on obscure short-haul markets may well then be operated by a more substantive long-haul market, raising consumer welfare. The biggest threat to air fares was insufficient airport capacity (as made clear in the Government's consultation on future capacity). The best way to prevent air fares rising was to provide more airport capacity; the incentive to do so was greater if airport charges were higher.

14.31. BAA agreed that it was difficult to assess the extent of the market's response to price changes, but to the degree that demand was not 100 per cent price inelastic (which would be exceptional) any move towards market-clearing prices would have some beneficial effect on efficiency which should be taken into account. There was ample evidence that the rises in runway charges on small aircraft at Heathrow from 1985 had an extremely beneficial effect on runway utilization of scarce capacity leading to significant increase in runway capacity. The dual till was likely at least to result in improved allocation of scarce runway resources at the margin, which would be of value: it was a reasonable assumption that some of the more marginal traffic at Heathrow would go to Gatwick. Airport charges at Heathrow were currently too low to clear the market: with the dual till, the gap between charges and market-clearing prices would be less, giving a higher incentive on BAA to increase capacity as well as on operators to make more considered decisions about the best use of capacity, to the degree that price elasticity was above zero. Since the process of trading in slots was likely to be made illegal by the European Commission, the differential in airport charges may be the only tool to improve efficient utilization of runway capacity: higher charges at Heathrow would help to manage the excess demand at Heathrow into other airports.

14.32. BAA also did not accept that the Airports Act confined the CAA's objective to promoting efficient 'operation', rather than 'use' of the airports as was argued by some airlines (see Chapter 12). Efficient operation encompassed efficient use; neither the Airports Act nor European regulation prevented the CAA having regard to the efficient use of airports. The CAA was merely making a contribution to a framework which provided for efficient allocation—not getting involved in the detailed allocation of individual slots.

14.33. As to whether higher charges at Heathrow resulting from the dual till could affect services to or from regional airports, BAA did not believe that it was in a position to make a value judgment about whether services to or from regional airports were of greater value than other services, for example long-haul services. Without any advice from the Government or the CAA on this point, the correct level of charges should be set, and the people who valued the capacity most would be those who used it. Low charges at Heathrow, moreover, discouraged direct services between the regions and overseas, contrary to Government strategy. Higher charges, on the other hand, could encourage higher investment in the London airports, and more capacity for regional services.

#### *Effect on investment*

14.34. BAA argued that it had invested adequately, subject only to the constraint of the T5 planning inquiry. However, whereas it had previously been possible to justify projects sensibly and credibly on a

single-till basis, BAA argued that a move progressively towards dual-till based charges was now required by the rising marginal cost of investment, in order to discharge the regulatory duty to encourage investment, a factor that had changed within the last few years. However, an increasing number of projects were required to manage service quality, safety and security rather than generating revenues. The dual till would also allow an improved focus on aeronautical investments, the single till making it very difficult to justify such projects on their own and biasing managers to invest in projects with an element of commercial returns.

14.35. Hence, under the single till return to aeronautical projects depended on what they made on commercial revenues. (If, for example, there was investment in a jetty, but retailing did better than expected, airport charges would be lowered, and the jetty project would never make an adequate return because it had been cross-subsidized.) The fact that under rate of return regulation a rate of return was allowed on all investment, aeronautical or otherwise, was only true as a general principle: what mattered was how the revenues were attributed to the project; it was undesirable to assume a 7.5 per cent return on any investment merely because a rate of return would eventually be allowed on it, but necessary to prioritize projects. The dual till, by unbundling investments into their constituent parts, would give separate revenues and returns to aeronautical projects. On the commercial side it would also put BAA under a clearer discipline only to invest where there were true marginal revenues on capital costs, whereas currently the same return was guaranteed irrespective of merit. The dual-till mechanism would therefore lead to the most efficient use of capital. It would allow capital decisions to be made on a privatized commercial basis; whereas to assume all investment earned the permitted rate of return gave no incentive inside BAA to prioritize, use commercial thinking, or spend wisely.

14.36. BAA gave us a paper by Oxera which considered the effects of the single and dual till on investment in an airport taken as comprising two activities of retail and aeronautical.

14.37. First, the paper argued that the single till distorted investment in retail activities. By including retail revenues in the determination of the price cap on aeronautical, the single till would constrain anticipated returns on retail investment to be equal to the assumed cost of capital on aeronautical. Furthermore, by adjusting the aeronautical price cap at five-yearly intervals, the single till limited the period for which unanticipated excess returns on retail could be earned. It therefore reduced the incentive to undertake useful retail projects and deferred profitable projects until the start of a new five-year period; but in the long term there was no incentive on BAA to choose the most efficient (ie profitable) projects, as all retail projects would earn the same return. The dual till eliminated this distortion as regards retail investments (although aeronautical investments would remain subject to the permitted returns).

14.38. Second, the cost of capital used in the determination of price caps under the single till was not appropriate for providing incentives to invest in aeronautical facilities. To encourage investment in aeronautical facilities, anticipated rates of return should be equal to the marginal cost of capital on aeronautical alone. The cost of capital on T5 was quite different from that on retail facilities. Hence, the single till distorted incentives to invest in aeronautical facilities.

14.39. Third, the dual till provided stronger incentives to expand capacity during periods of capacity shortage. In a competitive market prices would rise in response to increases in demand, but under the single till total returns on aeronautical plus retail activities were fixed in the long run after a regulatory review. Under the dual till, retail returns would be higher and could rise in the long run in response to greater passenger throughput; hence incentives to invest in aeronautical activities rose under the dual till in relation to the single till.

14.40. Finally, the dual till provided less scope for regulatory failure than the single till. Under the single till, the regulator had to consider both aeronautical and retail activities, while under the dual till the regulator had only to examine the aeronautical till. Thus under the dual till the scope of regulation was reduced at the same time limiting the potential for regulatory failure. In addition there was little precedent for price regulation of commercial businesses (although implicit rather than explicit) and this would arguably increase the chance of inefficient regulation of retail activities.

14.41. BAA also commented on the following possible objections to implementation of the dual till in the context of investment:

- (a) As to the objection that BAA had performed perfectly well and utilized capacity in full, BAA said that it was impossible to answer the counterfactual of what would have happened if there had been a different regulatory system. But economic regulation was based on the premise that incentives mattered and the correct incentives yielded superior outcomes not incorrect ones (see also BAA's comments in paragraph 14.43).
- (b) As to the objection that differential incentives on new investment and existing assets could be provided equally well under the single till and dual till, for example by the LRIC proposal, BAA said that in principle it was possible to have differential returns on existing assets and higher marginal returns on new investment. However, different marginal incentives would then be required for aeronautical and retail activities and regulated prices would not in general replicate the marginal incentives that retail activities faced and the competitive markets in which they operated. Regulation of retail activities created unnecessary complexity and incorrect investment incentives. If the CAA's LRIC approach was rejected, a move from single till to dual till was even more critical to provide correct investment incentives.
- (c) As to the objection that there was a spill over from earnings on aeronautical into retail, ie when passenger numbers increased, BAA benefited from retail activities as well as aeronautical, and that the single till internalized this externality while the dual till did not, BAA said that this argument was precisely the wrong way round. The single till did not replicate a competitive market because marginal costs exceeded average cost. Hence the single till distorted investment in retail activities when no impact from aeronautical activities should be felt; and to the extent there was an externality the dual till offset some of the distorting effects of regulation on incentives to invest in aeronautical facilities.
- (d) As to the objection that, by yielding a rate of return equal to the cost of capital on aeronautical and retail activities combined, the single till replicated competitive market conditions better than the dual till, BAA said that the single till set average returns equal to the cost of capital across the combination of aeronautical and retail activities, but not appropriate marginal incentives. The dual till ensured that marginal returns were equal to the cost of capital in each aeronautical and retail activity.
- (e) As to the argument that, by raising returns on retail, the dual till would divert investment away from aeronautical, unless BAA was capital constrained raising the marginal incentives to invest in retail or aeronautical would increase investment in both activities. Under its planning guidelines, moreover, BAA must provide a minimum amount of aeronautical space per passenger, and the Q factor, if it were to be implemented, provided further incentives to invest in aeronautical facilities.
- (f) As to the argument that planning constraints made investment incentives irrelevant and meant that, even if there were no financing constraints, raising returns on retail would lead to more space being allocated to retail rather than aeronautical facilities, the fact that there were serious planning and space constraints made it all the more important that BAA was adequately compensated for the risks and costs involved in planning applications and capacity expansions. The correct allocation of existing capacity was not obtained by artificially depressing returns on the competitive retail activity. The planning system itself reduced the relative amount of retail in any development as illustrated by the T5 planning decision in which the amount of landside retail space was restricted.

14.42. BAA also put forward the effects of the dual till on a number of illustrative projects:

- (a) For entirely aeronautical projects which did not increase capacity, there would be no difference between the single till and dual till. (BAA subsequently qualified this point by adding that there were demand-side as well as supply-side considerations. Under a dual till the cost of adding to service quality was apparent and the price paid for it was apparent, hence airlines could trade-off the effects on price. But under the single till airlines in asking for capacity and service quality projects assumed there were no cost implications, since they would be lost in commercial revenues.)
- (b) For entirely aeronautical projects which did increase capacity, the dual till would provide stronger incentives than the single till through greater retail spend.

- (c) For projects which were a mix of aeronautical and retail, in fixed proportions, and which increased capacity, moving from the single till to the dual till had an ambiguous effect on the size of investment but brought incentives closer in line with costs.
- (d) For projects which were a mix of aeronautical and retail in variable proportions, and which increased capacity, moving from the single till to the dual till would strengthen incentives, by increasing the returns to the project overall.
- (e) For projects which were entirely retail, but which increased capacity, the incentive effect of moving from the single till to the dual till was ambiguous, but projects which had higher returns would be more highly incentivized under the dual till than under the single till, and the ranking of projects would be more efficient.
- (f) For projects which were entirely retail, and which did not increase capacity, incentives would be higher for efficient projects and lower for inefficient projects under the dual till than they would have been under the single till.

14.43. In our July statement of current thinking on the dual till, we argued there was no evidence that the single till had led to under-investment in the past. BAA argued that if there had been under-investment then there were only two explanations: poor incentives under an RPI-X structure or the level of charges being too low. As to the former, the RPI-X structure did not in itself discourage investment, but would incentivize an investment rush at the end of the control period, for which there was no evidence. But if the level of charges was too low, either the cost of capital had been set too low or the formula had unreasonably credited investment for too low costs or too high income. BAA argued that there had not been systematic under-investment to date, because the unit costs of investment had been low and steady enough for investment to be remunerated under a single till. But this did not hold good for the future in which the unit costs of capacity were rising sharply. Hence lack of Q3 underspend did not in itself support a single-till regime, nor did the presence of overspend necessarily support a dual till. As to future under-investment, the CC's argument that there was no evidence that the single till would lead to under-investment in the future was not substantiated: there would be under-investment if charges were too low, ie if the cost of capital was too low or the unit cost of future investment was higher than of past investment and charges were set on the basis of past investment. This was the case under the single till and, although BAA acknowledged prices based on full marginal cost would not be a sustainable regulatory approach, the dual till provided a vehicle for moving charges towards marginal cost.

14.44. As to the CC's 'alternative proposition' that if prices were always set simply to remunerate past investment, then eventually all investment would be remunerated, this was not what would happen in a competitive market and it exposed the company to abnormal long-term regulatory and business risk, since returns were artificially deferred where marginal costs were rising. Single-till RCV therefore was inherently disincentivizing under this approach, and could only be corrected for by artificial adjustments which were by their nature unstable as they could be reversed by legal challenge or regulatory 'volte-face'.

### *Commercial activities*

14.45. BAA argued that it was completely fallacious to suggest the single till represented sharing of common costs or profits: all benefits went to the airlines. It did not accept that its investment in commercial activities should, as with any regulation of monopolies, be subject every five years to being limited to the cost of capital: its commercial activities were not monopoly activities, but equivalent to the competitive activities of other utilities which were ring-fenced and unregulated. Nor did it accept the argument that competing airports would lead to a single-till environment: the Australian authorities had considered this argument, and concluded otherwise.

14.46. BAA broadly agreed with the CAA's view that its commercial activities were conducted in contestable markets but acknowledged there were degrees of market power, and some commercial activities for which there was more of a market than others. It argued that none of the retail products sold at BAA's London airports could be regarded as intrinsic to the travel product but were sold via competing branded operators at prices linked to their high-street stores. Even for duty- and tax-free sales, there were plentiful alternative buying opportunities of which regular travellers would be aware—on the aircraft, from the non-EC departure airport on the return leg and on the high street overseas where lower

duty/VAT may apply—so market power was by no means complete. The same conclusions were reached by the Australian Productivity Commission. For catering, alternatives included eating before arrival at the airport or on the aircraft, passengers bringing their own food, or buying food from retail outlets such as Boots. Even if, for passengers with long check-in times and lack of catering on some flights, these were not realistic alternatives, this was merely a question of locational versus monopoly rent. Car parking was acknowledged as more contentious, BAA taking the view that short-term parking should remain in the aeronautical till. Market power in relation to long-term car parking was extremely low, this being a highly competitive market around the airport, and also with choice of different modes of travel (such as rail and buses) available in travelling to or from the airport

14.47. High rates of return on assets were primarily a function of asset valuation: off-airport market businesses would value the assets on a market asset valuation basis. The excess of market valuation over indexed historic cost, as in investment properties, effectively reflected a difference in valuation of the retail site, a reflection of the locational advantage enjoyed by airport retailing—ie a form of locational rental. The RAB made no allowance for locational rent in capital value. The historical expansion of airport retail and property space plus the BAA policy for most retail activities to price at or below high-street levels were also both evidence of lack of monopoly rent with regard to commercial space. A degree of locational rent was also at least partially due to entrepreneurial and development activity by BAA resulting in growing revenues over time. Even if there was market power, as the CAA argued, this was not an argument to use it to cross-subsidize airlines; but BAA ensured there was no abuse by requiring concessionaires not to price above high-street levels and in benchmarking prices against other locations.

14.48. In response to our July statement on the dual till, BAA said that we should consider the extent of the regulatory domain on a systematic basis, looking at each activity on its own merits. As noted above, certain activities, being clearly provided in competition with off-airport providers, should fall outside the domain: this was the only approach which was consistent with ICAO policy. They included inter alia long-term car parking and landside retailing where BAA's only strength lay in the location of its activities and consumers have clear alternatives. There was no reason in law, economics or regulatory best practice why the net proceeds of the sale of goods landside should be handed to airlines in their entirety. Although the CC's statement used the language of 'sharing' there had been no discussion of intermediate situations in which the proceeds of commercial activities (above the cost of capital) were shared on a continuing basis. Use of arguments against a full till to justify a full single till were particularly regrettable since BAA's proposition was never that a full dual till should be used, but only that the rigid single-till cap should be lifted.

14.49. The CC's statement also appeared to argue that the dual till would both deregulate and increase regulation of commercial activities, neither of which was accurate. Such activities were already regulated under normal competition and fair-trading law, duty-free and car park charges having been already investigated. The 14 per cent HCA return on commercial activities (including Heathrow Express) was well within the range of normal business. But the argument that the profits of commercial activities were monopoly rather than commercial rent were remarkable, not tested in any way. The profitability of retail or car parking was invariably driven heavily by location. BAA had shown evidence of significant additional retail space and property brought on stream in Q3; and highlighted its voluntary price code linking prices to those on the high street, neither of which were consistent with the concept of monopoly rents where supplies would be constrained and prices increased. Even NERA<sup>1</sup> admitted to the likelihood of some locational rent: to the degree the CC could accept this, it would provide a basis for an intermediate position between the dual and single tills.

● *The balance between aeronautical and commercial activities*

14.50. We also raised the issue of whether BAA's development of commercial activities had to date been at the expense of aeronautical activities, or whether this would be the case, or would be to greater extent under the dual till. We noted that BAA already performed better in IATA surveys for commercial than for aeronautical activities.

---

<sup>1</sup>NERA provided a paper to us arguing that the commercial activities at the airports earned returns beyond the cost of capital.

14.51. BAA disagreed with our interpretation of the IATA survey. It was not the case, it said, that for non-retail elements of service quality ratings tended to be significantly lower than average: the complaint only cited Heathrow, and Gatwick was generally better. BAA did, however, acknowledge that there were two areas where this could be claimed, notably ease of way-findings/signposting and ‘connections’. The first of these was, if the CAA proposals were adopted, to be incorporated into a Q factor; the second was a joint responsibility and BAA believed that great strides had been made to improve performance. On comfort of waiting at gate areas, Gatwick was above average and Heathrow slightly below average. On a further possible example put to BAA—that in T3 customers had to enter the departure lounge through the duty-free shop—BAA argued that the shop could be bypassed by fast track customers and regulars, with no material increase in walking distances; there had also been very little negative customer feedback on the arrangement. (We had also noted low QSM ratings of landside and airside seating availability in T3. BAA told us that there was a need to reduce landside congestion and it was clear passengers were not aware of the facilities airside. A number of landside seats had been removed, to encourage passengers to go airside: ratings should, however, much improve when the current expansion of the T3 International Departure Lounge is completed.)

14.52. As to whether commercial activities would benefit from the dual till at the expense of aeronautical activities, BAA believed that there was already a risk under the single till, for the reasons outlined above, of it being more attracted to projects with a commercial rate of return, since it was not certain that, for example, customer service projects would be adequately remunerated. Hence projects that did not have an aeronautical return in their own right needed cross-subsidization from commercial revenues. However, it aimed to get a balance between customer service and retail revenues. Under the dual till, however, the argument was not about incentivizing a fixed level of investment but increasing the total quantity of investment: aeronautical projects would now earn their cost of capital, while investment in general and especially mixed investment would be more highly incentivized and the cake would be bigger for all investment. Second, the presumption there would be more commercial investment did not necessarily hold: it was a clear weakness of the single till that it did not disincentivize poor excessive commercial investments since any losses were submerged within the till; rather, the dual till provided a much superior, normal commercial basis for determining what commercial project should be undertaken.

14.53. Third, BAA put forward comprehensive measures of protection offered in the form of a Q factor and a code of conduct, in addition to the safeguards provided by law and regulation. Under its proposed code BAA would commit to collection and distribution of data on space utilization in common user terminal areas; maintain aeronautical space levels to meet Q factor standards; and consult on development proposals in common user terminal areas. Local approaches could supplement Q measurements at the airport level to alleviate specific airline concerns and provide additional information on other areas as required. For example, an airport would wish to share its late-to-gate surveys with airlines and handling agents. BAA acknowledged that some improvement in its space data would be necessary.

14.54. Hence, even if the proportion of space occupied by commercial activities were to increase—which was not necessarily the case—that did not imply the amount of space occupied by aeronautical activities would reduce. Inadequate aeronautical facilities (for example, seating) would indeed themselves damage retail sales.

#### *Effect on BAA’s overall profitability and regulatory consistency*

14.55. As to the application of the single till from privatization, BAA said that its prospectus included an indication from Government that it expected commercial income to be taken into account by the MMC in the five-yearly price reviews, but this was not mandated. The requirement to account separately for the profits and losses of aeronautical activities signified and established dual-till information as relevant regulatory information. Custom and practice had since swung sharply towards the dual till. A move progressively towards dual-till-based charges was, moreover, now required by the rising marginal cost of new investment in order to discharge the regulator’s duty to encourage investment; the CA98 would remedy the absence noted in our previous report of any method of regulating commercial activities.

14.56. BAA believed that the dual till would not therefore be a departure from the basis on which it was privatized, and would not represent any windfall to its shareholders. Much of its current commercial

revenue was, moreover, due to entrepreneurial activity on top of the locational advantage of airports. However, there were precedents of unanticipated windfall gains made by privatized companies, which they had retained in whole or part, for example NGC's stake in Energis; Transco's properties windfall and Railtrack's property windfall. The effect of any windfall tax on the additional profits if a dual-till approach were adopted, moreover, would be to reduce the net level of charges to the point where investment was no longer attractive and/or severely weaken BAA's ability to finance investment: BAA was not asking for anything more than it thought necessary to incentivize and finance investment.

14.57. BAA was also asked about an alternative approach, of valuing aeronautical and commercial assets on the basis of profitability rather than cost. It thought that this would, in effect, require a one-off write down of the depreciated replacement cost of the aeronautical asset: but the end effect on charges would be much the same as the single till.

14.58. As regards income transfers and regulatory credibility, the CAA's estimate of a rent transfer of £3 billion to £4 billion—a figure BAA thought too high—was in BAA's view from airlines, not passengers: the transfer to BAA would take place over a very long time, with little in Q4, and the charge increase would merely take Heathrow's charges to the average level of European airports where airlines were all currently surviving and competing. It said that the CC was understandably concerned but did not reflect on the scale of the sums involved: only £2 per passenger in the next five years, equivalent to a transfer from airlines of approximately £200 million a year by 2007/08 at Heathrow. No individual airline would suffer a transfer of more than £80 million a year. This in turn would facilitate an £8 billion investment programme. The suggestion that such a regime would in principle be unsustainable or non-credible was not borne out by experience elsewhere, the CAA believing it could sustain the regime, and other regimes had been successfully sustained with significant activities excluded. The real danger was in the opposite direction: as the experience of NATS had shown. Although BAA accepted the importance of regulatory consistency, in this case the benefits of change would be greater than the cost of maintaining the current regulatory approach.

14.59. Also, however, in considering the objection that dual till could increase total returns and yield a windfall, BAA had noted, above, that in the presence of capacity constraints there were strong allocative as well as dynamic efficient reasons for raising prices. But, if only dynamic efficiency factors were thought relevant, the opening RAB could be adjusted to leave total expected returns unchanged. This would, however, create a perverse price movement in the short term—reducing prices now to raise them later—and amount to a sequestration of assets, with severe consequences for the reliability of the regulatory structure and attitudes of investors. A further option, which BAA put forward at a relatively late stage, would be to confine the dual till to new investment, with the single till maintained for existing assets.

### *Incentives under the single till*

14.60. In a final comment on our statement on the dual till, BAA said that it may be true, as the CC argued, that adequate incentives could be provided under the single till, but only if the single till was implemented in such a way that it produced the right level of prices in a sustainable way, which was inherently more difficult than under a dual till. This would be more difficult if BAA's charges were capped on a rigid single-till ROCV basis. Satisfactory resolution of the review would require the CC to continue to apply the system approach; apply a cost of capital which fully reflected BAA's growing riskiness; incorporate AICC in the asset base; accept the importance of providing BAA with a financial margin or cushion to avoid a crisis in the event of any further disruptions; and resist the temptation to claw back or underspend indiscriminately.

### *Price path commitment*

14.61. BAA said that the CAA had rightly recognized the particular problems of setting a five-year price formula in an industry which was exceptionally 'lumpy', extremely capital intensive and experiencing rising marginal costs. These factors tended to exacerbate the difficulties of prices based on five-year returns tending to vary wildly around a long-term trend; and for prices to lag behind cost increases, thereby disincentivizing timely investment. The CAA's proposed solution for this was the PPC, under which BAA received a significant uplift in charges per passenger after T5 opened, and guaranteed to apply for 20 years. The price signal set out in the PPC at £18 per marginal passenger after

T5 opened was very helpful in informing the industry of the likely long-term price path. BAA did not, however, give it the value of a true commitment, since the CAA had no power to commit its successors. Indeed airlines would almost inevitably and entirely rationally wish to avoid paying for what BAA had already built. It was also concerned that the consistency of this approach with Article 10(3) of the Bermuda 2 agreement had not been properly addressed by the CAA to date.

14.62. Hence, while BAA believed the notion of trying to achieve a long-term price signal was absolutely valid, it was not satisfied that under the current legislation there could be any commitment as to the appropriate level of prices in future reviews and attached very little significance to it. Indeed, BAA believed the CAA approach would lead to prices in Q5 being reopened on a single-till rather than dual-till basis. Lower costs, and higher profits than expected, would be liable to legal challenge—but not vice versa, resulting in asymmetry of risk. Hence, smoothing between quinquennia was also important, to give lenders a degree of certainty, rather than running the risks of any hike in prices, which airlines may be unable or unwilling to pay at the time. An alternative (discussed below), however, was the use of specific triggers for specific outputs.

### ***Recovery of under-investment***

14.63. BAA believed that the principle of claw back of net capital underspend was legitimate in principle where there had been deliberate underspending. However, it regretted the CAA's adoption of a 50 per cent level for claw back without any evidence that any of the 'underspending' to date had been contrived by BAA rather than externally imposed. (Indeed, BAA's returns had been in line with those projected in 1996.)

14.64. BAA objected to any implication of automatic recovery of underspend, since inter alia it believed such an approach would be a disincentive to efficient investment, and its rate of return had been broadly as projected. Hence there were no windfall gains—factors it believed were recognized in the CAA's 50:50 approach. Claw back of underspend should only be considered if underspend had been to some degree engineered by the company or it had made a windfall gain. Total returns, however, were very close to forecast because of high operating-cost depreciation due to the need to manage terminal congestion: high depreciation was partially caused by the purchase of shorter-life assets. Reduction of RAB would be arbitrary and mere punishment with no regulatory precedent and a very poor incentive for future capital projects.

14.65. BAA also noted the additional investment undertaken instead of T5, although it conceded that this was difficult to itemize. £500 million had been spent on T5 or T5-related projects including Heathrow Express, £200 million had been spent on additional non-T5 capex at Heathrow, £87 million at Gatwick and £186 million at Stansted: optimizing the use for existing capacity at Gatwick and Stansted and additional investment at those two airports was in its view a way of meeting unfulfilled demand at Heathrow; Stansted indeed had handled 60 per cent more passengers than forecast in MMC4. (Some £20 million at Gatwick probably could not be attributed to not building T5.) However, BAA believed another £100 million fixed expenditure on minor projects had occurred to replace worn out assets and deal with congestion conditions. It believed that this was conservative, as it excluded some additional expenditure on CIP lounges and the flight reporting centre. Changes in project scope were included within the additional £100 million element. (Such investment had been undertaken because BAA was confident it would be allowed a 7.5 or 7.75 per cent rate of return, since the airlines wanted it and BAA believed it right to provide additional capacity and quality of service before T5.) There had been increased depreciation on this investment, and there had also been some under-recovery of permitted revenues over the period. It was also now expecting to increase investment in 2002/03 by £70 million compared to its original forecast for the year: which, after allowing for the additional depreciation and under-recovery, reduced the amount of claw back to zero. Indeed, allowing for under-recovery of permitted airport charges, greater than expected loss of duty-free revenues, the CAA's allowance of £100 million for capital efficiency in its proposed recovery of under-investment (for which BAA could identify a number of specific efficiency savings) and centralized costs associated with capex but expensed, BAA could be regarded as overspending rather than underspending.

14.66. We have also noted above BAA's argument that any correction for under-investment should be applied not just to aeronautical charges under any dual till, but also to commercial activities.

14.67. On whether any claw back should be in Q4, rather than, as the CAA proposed, being incorporated in the RCV and spread over 20 years, claw back in Q4 would weaken the company financially at a point where it was already extremely weak due to the major capex taking place before revenues were on stream; it would also push prices down at a point where capacity utilization was highest, so prices should be at their highest. BAA drew attention to paragraph 182 of CAA 664 (the CAA's final report following the last review) as implying that, if there were other reasons, particularly to do with the trajectory of charges over the next ten years, return of that advancement may need to be over a period longer than five years.

### ***Assets in the course of construction***

14.68. BAA argued that to increase charges only when a project was on stream, rather than during the period of excess demand before that occurred, was inappropriate and could not be relied upon to happen. It referred to the 'Hong Kong experience', where airlines prevented increases in charges when the new airport opened. Without AICC, a project the size of T5 would be hopeless.

14.69. However, it recognized that the five-year control period presented the problem that some capex could be deferred without penalty. The CAA's proposal addressed this by the incorporation of price triggers linked to the delivery of specified capacity (namely ART and the T5 advanced stands). BAA supported the use of this device, and believed that it could be extended to other parts of the Heathrow programme in place of the PPC.

14.70. In response to our request for suggestions on airport charge increases linked to output and/or progress of a project by means of triggers, BAA suggested that only one project, T5, met the required criteria for such an approach of being financially significant; having an established scope of the project with confidence over timing; having the support of the airline community as a whole and providing aeronautical outputs; and for the airport concerned to be one where charging was based around the maximum cap and not determined by marketplace factors. Significant scope changes were also unlikely on T5 since they would be likely to be in breach of planning conditions. It proposed specific triggers of completion of the diversion of the twin rivers in 2004/05; completion of early release stands in the same year; the handing over of the visual control room to NATS in 2005/06; and the core terminal building being weather proof in 2006/07. These triggers variously represented important milestones in T5's completion; produced significant immediate outputs to airlines; provided a business partner facility without which T5 could not function and were all easily measurable and auditable. BAA had no objection in principle to a trigger for the opening of T5, probably at the beginning of Q5. The more detailed specification of facilities to be available on opening of T5—as put forward by BA—was, however, likely to change over the next five years. Some arbitration committee may therefore need to be involved but this was more an issue for the next quinquennial review: progress in constructing T5 was likely to be one of the focal points of the next review, and could directly effect the prices to be allowed in the first year of Q5. Triggers at Gatwick were less appropriate given the need for flexibility and the uncertainty of traffic patterns between Heathrow and Gatwick.

14.71. BAA proposed that where an event was expected to take place in a particular year but did not do so, one point be taken off the value of X in the subsequent year; the value of X would then be recovered to its base level if the projects were completed the next year. (BAA's subsequent views on this are included in Chapter 2.)

14.72. If the trigger was too large, on the other hand, highly adverse incentive effects could be created. It was more likely that there would be short delays with limited impact on the overall scale of a project rather than the total programme being delayed by a year: a large trigger could reduce BAA's ability to finance such a project.

14.73. The concept of triggers also mitigated the problem of how to deal with overspend or underspend at subsequent reviews, since it would give a significant incentive to deliver.

14.74. The CAA had also proposed an additional allowance of £300 per additional peak hour movement. BAA did not object to this, but did not regard it as particularly relevant given it already had every incentive to increase peak hour capacity if it could. An alternative approach put to BAA—of a penalty if total movements fell below a target figure—was legally more difficult given the limit on number of ATMs at Heathrow.

## *S factor*

14.75. BAA argued that security costs following the events of 11 September were highly uncertain and that if there was to be any abandonment of the cost pass through mechanism, it would be necessary to include a possible allowance for the costs of any additional security requirements, which would itself be subject to considerable uncertainty. Safety and security were BAA's first priorities and should be the first priorities of everyone in a position of responsibility in the industry. The CAA had rightly focused on the incentive properties of regulation, but it had consistently disregarded the incentive effects of putting airports in a situation where they received no compensation for any additional costs of meeting enhanced levels of security imposed by the DfT.

14.76. The S factor had worked well over the past 15 years. It had not produced any cost inefficiencies. In practice it had not led to major cost rises to airlines, but it had provided airports with the reassurance that most of any additional costs would ultimately be met. The percentage of recovery may be debatable, but the principle of recovery should be retained.

14.77. The limitation of the CAA's thinking on this issue was demonstrated by the financial analysis in the reference:

- (a) The CAA argued that the removal of the S factor would not alter the cost of capital because the risk was diversifiable, but made no attempt to demonstrate how it could be diversified. Neither did the CAA recognize the effect of risk, diversifiable or not, on the cost of capital.
- (b) The CAA proposed to eliminate the S factor without making any attempt to allow for the likely future level of increased security costs on the cost base. This was casually justified on the basis that sufficient headroom was built into the CAA's proposals for the Q4 settlement. However, the proposal actually contained no headroom above a 7 per cent single-till return at Heathrow. By definition no one could know what costs would be incurred; the zero cost assumption was therefore 100 per cent asymmetric downside risk.

The CAA suggested (see paragraph 13.24) in its proposals to the CC that 'some form of alternative arrangement' may be needed to deal with major costs arising from 11 September but did not suggest what this arrangement may be, although it would need to be incorporated in the price formula determination. A mechanism allowing for the recovery of a percentage of the additional costs was presumably what was intended; in effect, some form of S factor.

14.78. BAA gave further details on the additional requirements that could be imposed. Since 11 September 2001, a greater number of passengers and their hand baggage had been subject to a search by hand at central search areas; were BAA to adopt best practice as recommended by the DfT and subject passengers selected for hand search to routine screening for explosives, there would be a need to purchase a substantial number of additional trace detection equipment (estimated at 60 machines at £19,000 each). Additional operating costs and staff numbers resulting from such enhanced measures required by direction had not been budgeted for within current business plans, nor the investment cost for buying additional trace detection equipment should this be required by future direction. Temporary solutions were currently being implemented for segregation of arriving and departing passengers during 2002: achieving full segregation would take five to six years at significant capital cost. Development work was also being undertaken on measures relating to identification of suspect passengers; subject to successful airport trials, it was likely that new processes would lead to the installation of new communication networks, redesign of check-in desks, and purchase and installation of new equipment, potentially involving passport scanning equipment, biometric solutions and CCTV: the outcome of the trials was unlikely to be known until 2003, and no provision for this development work had been made in current business plans. On screening of passengers and their possessions, BAA had been relatively early in introducing HBS, so could be required to introduce latest technology (including, for example, an explosive-sniffing machine). Should any of the various technologies lead to increased detection capability airports would be required to implement them. The outcome of development work and evaluation was not likely for two to three years, and no provision for the development work or the procurement of new equipment had been made in current business plans. Hence it was currently exceptionally difficult to forecast at this time exactly what processes and technologies would be required during the next two years and given the uncertainty in government requirements it was essential that some mechanism remained available to airports to pass on what could be significant capital and revenue costs.

## *Q factor*

14.79. BAA believed that detailed service monitoring linked to the price formula was not necessary for BAA and may be counter productive. However, it acknowledged service quality was a legitimate area of concern for regulation, and had actively led the debate on the introduction of a Q factor that might achieve benefits while minimizing disadvantages. However, proper calibration of the model was very important if it was not to create its own distortions. It was also necessary to target those aspects of service important to the passenger, those for which BAA was wholly or mainly responsible, and those which were measurable without requiring a large bureaucracy to do so.

14.80. In this context it believed that the CAA's current thinking as set out in its proposals to us needed further refinement. It had the following areas of concern:

- (a) The 3 per cent ceiling proposed by the CAA, although an apparently small number, amounted to exposure of £15 million a year at current price levels. This was a very material sum for an approach which was intended to be an initial experimental testing of the concept. Figures of 1 to 2 per cent were used in utilities.
- (b) The major component of the Q factor, airline service, was structured on a penalty-only basis. That is, the airport could not be rewarded for service above the standard, it could only be punished for failure. Apart from the inequity of this approach, this created an asymmetric risk to the business, and had poor motivational characteristics for airport management: equalization of risk was important. Even a symmetrical approach, however, could have asymmetric effect, since marginal improvements in serviceability were increasingly difficult and costly as performance level got closer to 100 per cent.
- (c) The proposed Q factor contained an aircraft delay term, although delay was effectively outside BAA's control, being largely in the hands of other parties. This approach created moral hazards for airlines. There was also, at present, no reliable data on which to base such a coefficient or on attributing causes of delay and BAA would be concerned if the calibration of the factors were to be left unknown when the formula was set. It would be inappropriate to base any delay term on information gleaned from the subjective and simplified attribution of delays by airline or handling agent staff. However, BAA did not object to a delay term in principle as long as the measure reasonably reflected BAA and NATS airport navigation service performance, accurate data could be collected, and there was sufficient understanding and experience of the measure to allow appropriate targets to be set: it believed that the CAA's proposals failed to pass these tests, but if a measurement system could be developed that would do so, then it would be willing for a delay term to be incorporated by mutual consent into a Q factor midway through the next quinquennium.
- (d) BAA also objected to the inclusion of FEGP since this was not paid for through the airport charges covered by the RPI-X formula. It recognized, however, that FEGP was a high operational requirement and there were only limited alternatives should it be unavailable. BAA therefore conceded that it might be appropriate to include FEGP in a Q factor scheme.
- (e) BAA also argued against inclusion of pier service where it did not carry out the day-to-day stand allocation: the scale of infrastructure was the primary driver of pier service levels, but the way the stands were allocated led to significant variations around these levels (plus or minus some 5 per cent). There were also practical difficulties in predicting appropriate target values given that level of performance depended critically on the nature of demand and provision of pier service stands.
- (f) It also argued that departures baggage system performance should be excluded since increasingly bespoke financially incentivized agreements would be developed for individual baggage systems.

14.81. There were, however, alternatives to the Q term, namely additional transparency of service quality performance, without any airport charges; or a minimum service quality protection system, where penalties would be incurred only if performance fell below prescribed minimum levels.

14.82. BAA suggested equal weighting of the 12 elements it proposed: namely availability of runways, taxiways, stands, jetties, people movers (passenger lifts, goods lifts, escalators, passenger

conveyors and in Gatwick's case TTS) and baggage reclaim facilities; queuing time for departures security process, and passengers perceptions of departures lounge seating availability, way-finding, flight information and cleanliness. It suggested a maximum impact of 1.5 per cent of regulated airport charges, which would be reached for very poor performance across the entire range of performance indicators. It also proposed revised measurement definitions, including a reduction in scope of the down time that would not count against the serviceability targets (for example, the scope would be limited to such items as equipment taken out of service for major refurbishment work) and revised target levels to accompany these new definitions. It firmly believed that any form of service quality regulation should reflect issues of importance to passengers which would often only be measurable through opinion surveys. Although it did not accept criticism of its QSM surveys, it had no objection to a further external audit of the QSM. Par values should be based on existing target levels where they existed, but may need to change to take account of changing traffic levels or circumstances over five years. Initially, runway and taxiway availability would be measured, to inform decisions on appropriate targets by late 2003, which may have to be by 'mutual consent'.

14.83. The Q factor could, however, affect non-diversifiable risk, hence BETA, and BAA's cost of capital.

### ***Default price cap, treatment of discounts and non-passenger flight and volume term***

14.84. BAA was not strongly for or against the CAA's default price cap proposal. However, BAA submitted that arrangements to provide exclusive use of facilities would probably be discriminatory at congested airports.

14.85. BAA agreed treatment of discounts be changed as proposed by the CAA. As to whether discounts should be transparent, BAA preferred to apply these on a one-to-one, non-transparent basis, but with any operator on the same route having broadly the same discount (this did not necessarily imply exactly the same charge, but a contractual arrangement which had a comparable effect; this had been the position at Stansted). Since the discounts were geared to individual airline strategies on individual routes, it would be an unreasonable burden on airlines to disclose what their strategy was by revealing the nature of the negotiation with them. Since BAA was obliged to operate under a general principle of non-discrimination, however, it submitted that a halfway house would be to file the terms of discounts with the CAA.

14.86. As to the CAA suggestion that non-passenger flights should be excluded from the charging formula, BAA questioned whether it was desirable to signal an implied regulatory incentive to non-passenger flights at Heathrow and Gatwick or indeed Stansted which was likely to be congested in the short to medium term. Nonetheless, it felt the respecification of the pricing formula would have no practical incentive effect: it would only allow theoretically slightly higher charges for passenger aircraft if each airport was close to the maximum allowable yield. Competition with other airports with cargo facilities would deter charging increases at airports where there was capacity, and non discrimination provisions would ensure that charges for cargo aircraft at airports with limited capacity could not be increased to deter cargo aircraft. The effect on yield was less than 1 per cent at Heathrow and Gatwick, but 7 per cent at Stansted.

14.87. BAA agreed that since Stansted was not likely to charge up to its price cap, it should not be subject to a Q factor or default price cap.

14.88. BAA continued to maintain that a volume term was not appropriate; it would require higher charges when airlines were in difficulty, but also only worked with a time lag.

## **Specific issues relevant to setting of X**

### ***Passenger forecasts***

14.89. BAA objected to the CAA's suggestion that BAA had taken a too cautious view of economic growth and of recovery from 11 September. Comparing the BAA and CAA forecasts, the differences were minimal as a whole, but some 3 per cent in the first year. BAA also objected to the CAA's

suggestion that its assumed growth in average passenger per aircraft at Heathrow was conservative (0.4 per cent a year), believing the CAA ignored the fact that average loads at Heathrow had been in constant decline since February 2001 because of BA's decision to reduce average seating capacities and improve average yields. (For example, average seats on BA 747 aircrafts had dropped from 398 to 368 and on European services from 186 to 157.) BAA believed that its assumed Heathrow load looked optimistic.

14.90. Differences between the forecasts were greater at Gatwick, where BAA believed that the CAA short-term forecast looked untenable. Aggregate seat capacity this summer had fallen by 7 per cent: the CAA forecast would require growth of 3 per cent (for the remainder of this year), an implausibly high leap in load factor. If this year continued to decline by 10 per cent on two years ago, the CAA's forecast required a 20 per cent increase in 2003/04, way beyond any reasonable expectation of growth and unsupported by the airports runway capacity without a massive unforeseeable growth in aircraft size. BA's process of gradually unwinding its Gatwick services had not yet been completed, although it was doing so in manner which was not making available slots for others to use in a pro rata fashion. It had given up 35 per cent of its seats, carried 35 per cent fewer passengers but only surrendered 25 per cent of its slots, most at already off-peak times.

14.91. BAA also criticized the CAA's assumption that traffic growth at Stansted would decelerate as the lost cost market matured and new route opportunities diminished. Such growth had declined from an excess of 30 per cent to close to single figures in the space of three years. BAA believed there were parallels with the charter growth in the early 1960s and 1970s.

14.92. BAA's main arguments in support of its latest forecast were therefore evidence of worldwide sluggish and in some cases non-existent recovery from 11 September in terms of air travel demands; the faltering nature of economic recovery; and airline strategies of cutting capacity never seen before. It also believed our initial assumption (put to BA when we were at the initial modelling stage)—of adopting BAA's forecasts at Heathrow and Gatwick but the higher CAA forecasts for Stansted—were high and with no buffer for likely downturns during the period, which BAA believed there should be. The assumed high traffic growth at Stansted could well be at risk if discounts were phased out and/or charges rapidly increased to the levels of Gatwick as we had also assumed. There was also an inconsistency between these traffic forecasts and the capex plan for further terminal development at Stansted, which, with higher traffic, would have to be brought forward from Q6 to Q5.

### ***Cost of capital***

14.93. BAA said that the level of charges overall needed to be set to provide BAA with a more than 50 per cent prospect of achieving returns in excess of the cost of capital. As the CAA had recognized, the welfare loss from setting charges too low may be greater than the loss from setting them too high, and a degree of headroom was therefore appropriate.

14.94. The cost of capital needed to capture all the risks described above was certainly higher than the 7 per cent proposed by the CAA for Heathrow's existing assets. It may also be expected to increase as it undertook the very substantial and risky investment in T5 to above the 8.5 per cent proposed for new projects such as T5. The cost of capital of 6.6 per cent put forward by BA was not a reasonable basis for BAA to pursue its investment programme.

14.95. In response to the CAA consultation document BAA had said that 'the cost of capital for the aeronautical till should be set at at least 8 per cent for the airports taken together. The use of the 8 per cent dual till should provide sufficient headroom to allow BAA to proceed with investment with confidence'. However, the figure would be higher if other aspects of the CAA proposals were adopted, for example: individual airport regulation; PPC; 3 per cent Q factor; and no S-term.

14.96. BAA subsequently submitted to us a paper by Oxera suggesting a pre-tax cost of capital of 7.4 to 11.3 per cent (a mid-point of 9.3 per cent) without T5—see Table 14.1 (see also Chapter 4).

TABLE 14.1 Proposed WACCs for BAA

	<i>per cent</i>	
	BAA	
	<i>Low</i>	<i>High</i>
Real risk-free rate	2.75	3.25
Equity risk premium	4.0	6.0
Equity beta (number)	0.86	0.96
Asset beta (number)	0.66	0.77
Cost of equity (post tax)	6.19	9.01
Taxation adjustment	30.0	30.0
Cost of equity (pre-tax)*	8.84	12.91
Gearing	30.0	20.0
Debt premium	1.2	1.4
Cost of debt	3.95	4.65
Pre-tax WACC:		
Calculated figure	7.38	11.23
Mid-point	9.31	

Source: BAA.

14.97. However, BAA also believed that there would be a major increase in riskiness with the T5 project, given the scale of the fixed costs and the irreversible nature of investment with no second-hand value, the massive scope for cost overrun as shown by other major construction projects, and the dependence on increase in passengers and passengers per ATM. There was also a regulatory risk associated with a project dependent on 50 years of cash flow, and whether users would in future be prepared to pay for it. The events of 11 September 2001 had also changed the perception of riskiness of the industry.

14.98. Oxera estimated a cost of capital of 7.70 to 11.6 per cent (a mid-point of 9.66 per cent) for BAA including T5 on an RAB basis. It would be higher (a mid-point of 11.21 per cent) on the LRIC basis proposed by the CAA (applying the estimated LRIC of £18 per passenger to passengers above 60 mppa) given the deferment of revenue and the additional variability of income to passenger growth and higher risk that would be implied. This estimated higher cost of capital of BAA with T5 primarily reflected the additional operational and financial gearing that BAA would face as a result of the construction of T5. However, on top of this must be added the extra risk imposed by the regulatory structure that the CAA had proposed. These proposals could add around 25 per cent to the asset beta of BAA, due to the inherently higher volatility of returns under a system for which the marginal impact of an additional passenger could be more than twice the average revenues per passenger. The estimated cost of capital also omitted such factors as the possibility of regulatory renegement, and the small possibility that BAA might have to turn to the equity markets for finance in the event of very adverse circumstances, hence might be expected to lie towards the low side of the true cost of capital that BAA faces.

14.99. BAA commented on our own provisional views of cost of capital (which were of a range of 5.15 to 9.43 per cent, a mid-point of 7.31 per cent), being particularly concerned at low level of the mid-point estimate. It believed that if the estimate was too low, it would prejudice the investment programme—but if too high the consequence would merely be a small increase in cost borne by the airlines (and which would not necessarily be passed through to passengers), hence the greater public interest in this case lay in a high probability of a cost of capital adequately able to remunerate investment.

14.100. On components of the cost of capital, the risk-free rate we proposed was below previous estimates due to recent trends: BAA, however, believed the effects of MFR were still being worked through, putting upward pressure on yields, as would the move of government finances from surplus to deficit; if anything, the tendency was above the 3 per cent previously used by the MMC. There was also an implication from our proposal that whatever cost of capital was given now would not be achieved, because the recent downward process would continue. Rather than revising the rate as new information came along, it would be better for the CC to try to stabilize the rate, and form a judgment of a reasonable long-term view. Over the long term, the rate in the UK had been over 3 per cent: as it still was in many other countries.

14.101. As to the equity risk premium, BAA argued that there was an immense degree of uncertainty, studies giving a range of estimates of 3 to 8 per cent. BAA was concerned about putting more weight on a recent study, which suggested a lower range of 2.5 to 4.7 per cent. Another recent study, for example, suggested 3.9 to 6 per cent; and while there was little evidence of an ERP below 2.5 per cent, there was quite a lot of evidence of it being above 5 per cent. (An assumption of a long-term rate of return on equities made by BAA's pension fund of 5 per cent, implying a risk premium of about 2.5 per cent, reflected the need to be fairly conservative in that specific context.) Given current volatility of stock return, there was a prospect of increases in the ERP.

14.102. On the beta, this had been about 0.8 since 1997: but this would increase due to the scale of expenditure in T5, in effect a fixed cost, an expenditure that had to be undertaken irrespective of performance (like debt, as if BAA had geared itself up). The full impact of T5 had yet to come through, but an increase was also consistent with the recent greater volatility of BAA's share price. There were elements of the Q factor that would reduce beta, others that would not affect it, and others that would increase beta: for example, BAA would be exposed under the Q term to 'cost shocks' in the economy as a whole, since the Q term would require it to make expenditures to maintain quality even if cost pressures increased. It was far from clear which way the balance would go.

14.103. As to the debt premium, there had been a lot of fluctuation, and undue weight should not be put on most recent evidence (spot rates having recently been between 0.65 and 1.06 per cent): the three-year average had been about 1.35 per cent and one-year average 1.15 per cent.

14.104. Closely related to the question of cost of capital was the issue of financing, which BAA said that the CAA had not addressed. BAA's medium- to long-term regulatory forecasts of June 2002, based on RPI+2 in Q4 (as indicated in our last report as a possible price control for Q4) and RPI thereafter, projected return on capital value in Q4 declining from 6.9 to 5.1 per cent (below the 6.7 per cent (after smoothing) put forward in the last report). It also projected interest cover of [3x] by the end of Q4, but below [3x] by 2008/09 and for the rest of Q4, compared to covenant requirements of [3x]; and gearing (debt: equity) of [3x] per cent by 2007/08 rising to over [3x] per cent by the end of Q5. The decline in interest cover was regarded as more serious by putting its covenants and investment grade credit rating at risk. Such projections took no account of a possible share issue: BAA believed that such an option should be held in reserve for expenditure on any new runway, or should there be any further major disruption to the civil aviation industry.

14.105. On BAA's current estimate the development programme, as a whole, was financeable from internal resources and debt by the airports taken together, at the level of prices proposed. However:

- (a) The programme would be more difficult to finance from the equity base of each airport, taken separately, on a stand-alone basis. This was because the programme was inherently more lumpy at the individual airport level. It was difficult to imagine how Stansted—a £400 million investment followed by ten years of cash outflows—could have been funded under this approach. If the airport had not been developed, travellers would not have enjoyed the lower fares and greater choice the airport has brought.
- (b) The programme would be progressively more difficult to finance if the price control formula were to be tightened, and any more aggressive proposals would need to be tested against gearing and interest cover effects. It was particularly important to maintain interest cover of over [3x] given default clauses if breached.

### ***Regulatory asset base***

14.106. BAA argued that the CAA had adopted a method of valuation of the RAB inconsistent with the previous report and the CAA comments when setting the current charges. BAA believed that the RAB should be based on accounting concepts, including actual depreciation using actual asset lives, and be estimated in a consistent way at each review, and on the same basis as used in the regulatory accounts. BAA was also concerned about what it regarded as the CC's failure in figures we put to them to take into account a significant shift in the amount of net current assets and liabilities, although BAA had produced its regulatory accounts including net current assets/liabilities since the last review. That would also be consistent with a financial capital maintenance approach. Not to include working capital would be an expropriation of financial capital. This is discussed further in Chapter 10.

## ***Investment programme***

14.107. BAA said that its projects were keenly costed, with little scope for cost saving. Commenting on points made by our consultants, BAA agreed with the need to have an independent review of T5 costs. BAA believed that its approach of partnering was preferable to one of fixed-price contracts, which had often not worked well in the UK: airport specifications were unlike other projects, and firms which had done the same job before were able to do so again at lower costs by introducing innovative methodologies. The rest of the construction industry was moving in that direction. As to benchmarking, BAA recognized it was far from an exact science, but did not consider benchmarking exercises were invalidated, as long as the limitations were understood and adjusted for wherever possible. Its current study represented the best effort at benchmarking T5 that the comparator data would allow. BAA also noted that the CAA's consultants had regarded its capex control and cost effectiveness as excellent.

14.108. On the contingency element of T5, BAA had started with £400 million contingency, which it regarded as not unreasonable for a project of this size, and the need for which had been validated by consultants. Some £150 million of this amount was left: just about enough to bring the project in on plan. Some of the £250 million could be accounted for by the cost of increased planning conditions BAA had not expected. The vast majority of T5 costs were not the terminal building which only accounted for £600 million to £700 million (£500 million excluding the baggage systems), but included buying the land from Thames Water and the cost of alternative waste treatment, and road and rail access.

14.109. BAA's comments on complaints about the capital programme, in particular about arrangements for consultation, are given in the section on public interest below. BAA said that it would have liked to have agreement with airlines on the investment programme—but had received few comments on whether the quantum, timing and distribution between airports was reasonable.

## ***Operating costs***

14.110. BAA also commented on a number of points raised by the CC on opex (see also Chapter 7). First, it believed there was little scope for real wages to increase less than assumed. It had already achieved everything achievable on pay in Q3, including lower pay rates for starters, and was now having genuine problems in recruiting the right quality of people for security, and there were increasing pay pressures in other areas. The job content in a number of activities was changing dramatically, much of which was dictated by Government. To meet these requirements it needed a good employee relation environment, a high-quality workforce, greater investment in training (including government statutory training) and low staff turnover. It believed its current pay levels were at the right level.

14.111. On productivity, BAA believed that it had taken all of the easy productivity gains over the last ten years or so: it believed it could not obtain further improvements without putting customer service at risk, particularly given government requirements. Productivity trends partly reflected lower traffic growth; but inter-company transfers also complicated comparisons of past and projected productivity improvements. Nonetheless, significant productivity improvements were built into BAA's forecasts, against a background of increasing requirements, particularly on security, and to cope with increased congestion before the opening of T5.

14.112. BAA believed absence levels were similar to comparable employees elsewhere, but had got slightly worse due to the increased stress on, for example, security staff: there was scope to make minor improvements. The degree of overtime was a direct corollary of efficiency in coping with peaking of passenger flows, but broadly in line with industry norms. BAA was, however, investing in a roster management system, which should result in some reduction in overtime, but which was already built into its projections. Central contingencies resulted from managers being set targets in the knowledge there was more chance of not meeting them than meeting them: the contingency balanced that to a more realistic target.

14.113. On pensions, there had been a five-year pension holiday with a zero contribution for Q3 (a 14 per cent funding rate had been assumed for that period), largely resulting from the performance of the stock market generally over that period. However, there was also at the last valuation a surplus associated with BAA's outperforming the market and similar schemes. In the financial projections there was allowance for a 7 per cent contribution, assessed taking the surplus into account, but there was a further 15 per cent centrally to take it up to a figure of 22 per cent which was assessed assuming the

surplus did not exist. (The accounts also previously contained a 3 per cent allowance for a separate fund for firemen.) The size of the surplus was, however, likely to have reduced due to falls in stock market prices and the 7 per cent figure would need to be increased. BAA did not, however, believe that the surplus should be expropriated to give to airlines. This was a one-off gain, due to outperformance over a defined period of time (unlike permanent staff savings which BAA would expect to be reflected subsequently in charges). To reduce airport charges as a result of the surplus would effectively confiscate the gains that resulted from the schemes' managers outperforming the market. Such an approach would mean that BAA could not take any risk in its schemes but merely cover the liabilities, since it would not get the benefit of any return on that risk. This would mean closing the existing scheme and switching to a defined contribution basis. Alternatively, if excess returns were to be taken away in such a way, the CC must be equally prepared to compensate for underperformance.

### ***Proposed value of X***

14.114. BAA supported continuing with a ten-year analysis since it was strongly against significant oscillations in inter-quinquennial charges levels. It believed a strong price signal was needed in particular for T5 so current users started to pay earlier in Q4 for the costs of a terminal expansion which the airline community had been requesting. As apparent above, BAA disagreed with any allowance for capex underspend; any revenue claw back should be deducted from the RAB to avoid a huge price increase in Q5.

14.115. Overall charges should therefore be set by reference to the long-term financial needs of the London airports overall, translated into individual airport formulae which reflected the relative levels of demand and capacity at each airport and such that:

- (a) BAA's airports had a reasonable expectation of achieving their overall cost of capital over the ten-year period, with recognition that this would rise as it became more committed to T5;
- (b) the cost of capital could be achieved without reliance on steep increases in charges in T5. Smoothing of returns between Q4 and Q5 and allowance for AICC was essential if BAA was to be able to raise capital for T5, since the likelihood of getting a very substantial price increase in six years' time was so debatable and uncertain the risk would be very high;
- (c) BAA could finance its £8.1 billion investment programme without any presumption of new equity and taking into account the need to allow for downturns from forecast in the event of repetition of 11-September-type incidents;
- (d) BAA could maintain an investment grade rating; and
- (e) BAA would have a reasonable platform to start work on a new runway, at whatever location the Government chose and take into account the initial capex on runway work required in Q4. This may require the raising of new equity.

14.116. The CAA had said that it would not accept proposals in excess of RPI+6 at Heathrow and RPI+5 at Gatwick and Stansted: hence BAA needed a formula at least equivalent to the CAA's proposals overall, constructed to reflect the relative pressures on each airport. Hence BAA proposed formulae of RPI+7 at Heathrow, RPI+3 at Gatwick and RPI+1 at Stansted: its priority, however, was the overall revenue requirement, rather than the balance between the airports. (The Stansted and Gatwick proposals did not increase the differential between the airports since in practice Stansted charges would rise as introductory rebates expired, whilst it may well be that the full RPI+3 was not taken at Gatwick.)

14.117. The formula should include trigger components, on the line suggested by the CAA, in which an extra £10 million a year in revenue was allowed on completion of the ART and ERS. The proposals assumed substantial increases in charges in Q5 would be required, but BAA would commit to set out on the capital programme on this basis. It could not, however, give an absolute assurance that the programme could be completed at this level of charges, especially if any of the forecasts turned out to be optimistic. It also proposed the formula would be subject to a Q factor accounting for not more than 2 per cent of revenues, symmetrically balanced, with half the total accounted for by airline-related elements and half by passenger-related elements, and an S factor with 95 per cent recovery.

14.118. BAA also proposed that we ratify the CAA's proposals for enhanced consultation, including spelling out clearly the responsibilities on airlines for effective participation in consultation; BAA would also be consulting airlines on proposals to implement a structured formal dispute procedure so that ongoing operational and capital issues were fully addressed between reviews. (These points are spelt out below.)

14.119. BAA also said that the CC needed to set out the criteria which would be used at future reviews for the treatment for overspend and underspend of capital. It should distinguish efficiency gains/losses, which should be kept or borne by the airport in their entirety; savings from a deliberate avoidance of spending obligations, which could be clawed back in full; and exogenous or windfall changes such as the delay to T5 which may be shared, but not less than 50 per cent being borne or kept by the airport. (Subsequently, however, it suggested that adoption of the trigger mechanism spelt out in paragraph 14.70 et seq would reduce the need for such an approach.)

14.120. BAA also commented on provisional proposals of the value of X we put to them based on a 7.25 per cent rate return. It said that, being on an IRR basis, this was effectively 7 per cent on a conventional basis, compared with the 7.75 per cent it had had, and which it believed was the absolute minimum in order to embark on such a large investment programme, when the aviation industry was in such turmoil. (It had previously regarded below 8 per cent as unacceptable.) If it did not get the IRR on which its own proposals were based, with no allowance for such a contingency, it would have three years of interest cover under [X], and one year of [X]. Moreover, in an industry investing for returns over 50 years' uncertainty about what the regulator was going to do at each review given such a change of policy and the prospect of [X] interest cover did not provide a basis for such an investment programme. Risk on the other hand had increased since the previous review. Adoption of a lower return would also increase regulatory risk, BAA having been encouraged to invest over £2 billion in the current quinquennium on the understanding it would get a 7.5 per cent return on capital value: if it was now to get less than that, there was a significant problem in terms of further risk. No normal company, moreover, would financially plan on the basis of a mid-point estimate of interest cover of [X], particularly if it was getting signals from its regulators about the unreliability of its long-term returns. Some of its covenants would be breached at [X], so it would be in default, and there would immediately be a significant credit problem if it were to plan on the basis of a lower figure. It would therefore have to reconsider aspects of its investment programme—for example, to introduce T5 in many more phases.

14.121. BAA also believed that its own proposals were necessary to provide an appropriate profiling of price increases, before T5 opened. There may be scope to bring forward price increases from the end to the beginning of Q5, should there be problems of interest cover and an indication from the CC that price increases would be necessary in Q5 was important. But it could not rely on investing money now on the prospect of more significant price increases in Q5 than in Q4. One-off price increases were also extremely difficult to achieve since the airlines might not be in a position to pay them at the time. It could not therefore be in a position of needing, for example, a 25 per cent price increase on opening of T5; hence any deferring of increases from Q4 to Q5 would be unacceptable.

14.122. BAA also noted that the need to advance income from Q5 to Q4 was because we proposed that the advancement of revenue to Q3 be recovered in Q4 rather than later: as noted above, the CAA had not said there would be an automatic return of the advancement in Q4, but left open the possibility that there might need to be some consideration of the rate at which it was dealt with. Events had, moreover, changed, particularly BAA's substantially raising its levels of investment.

14.123. BAA also noted that its model did not allow for the effect of higher gearing on interest rates, which could affect the financial ratios; that there was no allowance for expenditure on a new runway in our preliminary projections, nor for any asymmetric Q factor and the payments that would result; nor for payment under the possible 'triggers' being considered to relate charges to progress on capex, which also involved downside asymmetric risk.

14.124. We suggested that, even if the maximum level of charges at Stansted were set to earn the cost of capital, for modelling purposes Stansted charges should be assumed to be no higher than Gatwick. BAA said that published prices at Stansted above those at Gatwick would make no commercial sense. A lot of the low-cost airlines flying out of Stansted had an approach quite different from any other in aviation, and were quite capable of deciding against adding service, or moving to another airport. A one-off increase in prices at the beginning of Q4 was also not possible given the two- and three-year deals based on volumes. Some discount on Gatwick prices would therefore be logical, with an

assumption that charges moved towards those of Gatwick given BAA's intention to reduce current discounts.

## **Public interest issues**

14.125. In commenting generally on public interest issues, BAA said that many complaints were unsubstantiated or subject to ongoing negotiations or to negotiations that had been successfully concluded. Some were seriously inaccurate; several had never previously been brought to the attention of BAA, and in some circumstances actually contradicted previous feedback from other parts of the same airline; many attempted to contrast quality of aeronautical and retail areas etc, possibly an attempt to undermine the dual-till approach, which presumably could be put to one side if the single till were retained; several referred to projects being stopped/alterd without recognizing the fact that the primary driver for this was often a change in airline strategy which BAA was seeking to respond to; many allegations were 'naked self interest'; and others were merely 'fishing expeditions'.

## ***Investment***

### *Interim review*

14.126. We referred above to under-investment in T5. Some airlines believed that BAA's failure to request an interim review, or further adjust charges because of under-investment, was against the public interest. BAA argued that none of the triggers mentioned in CAP 664 (see Chapter 5) had been activated; it itself gave no assurance that a review would be triggered merely by delay in receipt of planning consent. It argued that timing fluctuations were and are a part of the risk of running the business; if the decision had been earlier rather than later it would have honoured its commitment. In maintaining this view it was reassured by the fact that its returns on capital value were almost exactly as the MMC had intended. Hence it regarded the view it had taken as true to the concept of RPI-X regulation, which envisaged that once fixed, the maximum price should not be variable at each turn of events but be reviewed at the end of the control period, taking account of the evolution of all aspects of business environment in the meantime.

14.127. When a mid-term review was sought by BA in late 1999, it was already too late to incorporate it in the regulatory cycle. Airlines had previously requested mitigation of charges as part of the annual charges negotiations but not a mid-term review. A review could not have started before January 2000; its scope would have been controversial and possibly wide ranging (for example, BA also wished it to deal with traffic forecasts, but it would also have had to consider substitution projects); and in all probability the process would not have been finalized before charges were in place for 2001. Moreover, at the time BA made its request, the CAA had just extended the existing formula for one year, to 2002/03; to have opened a mid-term review at the same time would have been perverse. The scale of the airline demands was indeed disproportionate to the delay to T5 expected at the time; the length of the delay, however, was also uncertain at that time.

### *Specific complaints*

- *Runway developments*

14.128. We note in Chapter 12 criticisms by BA and others of BAA's asking the T5 Inspector to rule out a third runway at Heathrow. BAA argued that much of the massive local opposition to T5 was based on the fear of the third runway; it had become apparent the Inspector understood this fear and found it difficult to find a way to recommend the approval of any development without trying to close the door to such a runway. It also argued that BA had not linked T5 with a third runway either privately or in public. BAA argued that it could not have consulted airlines publicly on the statement since that would have invited massive criticism. Indeed it had to be able to say to the Inspector the disposition had not been driven by airline views. However, BAA was in no doubt that BA did not wish it to make the statement but it felt it was the price which had to be paid to secure the T5 consent.

14.129. Airlines also complained about BAA's failure, as they saw it, to push for mixed mode to increase the capacity of existing runways at Heathrow. BAA told us that mixed mode would require

approval by the Secretary of State and planning approval for associated developments. The ATM limit to be introduced on opening of T5 would also much reduce the benefits of mixed mode, although this was an option being considered in the SERAS process. BAA argued that at Heathrow its objective had been to get T5 agreed and it had not wanted to do anything to undermine this.

14.130. As to criticisms of lack of runway development at Gatwick, BAA said that there had been improvements in Gatwick single runway capacity and the level of delays had declined, and any suggestion of another runway at Gatwick was subject to the role of Government in approving construction of any new runway: the Government had rejected all of the options of RUCATSE including one at Gatwick. It was not practical for BAA to bring forward proposals for another runway other than in the context of government policy, and given the government approach the question was one of runway capacity for south-east London as a whole, not for Gatwick in particular.

● *Iceberg*

14.131. We refer in Chapter 12 to criticism of delays to and other aspects of the 'Iceberg' project to provide additional long-haul capacity in T1. BAA said that the original target completion date of April 2001 alleged by BA was not one which any normal supplier would have committed to contractually because BA had not specified the project at that stage and BAA always had reservations about its achievability. (It had been accepted as a target only before the project scale had been defined.) The project was substantially delayed by the failure of the BA board to approve its financial contribution for some months, the ongoing operation requirements and by the very reasonable requirements of other T1 users to understand the impacts of changes on their operations and costs. BA's own Board of Directors did not approve the project until October 2000 because of its complexity. The project was also complicated by renewed pressure for Open Skies. As to BA's complaint of poor project management (see Chapter 12), the project was massively complex. Indeed BA staff had been appointed to the BAA project management board, and to that degree shared accountability for the project. BA had also not noted that the major victim of the post-11 September review had been that part of the project that provided enhanced retail space.

14.132. The project board had members from the principal T1 airlines, and consequently the airlines had full access to the development and delivery process. BAA also had the support of BA operational management in developing project timings and mechanisms which were compatible with the need to obtain satisfactory day-to-day operational capability. The need for a schedule which met the needs of both BA operational and BA project groups had been a major challenge and was one of the principal reasons why BAA had been unwilling to offer any guarantee of a delivery date in advance of such an agreement.

14.133. On other aspects of complaints about Iceberg, BAA said that it never sought to make a total 15 per cent IRR on the project, its current forecast overall IRR being a negative 2.7 per cent without the IDL extension, 2.8 per cent once the IDL extension was completed. This was associated with an increment in capacity of around 200,000 passengers a year. BAA's decision to proceed on this basis should reassure the CC that it did not use IRR's wilfully to evade its capital responsibilities. However, being less than the MMC's last cost of capital benchmark, this should alert us to the fact that projects of this kind would lead to rises in price over time.

14.134. As initially proposed, any capacity gain was modest and incidental: BA wished to take passengers from other airlines, BAA providing BA with new and altered facilities to allow it to shift long-haul routes into T1 and short-haul into T4, and to collocate routes with high connecting passenger flows, a facility not available to other airlines. It was also to provide a premium check-in area occupied exclusively by BA and capable of providing powerful branding: an exclusive facility not, for example, available to bmi (a scheme acceptable to bmi was subsequently achieved, but not pursued when bmi deferred its long-haul plans). It also provided other ancillary exclusive use facilities needed for long haul such as arrivals and CIP lounges.

14.135. BAA said that it did not and should not oppose projects of such a kind, recognizing it was a pursuit of competitive advantage which took forward the industry generally. However, it could not offer bespoke projects to all airlines at the same time for reasons of space if nothing else. Hence such projects could either be funded through inclusion in the RAB, which might be unreasonably discriminatory; or be separately appraised and a separate charge levied on the client airline, including the cost of capital.

(Failure to recover the full return from the client airline would mean other airlines would be paying for their capital.) This approach was of no lasting financial gain to BAA, since the revenue from specific charges offset general user charges. Given such competition concerns and the provisions of the Airports Act and CA98, BAA believed that it had to adopt this second approach.

14.136. However, it regarded key aspects of BA's initial scheme as ill-thought through and developed the project into a more worthwhile scheme which combined both specific elements for BA and general purpose user benefits to the airline community at large. Only as a result of such changes did any increase in capacity now result and the new facilities were likely to handle fewer passengers as BA reduced the number of seats per aircraft.

14.137. The project was therefore now divided into two parts: the bespoke elements to be separately remunerated under a bilateral agreement and the common elements to be remunerated by airport charges. The 15 per cent number related primarily to those elements of the project which were not general-user airport capacity, but bespoke provision for the improvement of BA's competition advantage, such as improving BA's check-in area. The 15 per cent was a nominal ex ante hurdle rate, likely to exceed the ex-post out-turn; and offset by much lower rates for other elements of the project such as bespoke baggage systems. A rescue contribution was directed only at CIP lounges, without that contribution these lounges were forecast not to make an adequate return. BA already had extensive CIP lounge facilities and its need for additional space arose only because of its wish to reorganize services between terminals to its own advantage; since 1987 BA had indeed provided CIP lounges as separate commercial projects which the MMC in 1991 and 1996 had not faulted. Hence, it would be unreasonable for BA to expect CIP lounges not to be fully remunerated including their cost of capital, through separate charges to BA. BAA was now content to receive the remuneration through rentals rather than through a capital sum.

14.138. After 11 September, there had been cuts to retail facilities, the baggage system (subsequently reinstated) and Europier: BAA said that it had accorded Europier high priority in the expectation of Open Skies which did not happen. It was still open to reinstating the project if airlines could establish it represented one which gave appropriate benefits (evidence on the value of pier service which it had asked for from BA would have been helpful). Consultation post-11 September had produced a clear level of emotional commitment to the scheme from BA, but little clarity on its strategy or business case.

14.139. As to the complaint that BAA had originally required BA to compensate for the loss of retail revenue in T4, this was simply a complaint that there was a single till at Heathrow: ie about the way the MMC had regulated BAA. Either all users would have borne the cost of lost commercial income; or BA through a separate arrangement. There was at the very least a case for this latter approach, but in the end it was not pursued.

14.140. BAA also argued that BA could have pursued any complaints either under the detailed dispute resolution procedure in the heads of agreement or with the CAA. BAA inferred that BA had effectively committed BAA to the investment and was now trying to evade the cost. The reality was, according to BAA, that BAA had sought to develop a cooperative, inclusive, team-based stance with BA throughout the project development, where a large number of contentious and difficult issues had been constructively addressed and resolved by the operational and project management of both parties.

- *T4 baggage*

14.141. There were also complaints about BAA's reluctance to invest in T4 baggage facilities. BAA said its problem was that BA sought a baggage systems specification which it believed would not be required by any other airline: hence after T5 opened and BA moved out of T4, any incoming airline may reasonably decline to pay for the higher specification, in which case all airlines would pay for it under the single till. BA had never denied it approached baggage operations differently from many other carriers, and hence that its facilities were often more automated and more complex.

- *Gatwick Pier 6*

14.142. Several airlines complained about delays to the Pier 6 project at Gatwick. BAA described Gatwick Pier 6 as a project which did not add to airport capacity significantly but simply provided pier

service to additional stands. It was originally conceived by BA and agreed with BAA as part of the BA strategy to develop Gatwick as a second major hub (although initially BA had pressed for construction of a major satellite costing several hundred million pounds and a row of B747 hangars); BAA was subsequently concerned that the cost of Pier 6 alone could exceed the benefits accruing to airlines and asked BA repeatedly for assistance in identifying and quantifying the benefits, but no useful information was forthcoming. BA had subsequently rested on the argument that the project must be completed regardless of its cost and benefits to meet the 90 per cent pier standard. BAA, however, pushed ahead with the work, the stage 1 reconfiguration of stands being completed shortly after 11 September.

14.143. After 11 September, however, Gatwick traffic collapsed, BA abandoned the Gatwick hub strategy and began lobbying for Open Skies at Heathrow and was also gearing up for its own ‘size and shape’ strategy review, telling BAA its own financial situation was desperate and asking for massive reductions and waivers for landing charges among other things. Other supporters of the project included the US airlines who had also given notice of an intention to shift service from Gatwick to Heathrow if they won open skies. Any airlines transferring into North Terminal to replace BA or other airlines may either use the existing piers more efficiently than BA for which there was considerable scope or attach a lower priority to pier service. BA was not revealing its intentions to release slots at Gatwick, while BAA was aware the airline most likely to want to pick up any unused slots was easyJet, which was currently in South Terminal and had a lower priority for jetty service than BA. Hence BAA decided to delay the project. BAA believed its judgement had been vindicated, because of BA’s massive cut in its services at Gatwick and release of slots in tranches, while easyJet grew its operation in the South Terminal. Completion of Pier 6 was included in the capital programme, however, since other airlines supported it and it would be restarted as and when the prospects justified it. BAA did not, however, want to execute the project primarily for use by an airline which then left Gatwick leaving others to pay for it. Airlines needed to engage with BAA on the issues raised about the real benefits of pier service. (See also paragraph 14.183.)

- *Metro stands*

14.144. We also received complaints about delays to a project to provide pier service to the Metro stands in T4. BAA said that the decision to pause the project was taken at a time when Heathrow’s traffic was down by 20 per cent, and following BA’s announcement of massive staff and service cuts, and demand for emergency relief. BAA was also ‘bleeding cash’: hence, temporarily pausing non-essential projects was a sensible step. BAA also said that BA’s response to consultation did not give BAA confidence that BA had a clear strategic priority for the project, since it was entering its major size and shape review, with uncertainty as to the restructuring of its activity in the Heathrow short-haul market, which would have made the Metro stands redundant before being opened. When BA decided to transfer-in services from Gatwick, the scheme was reinstated in a draft CIP provisionally to start in 2003, but still subject to consultation: if users attached high priority to the scheme, BAA would be sympathetic to bringing it forward. (Further comments by BAA on this scheme in the context of quality of service are in paragraph 14.182.)

- *Transfer baggage facilities*

14.145. We refer in Chapter 12 to complaints about the time taken to improve transfer baggage facilities for bmi in T1. BAA said that construction was originally scheduled for April 1998 and Phase 2 by summer 1999. The construction of Phase 1 was delayed by the time taken for decant of BA ramp handling from that building. It was therefore complete by only August 1998; however, the actual processing capacity of the facilities did not meet the original design specification, and extensive analysis and monitoring was implemented to determine why. The processing and bag profiles were found to be different from the original brief in relation to messaging and reconciliation. Discussions took place during 1999; and the final design brief for Phase 2 in the light of those shortcomings was not agreed and signed off until December 1999, when both parties were convinced it was robust.

14.146. BAA acknowledged that the redesign of the original T1 baggage works and implementation of the tunnel did create disruption for bmi, hence in 1997 BA made a concession on the rent of the bmi hangar to include a waiver of the up-coming rent review in part to offset the costs to bmi of disruption. In February 1999, it agreed to give bmi a credit of £[£] against its invoices, as ex gratia compensation for the disruption. The payment was an agreed settlement of all bmi claims relating to Phase 1. As part of

that settlement it undertook to complete Phase 2 as soon as possible with an initial target date of early 2000. In the event the final design brief took longer to complete, as well as the delay in reclaiming occupation of the site from its previous tenant: hence the project was not fully completed until May 2001. In August 2001, bmi submitted an additional claim against BAA for losses resulting from this delay (for £5.4 million); BAA did not have a legal obligation to meet the claim but it was prepared to consider a further *ex gratia* payment. bmi admitted that the calculations were subjective and were based on the arbitrary and unexplained assumption that the delay to the project was responsible for 62.5 per cent of missed bags during the period. BAA, on the other hand, examined the records held in the data warehouse, collected automatically from the system installed in response to exhortations in the 1996 review; this established that no more than 5.4 per cent or less of total missed bags could be attributed to inadequacies within the building. By contrast, a significant proportion was attributable to the sale by bmi of tickets allowing insufficient connection time. The quality of the data had not been challenged, but notwithstanding this BAA made a goodwill offer of a package of measures worth [£]. BAA had also indicated its willingness to consider an increased package of compensation measures, although it did not accept that the evidence supported a larger settlement. BAA subsequently told us that it had agreed with bmi a full settlement of bmi's claims, and that bmi was now happy with its facilities.

- *Stansted*

14.147. We refer in Chapter 12 to criticism of investment at Stansted not reflecting the needs of lower-cost carriers for inexpensive facilities. BAA referred to Satellite 3 at Stansted being developed as a two- rather than three-storey building and without provision of airbridges, at significantly lower cost, as an example of the flexibility it needed to embrace the needs of current operations and potential future users (provision had been made to add airbridges at a later stage should circumstances alter). It also said that amendments and additions to Stansted had to be in line with the terms of original permission. BAA did safeguard the TTS station box in Satellite 3 in order to allow future extension of the TTS to Satellite 3 and 4 if required: this aspect did not meet with the universal approval of the low-cost airlines, but BAA believed this to be the most appropriate design to protect the airports' long-term flexibility.

- *Gatwick*

14.148. BAA also commented on BA's claim that there had been less investment at Gatwick than projected at the time that the formula for Q3 was set. It said that Gatwick investment had exceeded that previously projected, the figures showing this being available in each year's CIP.

### *Systemic under-investment*

14.149. Airlines, including BA, argued, based in part on the above project, that there had been systematic under-investment in Q3. BAA argued there was no evidence to support this, referring to investments on projects other than T5 exceeding the 1996 assumptions, and projects added to the programmes of all three airports in response to the T5 delay. Net underspend of £435 million was itself less than 15 per cent of total capex. BAA's willingness to commit £250 million to T1 future concepts (previously called Iceberg—see paragraph 14.131), which was not in the 1996 programme and which had a weak financial case, was strong evidence against systematic underspend. Neither had BA acknowledged that at each year's capex consultation BAA asked airlines to identify additional projects to compensate T5 delay, but airlines had failed to do so. Two of the projects cited, Pier 6 and Metro stands, were both based on the events of 11 September. BAA also argued that BA failed to address the consequences of its own swings in strategy and its shortcomings in providing information and explanation for its proposals.

### *Response to 11 September 2001*

14.150. Some of the specific complaints raised related to BAA's failure, as airlines saw it, to consult on reductions to capex after the events of 11 September, or to lower airport charges following those reductions. BAA argued that such assertions were incorrect. In the two months after 11 September, traffic was so volatile and so depressed it was impossible to forecast, especially as it was unclear whether further acts of terrorism would follow. Traffic was 20 per cent down at Heathrow, 12 per cent at

Gatwick; airlines were in deep distress and using the uncertainty of future demand to justify major reductions in capex and other expenditure; BAA was still spending over £10 million a week on capital projects; but was also experiencing monthly revenue shortfalls against budget at a rate equivalent to over £150 million a year.

14.151. For BAA to have proceeded without at the very least taking stock of the situation would have been irresponsible. Indeed had it continued spending unabated, accumulating the cost into the RAB would have exposed airlines to the greatest infrastructure risk.

14.152. BAA had indeed written to all airlines inviting their views; and consulted the AOC and arranged a meeting with some of the airlines, and also had discussions with LACC and SEAG.

14.153. As to consultation with BA, BAA said that in its view exchange of correspondence was merely a vehicle for BA to game in front of the regulator. Correspondence with BA at the time was focused almost entirely on demand for charges reductions.

14.154. As to the BA argument that BAA did not cut its airport charges in line with its capital expenditure cuts, BAA was not considering changes to the capex programme simply to give airlines cuts in airport charges. Airlines were already paying charges below the maximum allowable, and were separately demanding major rescue cuts. BAA in reviewing its programme had in mind that if the collapse in traffic was prolonged, its own finances could be severely tested; and that 11 September was likely to presage major structural changes in the industry which were likely to affect the level of demand and distribution between airports (as subsequently proved true, demand being lost at Gatwick and gained at Stansted). This would affect the priority between projects; airlines themselves were likely to change the balance of their priorities after these events, for example by deferring aircraft purchases such as the A380; 11 September was likely to create demand for new security-related projects, the cost of which was unknown, but which would have to be financed out of existing resources; and it was most critical to focus efforts and spending on those projects which contributed most value to airlines and passengers.

14.155. BAA said that it had raised all these issues in the consultation; the first was simply ignored, little insight was provided on changes in the structure of demand, and not much was said on priorities.

14.156. In practice, the capex programme was not halted immediately after 11 September; the largest projects continued on site; some projects were temporarily paused, mainly Pier 6 at Gatwick, now reinstated for start in 12 months, and Metro stands at T4, also now reinstated. New projects were added to the programme, most notably the accelerated segregation of piers to meet security requirements. Actual spend in 2001/2 was £525 million, a shortfall of 10 per cent: the effect of any reduction in airport charges to reflect that amount would have only been one-fifth of 1 per cent (about £0.01 per passenger).

## ***Consultation***

14.157. BAA said that the CAA rightly identified effective transparency and consultation as an essential part of the regulatory contract. BAA supported this view and was continuing to improve its own consultation processes independent from any regulatory requirement. It also welcomed the CAA's acknowledgement that future consultation processes may be subject to some issues of price sensitivity and delicacy in relation to planning negotiations.

14.158. A number of real world limitations needed to be recognized in specifying the content of consultations, namely:

- (a) The views of today's airlines did not necessarily represent the long-term interest of the public. The CAA recognized this in its October 2000 paper. Indeed there were circumstances where users may wish to frustrate the development of new competition, or gain competitive advantage. Airports must not therefore be put under an obligation simply to do 'as asked' in consultations, although they may legitimately be expected to justify their decisions where they differed from airline preferences.
- (b) The consultation process should not inject undue rigidity into planning. A fixed fully specified ten-year master plan would represent a kind of mechanistic, deterministic thinking dating back to the 1970s, which had now been superseded by broader long-term strategies, with detailed plans for the short term.

- (c) Excessive information and publication demands would create an ‘intrusive cottage industry’, aimed at satisfying the regulator in a ‘gaming’ process, rather than genuinely improving consultation.
- (d) More generally on BA’s suggestion that the capital programme be established as part of the regulatory decision and executed as set out and only altered with full airline agreement in writing, BAA believed it highly improbable that airlines would ever reach a full consensus on major aspects of the CIP which affected their commercial objectives.

14.159. Of course consultation would only be effective if all parties resisted the temptation to ‘game’, and came to the table constructively. BAA had made the proposal that the obligations of both airports and airlines should be the subject of a code of conduct, and encouraged the CC and CAA to consider this possibility further.

14.160. BAA referred to over 80 ‘main ways’ of consultation at Heathrow over the last six months. It told us that it had made great efforts to improve consultation arrangements on its investment programme, with very positive feedback from recipients. It was used as an example of best practice by airlines.

14.161. Its broad ten-year development strategy was set out in the 2002 CIP. This represented another step forward in providing airlines with information on which to review the overall programme, and was almost certainly the most comprehensive consultation document produced by any airport operator in the world. A number of airlines found it too detailed and were unable to digest the amount of information provided. The CAA’s requirements had only emerged during the course of this review and the 2002 CIP was BAA’s best effort to moving towards meeting them in the time available, but it envisaged further improvements next year. The CIP was not meant, however, to be the main vehicle to discuss in detail the changes and configuration of individual projects. Quantification of outputs was normally provided in separate specific consultations, and the same was true of options which were discussed with airlines at great length. To include all these individual project details in the CIP would make the document extremely voluminous and unwieldy and divert readers from the broader issues into detail. Precise quantification of outputs of projects in the medium to long term, moreover, was more problematic: they were by definition not fully designed and in some cases simply represented provisions of money to deal with anticipated issues. Even if specified, the outputs would depend on major forecasting assumptions

14.162. To the degree that BA’s version of a masterplan was not reflected, BAA took this to mean a fixed and fully specified programme for each individual investment comprising the total development of the infrastructure. To produce a fully specified single plan would also require an assumption on if, where and when a third runway would be built. The Government had made no decision on this. BAA would also have to make an assumption about segregated mode and the ATM limit; Open Skies; and which airline would occupy which terminal in future; and other external issues including, for example, prospects for Crossrail, powers to road charge, future environmental policies and constraints; and finally about future airline alliances. These were all good reasons for BAA to operate a broad development strategy which could accommodate evolving conditions rather than work to an original masterplan. Had a masterplan previously been adopted, there would have been considerable expenditure at Gatwick related to BA’s development there of a separate hub, a strategy that subsequently changed but would have left other airlines to pay significantly higher charges had that investment gone ahead.

14.163. On criticisms that the absence of a masterplan resulted in piecemeal development, BAA said that it did not believe there was a material risk of projects currently in the programme needing to be demolished in the foreseeable future: over 15 years it only had to mothball one project (a small scheme to provide domestic facilities at Gatwick North Terminal, specifically demanded by BA to meet its urgent need to transfer services from the South Terminal). It also did not envisage any need to demolish the Virgin hangar at Heathrow, about which BA complained, which would only be required if the most grandiose scheme for the development of the Eastern Apron were implemented. This would only be contemplated if there were a third runway and there was no prospect of it happening in the next 10 to 15 years. The Eastern Apron development was not included in this capital programme and if it were it would have a major effect on charges.

## *Connectivity*

14.164. As noted in Chapter 12, we received particular criticism of lack of consultation on connectivity between T5 and the CTA. BAA said that studies had been undertaken into connectivity as part of the design concept work for T5 which identified road-based solutions as the best way forward. The airline community had expressed a strong interest in the TTS with both passengers and baggage; at their request, BAA had investigated such a solution and sought views on it. The core issue was whether a TTS would be a cost-effective solution: BAA had been determined to ensure a careful consideration of costs and benefits. It was recognized in the planning objectives that overall benefits should outweigh overall costs.

14.165. A minimization of the need to transfer bags and passengers was one of the criteria adopted in the original T5 occupancy discussions, at which time BA envisaged moving all its service into T5 and T4 and connectivity requirements would have been low. Subsequently, BA's vision of its operations had changed and it now envisaged keeping operations in T1 and subsequently in T3 or T1. But the number of passengers using the system would still be relatively small, and at high cost per passenger.

14.166. A development of initial cost estimates for connectivity, an outline programme, and outline charges implications were presented to the London AOC in October 2001 when the airlines were asked to consider the implications of the potential charges and advise on their wish to proceed or not. Neither was forthcoming but in February 2002, BAA were asked to proceed with the next stage of planning against an understanding of an airline commitment to consider and debate charges implications, with feedback anticipated this coming autumn. BAA was now focusing on the incremental benefits and costs that would arise from a change from the current plans for a road-based solution to a TTS for passengers and a more automated transfer baggage system. However, the work continued to be complicated by the continuing uncertainty over terminal occupancy post-T5s opening.

14.167. BAA recognized, however, that efficient and effective connectivity was essential; any nervousness was a product of uncertainty over whether incremental benefits exceeded incremental costs. However, it had responded constructively and its CIP assumed the first phase of an automated transfer baggage system at the opening of T5 between that terminal and T3; Phase 2 would then extend the system to T1 and Phase 3 to T4. There were a number of options for further elements of connectivity, including road-based, automated and mixed system: airlines had been provided with cost data and asked to advise their preferences. The possibility of a third runway further complicated the issue since different schemes would be appropriate with/without the runway. There would also be significant disruption problems if the project was to be completed to make the T5 Phase 1 opening: and the need for land acquisition from Thames Water may prevent that timing. It was also not feasible to extend the TTS until Satellite 2 was in operation; Satellite 2 itself could not be built until the new Thames Water sewerage works was in operation. But when Satellite 2 was open and more BA services could move to T5, the case for the TTS was even weaker.

14.168. BAA argued that BA had pressed for early implementation of a fully automated option with no regard to its costs or who would pay for it. The cost of additional tunnelling schemes put to it approached £1 billion, of which little material on the benefits to airlines had been made available. The project was linked to BA's promotion and development of the Eastern Apron, which would also cost well in excess of £1 billion (major remodelling of the apron, the closing of the crosswind runway, and the construction of two satellites). BA's proposals for an Eastern Apron scheme that would provide very substantial increase of total aircraft parking capacity were very difficult to reconcile with the 480,000 movement limit cap. BAA also felt the BA proposal for a T1 to T5 tunnel inconsistent with its wish for T3 airlines to move into T1 and for itself and its partners to co-locate to T3 and T5. The optimum design of a TTS system also depended on whether BA was successful in promoting the third runway at Heathrow; if so, any scheme which failed to take that development into account would be very suboptimal or even a major constraint on third runway or terminal design. Increased construction work in the CTA would also have major implications for airline disruption and passenger service, but BAA had received no clear guidance from airlines whether they would be prepared to contemplate such disruption: without such guidance, its view was that such a scheme could not be implemented in full before around 2010.

14.169. Hence, when T5 opened, BAA would have provided for a workable, flexible, low capital cost, road-based solution to connectivity with an automated baggage link: BA had not yet made a compelling case for its fully automated TTS option, but if it could do so and users generally were

prepared to commit to paying the high charges and land purchase could be resolved, BAA could move to a decision to move forward. (One option could be for the TTS to go halfway into the CTA rather than all the way around.)

### *T5 occupancy*

14.170. We also refer in Chapter 12 to complaints of inadequate consultation on which airlines would occupy T5. BAA told us that it sought to establish the likely occupiers of T5 at an early stage so it could work with them to develop the details of the scheme most effectively. To help make that decision it established, in consultation with the industry, three criteria for terminal allocation generally and T5 specifically, namely to allow for best use to be made of the airport, terminal and apron capacity overall; to maximize the number of passenger transfers able to take place without changing terminals (and connectivity issues were still best satisfied with the current plan); and to minimize the number of airlines required to shift between terminals. It employed consultants to build a complex computer model to test options under the criteria which demonstrated that BA was the occupant best able to fit them. The community overall was consulted thoroughly in 1996 and again 1998. Having established the preferred occupancy BAA was addressing the subsequent issues. It was important to ensure that the appropriate infrastructure was in place to allow airlines remaining in the CTA to have appropriate facilities: hence, the CIP included £510 million expenditure over five years at T1 and T3, plus minor projects at T2, T4 and between CTA terminals. However, BAA had not yet committed to a specific long-term allocation of airlines between terminals but wanted to discuss the needs of each airline individually, and then to consult further about the occupancy paths for all five terminals when T5 was open: no airline had yet been firmly committed to any particular location. There was also provision for a further £600 million expenditure on CTA post-T5 opening.

#### ● *T5 costs*

14.171. We raised the issue as to whether there had been adequate consultation about T5 with those airlines unlikely to occupy it, but who would nonetheless pay higher charges as a result. BAA said that there had been consultation at varying levels over the years, including all airlines on the broad issues at the early stages. Subsequently, consultation on detail had been primarily with BA (but with major consultation on the TTS). All airlines were given details on the overall shape and structure of the project and its cost, and there were six-months of discussion with them about this; and LACC met frequently and could raise any issues on it. BAA was quite happy if airlines wanted to look over the detailed changes, but none had not yet wished to do so.

### *Little America*

14.172. We also note in Chapter 12 criticisms of inadequate consultation on changes in security arrangements in T3 after 11 September—a scheme referred to as Little America. BAA said that a directive was issued by the DTLR in January 2001 requiring all non-segregated terminals to become segregated and until such time as segregation had been implemented, non-compliant terminals were required to carry out additional security measures. Following 11 September, there was a requirement that in all non-segregated terminals, passengers were to be subject to 20 per cent search at the departure gate and, in addition, continuous searches of passengers' cabin baggage and items carried were to be conducted in respect of all North Atlantic departure flights. This was later formalized as a direction. To achieve economies of scale, HAL attempted to consolidate gate search: hence the possibility of using Gate 16. Planning exercises, however, identified resulting problems of stand utilization and loss of pier service, and the gate room was also found not to be physically large enough. It was also identified that there was insufficient capacity to accommodate all the non-European flag carriers on Pier 7, placing these carriers at a competitive disadvantage as their flights would require searching in the departure gate. There would be a significant decrease in pier service for these and other T3 carriers not flying to the USA. The DTLR also failed to give definitive answers as to the acceptability or otherwise of Little America: but stated that an alternative partition solution on Pier 7 offered a better all round product. Final notification from the DTLR that the Transport Security Administration (successors to the Federal Aviation Administration) had rejected the UK proposals for Little America was received 22 April 2002: the DTLR were stressing that physical segregation of Pier 7 must be given immediate priority. This had recently commenced.

### *Alternative approaches to investment and consultation*

14.173. During the course of our inquiry, BAA and the CAA agreed the contents of an enhanced information disclosure and consultation document. The document would allow users to understand the principal business drivers; forecast demand capacity (including implications for quality of service); options for the development of the airport around the central plan; resourcing implications; cost estimates of individual projects; and expected outputs. It would be provided on an annual basis and include an account of how the plan had changed and an explanation. It would act as a basis for consultation only and would not represent a mandatory investment programme. BAA noted the CAA's statement that 'demonstration that BAA has consistently ignored the reasonable request of users in the consultation process without good reason and contrary to the interests of local users generally would jeopardize the sustainability of the regulatory framework'; also that airlines would need to cooperate in the provision of information on the costs and benefits to them, and allocate sufficient resources to engage in the process.

14.174. We note in Chapter 12 suggestions that there should be legally binding agreements between BAA and the airlines, and/or mandatory investment programmes. BAA believed that there were several problems to this approach to capital planning:

- (a) There was no evidence the current approach with an annual CIP is in any way flawed. Users did not seem to have claimed there had been projects undertaken which were not required or projects not undertaken which should have been and which were within BAA's power to instigate.
- (b) Such an approach would be completely inflexible as BAA would be uncertain how to proceed with mandatory investments which might no longer be required (for example, due to airline moves).
- (c) It was unclear how agreements which were legal/mandatory in nature would deal with projects delayed by planning or governmental issues.
- (d) As a result the process would continually be stuck with either the CAA or lawyers to resolve leading to more intrusion, higher costs and delays.
- (e) Incentives would be very poor—BAA would only proceed under conditions of complete certainty and there would be no incentive to be cost-efficient.
- (f) Agreements that obligated BAA to carry out investment projects which airlines were free to use or not would be one-sided.
- (g) It was by no means certain the current legislative framework supported such an approach.
- (h) As a result, not surprisingly, the CAA rejected this form of capital planning and investment.

14.175. BAA therefore agreed with the CAA approach which focused on customer specified outputs rather than levels of expenditure. If airlines specified throughput levels and quality of service, BAA's performance should be judged on these. The CIP consultation should be positioned within this framework allowing BAA to judge how best to meet user needs.

14.176. However, BAA was sympathetic to airlines' views that charges should in some way be linked to delivery. This could comprise either airports simply undertaking to provide any given level of throughput at a certain level of service standards (with the incentive provided by its Q factor proposals); or charges linked to the provision of certain predefined outputs; or charges contingent on major project milestones throughout Q4. These would have to be for projects already well defined where there was a high probability this would still match airline requirements: see BAA's specific proposals in Q4 in paragraph 14.70.

14.177. In the context of complaints more generally, BAA said that it was surprised and disappointed by submissions regarding its conduct. Few of the issues put before the CC had been raised at meetings with the Chief Executives of major airlines. No complaints, moreover, had been made in the last six years under section 41 of the Airports Act.

14.178. BAA was therefore intending to consult with airlines and other interested parties on the creation of a formal complaints procedure, to provide its business partners with a mechanism to

challenge actions which BAA had taken after those business partners had exhausted the usual means of communication. Subject to a positive response from consultees, BAA would launch this procedure in April 2003, and review the trial later that year.

14.179. It thought that there should be a two-stage process. In the first stage the complainant would submit a written formal complaint to the relevant airport, indicating whether or not it wished to have a meeting; the recipient would then have a specific period within which to arrange any meeting and to respond. If the complainant was not satisfied with the response, it would have one month in which to decide whether to submit an appeal, to be made in writing to the member of BAA's Executive Committee with responsibility for the airport. Again the submission would indicate whether or not the complainant would wish to have a meeting with that member; that person would then have a specific period within which to arrange any meeting and to respond. Before responding, the member of the executive committee would be required to review the complaint with a senior BAA executive not employed at the airport concerned, to enhance the degree of independence in considering the appeal. BAA had considered creating a role for an independent third party, but believed the risk of a third party making recommendations based on limited knowledge of the subject outweighed the potential benefits of a fresh view. This would though be an issue to raise in the consultation. This mechanism would not be used for individual passenger complaints, but for complaints by aircraft operators and handling agents. BAA would expect any complainants to agree to suspend or not initiate litigation action or Airports Act section 41 complaint while the formal complaints procedure was underway. Suggested time scales should enable a relatively rapid response to any complaint made, but it would be prudent to allow for them to be shortened or extended if necessary by mutual consent.

14.180. The main advantage of this approach was that the procedure could provide an additional mechanism for resolving issues about which business partners felt strongly, thereby reducing the danger of issues festering. There might also be fewer complaints made at the next regulatory review. The main disadvantage was that it could harm the generally successful relationships that BAA enjoys with its business partners, or add costs and possible delay to the resolution of any disagreements.

### ***Service standards***

14.181. We referred in paragraph 14.79 et seq to BAA's views on the Q factor proposed by the CAA, and in Chapter 12 to complaints by airlines both about service standards in general, and particular aspects of service.

#### *Specific complaints*

- *Pier service*

14.182. There were criticisms of pier service levels, particularly at T4 at Heathrow, and North Terminal at Gatwick (partly associated with complaints about the Metro stand and Pier 6 investments referred to above).

14.183. BAA acknowledged that T4 pier service levels had dipped below 90 per cent. However, pier service levels were determined by a combination of infrastructure, operating practice of airlines, and commercial and operational priorities adopted by airlines and handlers in operating aircraft stands: BA's choices regarding its aircraft maintenance regime had a tendency to lengthen aircraft turnaround and on stand time, thereby reducing pier service levels. BAA had been determined with the support of airlines to provide additional aircraft parking stands whether pier served or not to minimize the impact of this capacity constraint. The opening of T5 in 2008 implied the benefit of any new pier development would be negated in six years' time. Nonetheless, extension to the Victor Pier into the Metro Stands would increase the level of pier service by between 6 and 10 per cent; this project had faced a number of practical difficulties in addition to these operational and strategic difficulties. The recovery of Heathrow's traffic subsequently had been more rapid than expected and BAA would entertain positively a suggestion from BA that the project should be brought forward, although BAA subsequently told us this also offered the only ability in T4 to provide capacity for A-380 aircraft operated by Qantas (which would presumably in turn free up stands for BA). The move of BA from Gatwick to T4 was itself likely to lead to a reduction of around 4 per cent in pier service levels this year. It would be prohibitively expensive to provide pier service to some stands, which BA had accepted. With the benefit of hindsight

BAA recognized that it was possible that it could have progressed more speedily on extension of the Victor Pier: but BAA was confident that at each stage of the process it had taken the appropriate decisions.

14.184. BAA said that the overall pier service level at Gatwick was not as low as quoted: in 2000/01, the figures were 96 per cent for South Terminal and 79 per cent for North Terminal (the latter figure, however, probably underestimates the true level of pier service as it excludes for example aircraft that depart from a pier served stand but were held on a remote stand). BAA did not believe it appropriate to reduce runway and terminal capacity to improve pier service: and BA had been aware of pier service limitations when it moved from Heathrow to Gatwick and subsequently co-located its operations in North Terminal, worsening the pier service level. Subsequently, studies with BA into a wide variety of options took time to complete. Pier 6 was the more obvious example. Were BAA to have leapt forward with more radical pier service options, the airport would currently be in an extremely difficult position.

14.185. There were also complaints about BAA's failure to achieve the T4 jetty service availability target for two months. BAA said that this resulted from two unforeseen and serious faults with the airbridges which involved the acquisition of spares that were not normally stock items for Heathrow or the manufacturer. However, except for those two months the target had been reached, and had been reached over the year as a whole. BAA also said that as a goodwill payment it had voluntarily made the standard airbridge rebate in circumstances where an airbridge was unserviceable but the stand could still be used, although coaching costs would not normally apply.

14.186. On the adequacy of the remote stand rebate, BAA said that it was intended to recognize the service offered to passengers on remote stands as less attractive. Airlines in recent years had raised concerns that the rebate did not reflect the cost of coaching and BAA had responded by increasing its size to £3.00 per departing passenger. The purpose of the rebate was never to compensate fully for any increase in costs to airlines or reduction in services to passengers: but it was also a very substantial proportion of the total charge per terminal departing passenger. However, the coaching service at Gatwick had recently been tendered with the supplier currently charging £0.93 per passenger—hence it was surprising to see the suggestion that rebate was insufficient to cover costs. That benchmark of £0.93 per passenger suggested the rebate more than covered coaching costs and, therefore, probably met or exceeded any additional costs arising from coaching (handling staff were clearly required to operate a jetty and these costs should be deducted to arrive at the incremental costs in any assessment). It was difficult to envisage an airline losing business as a result of passengers being bussed or walking up and down stairs: BAA's survey of passengers in 1999 showed use of jetties to be the 33<sup>rd</sup> most important contributor to a good airport experience out of 38 items listed. BAA had also asked BA for information on the value of pier service: no such information had been forthcoming which made it difficult for BAA to take account of airlines' costs and any marketing loss in evaluating pier service projects and judging how to set the remote stand rebate.

- *T1 complaints*

14.187. We note in Chapter 12 a series of complaints about service standards in T1. BAA told us that during holiday periods bmi operated some charter flights which check in earlier than usual: on some of these occasions HAL was asked to open the security combs earlier to accommodate these passengers and to allow for the increase in security processing time. Where possible it tried to respond positively to these requests by bringing in staff early, but on the last occasion this was done the facility was not well used, which led to a discussion with bmi explaining that HAL would be reluctant to do this in the future if bmi was not able to confirm expected flows in advance. BAA was not aware that these opening times had been the cause of delays to departures. In the immediate aftermath of 11 September, however, and with new security requirements implying secondary searches at gate rooms, HAL did not have sufficient staff to cover simultaneous flight departures and at times staff were rushing from one gate to another: it was possible that staff were delayed to the gate sometimes. Additional staff had since been recruited.

14.188. As to hours of manager service delivery (MSD teams) although they were as stated by bmi, these were supported by a team of customer service duty managers who covered across the full 24-hour period. The MSD teams were in addition extremely flexible and altered their hours to suit local needs. HAL did not believe the MSD teams' rostered hours impacted on the level of customer service or operational management.

14.189. On contingency arrangements for baggage system failures, the T1 baggage system had built in contingency and redundancy and most failures could be addressed by redirecting bags on the system. Serviceability of the system was good and in most eventualities BAA could alter the process in a secure manner and secure the operation. Prior to 11 September a major departure baggage belt outage could be addressed by sending hold baggage directly to the gate via the main passenger security comb. A change in the security requirements since 11 September had meant that a major baggage belt failure had a more serious impact on the main passenger security comb since all sharp items must be removed and due to the increased search imposed by the DTLR. As a consequence HAL was actively exploring options to give further redundancy contingency to the system on the very rare occasions when hold bags needed to be taken to departure gates. The airline community would be involved once the contingency arrangements are sufficiently developed.

14.190. On time taken to repair major operational systems, the individual PCs used to run the system to the monitors at Gates 36 and 38 had failed and required rebuilding with new main component parts. Once this had been completed the systems were reinstated, but subsequently the monitors themselves failed and had to be replaced. The accumulation of these activities led to the delay in repair which was regretted. HAL planned an investment project to replace these entire systems, which was under development.

14.191. As to short notice closure of stand for insurance inspections, HAL was aware there had been some difficulties. Its aim was to communicate with airlines by notifying them four weeks in advance, but there were occasions when inspection staff arrived at the stand at the planned time to find the stand in use preventing the inspection from taking place. HAL did receive and respond positively where possible to request from airlines to change these times. However, a more carefully planned approach was now being undertaken with regard to insurance inspections on all passenger sensitive equipment: the appointment of a statutory insurance planner within the HAL engineering department and the integration of this activity with planned maintenance had already improved performance.

14.192. On roof leaks, roof repair had been part of the general airport building and civil engineering contract. Following some concerns about work undertaken and the complexity of other repairs leading to unacceptable periods of disruption, a specialist roofing contractor had been appointed, and he had a planned schedule of surveys and maintenance. Any minor repairs identified were rectified immediately, more detailed work was raised with the project/planning department. Blocked gullies and roof outlets had already been identified as a major contributory factor to roof leaks and the planned maintenance of these items had been included in the role of the roofing contractor.

14.193. On air conditioning, poor performance of air handling units serving Gate 2 and 8/12 was identified last summer and the original manufacturer was repairing and enhancing the performance due to the inability of the existing contractor to rectify the faults. At Pier 4A the units had also been identified as performing badly and these were currently being replaced.

14.194. As to Pier 4 a programme of repainting and replacing significant areas of carpet was underway; seating was provided throughout the gate rooms totalling approximately 1,000 seats.

14.195. On specialist assistance facilities, the pier was built over 30 years ago and was not as wide as more recently designed piers which could provide traveller assistance. Special need assistance to the apron level was provided via a lift at Gate 6; provision of a lift in Gate 5 was part of a recent scheme to extend the gate room in partnership with BA.

14.196. We put to BAA a complaint that passengers on Dublin and Republic of Ireland services at Heathrow were encouraged to divert via retail outlets. BAA commented that a retail unit on Pier 4A did not require passengers to divert; rather, they walked past a shop and catering outlet on their route. BAA further commented that they could not identify any situation where passengers were required to divert significantly from their route to go through retail outlets.

- *Pier repainting*

14.197. A number of airlines, including BA, complained about closures of stands for repainting with advertising logos. BAA said that BA supported the project in principle, which comprised not only external repainting but some internal redecoration, improvements sought by airlines which enhanced passenger service. It could not be undertaken without some outage but yielded significant benefits.

14.198. The programme for the jetty painting was developed and implemented to cause the minimal disruption to the normal airport operation. For scheduling purposes each terminal apron stand declaration assumed an allowance for stands which had to be closed for maintenance, to ensure that both planned and unplanned maintenance could be accommodated without impacting on the operation. All the stand closures required for the jetty painting were carried out within these allowances. A maximum of one bridge was taken out of service in each terminal at one time and every effort was made to coordinate other maintenance activities with the jetty painting closures. The programme was finalized and agreed at the weekly works programming meetings and was attended by BA's stand planning representative from T1 and T4, and amended to suit particular airline requirements. The work was carried out from July 2000 to May 2001 and protective tents purchased so that it could continue seven days a week throughout the winter. Preparatory work was undertaken at night. Stands were normally repainted on a four-day cycle and in all 136 jetties on 115 stands were painted. In general the work proceeded very smoothly and the only issue that was raised at the time concerned T4 in spring 2001 when it became clear BA had stand planning problems and could not accommodate its summer schedule. HAL agreed to assist by only having a single stand closed and indeed suspended the work over Easter 2001.

14.199. As to whether the closure times were extended to allow for logos to be painted, BAA said that it was a multi-purpose project which brought some refurbishment benefits alongside the income gains, and it was therefore difficult to separate the time required for each element.

- *Way-finding*

14.200. BAA said that it was not yet satisfied with the way-finding and signage particularly at Heathrow. Indeed in its 1999 survey, half of the top six aspects about which passengers were asked in terms of relative importance, related to way-finding or signage. Hence, it had been placing increasing efforts into improving way-finding, including appointing a group way-finding manager; developing a tool kit, a guidance methodology which could be applied in a variety of situations generally to improve way-finding; appointing a way-finding consultant (uniquely in the world), and on-the-ground improvements. Though not satisfied with way-finding, the results of its QSM survey were generally satisfactory.

14.201. On specific complaints about signage of Gate 24 in T2, signage had been complicated by segregation requirements; BAA had reviewed the issue and implemented some changes to reflect a clear understanding for the route to Gate 24. BA had been advised of the changes and appeared satisfied with the response. BAA also noted that its proposed Q factor would include way-finding measures because of its importance to passengers. Hence, airport charges would be dependent in part on its performance in way-finding.

- *Security*

14.202. BAA said that BA had only recently, and informally suggested that the target that 95 per cent of the time, security queue lengths should be no more than ten minutes should be tightened. It believed the current target to be a reasonable balance. There were, however, problems in the time taken to recruit staff to meet the additional requirements following 11 September; and shortage of space for the additional equipment required. On monitoring of performance against this target, BAA said that it was going to move to a CCTV-based system.

14.203. As to complaints about charges for Fast Track, BAA said that Fast Track was a marketing product which airlines at Heathrow chose to ask BAA to provide as a specific facility to support their product differentiation requirements. BAA responded positively to this request. Agreement was reached on how it would be funded: in essence BAA charged for the security manpower resource required to operate the channel plus a charge to fund the equipment in that channel. Advertising was visible from both the fast track and the standard track. The advertising visible by passengers in the fast track channel would have been located there whether or not a separate channel existed. Income from this source was not therefore included in fast track charging calculations. Charging arrangements were based on BAA proposals for the hourly cost rate for security staff. These rates had been discounted by BAA Heathrow in recognition of passengers using fast track and not using standard channel; discussions were under way into future charging calculations. It was possible fast track arrangements would not be sustainable in the longer term as resourcing implications of government requirements remain onerous.

- *Gatwick*

14.204. On criticism of poor service standards at Gatwick, BAA did not believe that this allegation was consistent with SLA performance. There had been some problems with transit system availability but this was far from being a course of conduct against the public interest.

#### *Service level agreements*

14.205. We received complaints of poor progress in development of SLAs. In response, BAA said that airlines had not raised such concerns with BAA to date. Other than BA, airlines had shown no particular interest in extending the scope of SLAs to new areas. Nor had BA consistently argued in favour of financial incentives. SLAs had been in place at Gatwick for several years.

14.206. BAA referred to the conclusions of MMC 4 as suggesting any compensation under SLAs should be reciprocal. BAA had followed this lead and suggested the best approach would be for any compensation to be on a reciprocal basis. It also noted the reference in MMC 4 to reciprocal arrangements ‘where the trials show compensation to be feasible’: this was possible with bilateral agreements but significantly more difficult for any multilateral agreements. Hence the Q factor proposals circumvented the difficulty of creating a payment mechanism separate to airport charges. BAA added that in reality there had been little or no interest from airlines on even penalty-only SLAs. Even for baggage systems, detailed work by BAA and BA had led to the development of carefully considered measures; the initial ideas for measures had been shown to be inappropriate.

14.207. BAA’s view was also that any mechanism for regulating service quality did not need to be financially compensatory to form an effective incentive; incentivization included the personal distress to BAA senior managers on publishing poor results at AOC meetings, and incorporation of SLA performance into incentive schemes.

#### *Generic standards*

14.208. On the suggestion that there should be generic service standards, BAA told us that it had undertaken an initial piece of work which it had thought would clarify the service quality level that airlines might expect to achieve in each of the areas covered by airport charges: the results of the exercise were shared with BA. However, the exercise highlighted how difficult it was to quantify the expected level of service in many of the areas and that BAA’s performance in a number of areas was covered by safety regulation. It therefore did not believe it was possible to develop a statement quantifying the level of service which airport users could expect for each area covered by airport charges. Partly as a result of the difficulties inherent in that approach, BAA and the airlines had developed SLAs, and BAA had more recently developed the Q factor concept.

14.209. We noted in paragraph 14.81, however, that BAA did itself suggest shortfall from minimum standards as an alternative to a Q factor. It suggested that a minimum service level approach with action only taken when particularly poor performance was observed might be a simpler scheme to administer than a Q factor but subject to the same level of complexity in developing a workable scheme which avoided perverse incentives.

14.210. BAA were supportive of bilateral top-up contracts if an airline wished to receive service above the generic level—but a number of issues related to extensive use of them in general would need to be considered.

- *Public interest consideration and possible remedies*

14.211. We note in Chapter 12 that a number of airlines argued that the absence of standards was against the public interest, hence standards should be included in airport charging conditions, rather than as a Q factor. BAA acknowledged that there was a public interest concern in a system where BAA provided a set of services without any defined standards. However, BAA did not believe the absence of service level standards could be a public interest issue of itself: if all services were being carried out to appropriate levels then the fact there were no service targets was of no concern. It was, for example,

difficult to see how an adverse finding could relate to runway availability, where performance was 100 per cent. Rather any public interest issue would have to be related to a service failure and proper thought needed to be given as to how that failing might be remedied or prevented.

14.212. Moreover, as noted in the MMC's previous report, the concern related to a structural problem with the system of regulation in that it did not capture the issue of service standards rather than conduct on the part of BAA. (BAA believed that the MMC's statements at the time of the previous review and BAA's actions in the light of them, had a strong bearing on whether it had carried out a course of conduct against the public interest. BAA acknowledged, however, that this might not determine the CC's conclusions on this public interest issue.) The MMC, in the previous report, had said that BAA should try and mitigate the structural failure in regulation by introducing SLAs—which BAA did—and by introducing compensation in those SLAs where the principle of reciprocity was recognized, but most airlines refused to recognize that principle, so it could not do so. Nonetheless, BAA had worked closely with airlines on improving the very poor performance on baggage, one of the most important factors for passengers and airlines, as a result of which performance was now among the best in Europe. It had also introduced four two-way SLAs on baggage where there were opportunities for both bonuses and penalties to BAA, with two more on offer to airlines. It had introduced 52 non-financial SLAs that it monitored regularly. It also went beyond that, in deriving Q to go into the price control formula. This was therefore a structural problem which could be dealt with in the formula.

14.213. Moreover, although there was no formal tariff under which prices paid reflect levels of service, there was a variety of situations where BAA did indeed adjust prices when the service quality was worse than expected, for example:

- (a) Contractually binding SLAs with BA for a number of baggage systems at Heathrow, with two-way financial incentives—referred to above. This opportunity had been offered to other airlines who had so far declined to participate.
- (b) The remote stand rebate.
- (c) A rebate at Heathrow and Gatwick when airbridges were not serviceable. At Heathrow, this was at a rate of the original air jetty charge (when invoiced in its own right about ten years ago) uplifted by inflation.
- (d) Rebate of the FEGP charge on application when the supply was not serviceable.
- (e) Well-defined rebate structures of BAA Heathrow's property management where facilities were unsatisfactory, such as heating, ventilation and air conditioning equipment.
- (f) At Gatwick, different check-in desk charges for each line of desks in South Terminal, reflecting the differing quality of the check-in area and the associated baggage systems; information on these different charges are publicly available.
- (g) In some instances agreement not to fully recover specified activity costs where there were service quality issues. (For example, BAA Heathrow had recently put additional temporary staff into the ID unit to deal with a backlog in applications, but had agreed not to increase charges as a result.)
- (h) Examples of other ad hoc price adjustments which tend to be on an individual negotiated basis, for example with bmi relating to their transfer baggage facilities; and where BAA Heathrow rebated aircraft parking charges when there was operational disruption caused by a major fire in T1 and when there was an explosion in an electrical sub-station resulting in delays to aircraft movements.

14.214. BAA did not believe that there were other alternatives available which it could have implemented.

- (a) Further airline rebates or discounts around particular SLA failures would have not only been very rare but also complex to administer (even impossible in some cases). This was essentially because of difficulties of establishing which airlines were disadvantaged—either because the SLAs related more to passengers or because it would be difficult to recreate what would have happened had a specific facility been available.

- (b) A much more promising approach was via the Q factor which could only be implemented as part of the regulatory review. BAA had therefore been working on this concept for the last two years.

14.215. Moreover, BAA also believed its priority was to help the airlines optimize the throughput of its scarce facilities at Heathrow: this might require reductions in, for example, pier service, by helping BA move flights from Gatwick to Heathrow, for which it was not right that BAA should suffer financially. Such trade-offs were also relevant in considering the public interest.

14.216. BAA believed the suggestion of the CC that a quality company operating in a competitive market would make a standard trade-off between service quality and price was not clear cut. Suppliers often tried to raise their overall level of service to match their overall level of price—which was inherent in the price formula setting itself—but without compensation for specific service failures.

14.217. BAA said that, although it might be difficult for us to crystallize a Q factor before the end of the review, nevertheless it believed that if we gave the CAA clear guidance as to what we thought needed to be in a Q factor, the CAA could put that into the price formula either at the start of the quinquennium or during it, on the back of a commitment by BAA that it would accept the price control formula which met the criteria we set out. There were three dimensions to its commitment:

- (a) BAA's commitment that it did not expect, nor did it believe it was required legally, a fully defined and detailed Q factor scheme, to be contained in the CC's recommendations to the CAA; it was important, however, for the CC to give general recommendations.
- (b) BAA's commitment on developing runway and taxiway performance measures. Namely it could:
- (i) develop, with airlines and the CAA, well-defined measures of hours of unserviceability of runways and taxiways;
  - (ii) collect data on actual hours of unserviceability during 2003/04;
  - (iii) propose to the CAA targets and a bonus/penalty structure for unserviceability from 2004/05 onwards;
  - (iv) either, at the appropriate point in time, agree voluntarily with a CAA proposal to make an amendment to the price control formula to accommodate this specific element in the Q factor at Heathrow and Gatwick, if the proposal was in line with the CC's general recommendations on a Q factor; or
  - (v) create a separate stand-alone method of rebating airlines for poor serviceability performance of our runways and taxiways at Heathrow and Gatwick.
- (c) BAA's commitment on developing measures of delay. Namely it would:
- (i) use its best endeavours to work closely with NATS, airlines, handling agents, and the CAA, to research existing and new measures of delay and its contributory factors;
  - (ii) gather data on these measures to understand their robustness and degree of attribution to an airport operator's performance;
  - (iii) conclude by September 2004, for review by the CAA, whether it was possible to measure satisfactorily an airport's contribution to delay and, if it was possible, what the appropriate measures and targets would be; and
  - (iv) if it did prove possible, agree voluntarily to a CAA proposal to make an amendment to the price control formula to accommodate this specific element in the Q factor at Heathrow and Gatwick, if the proposal was in line with the CC's general recommendations on a Q factor. (The amendment may need to include adjustments to other aspects of the Q factor such as the removal of runway and taxiway measures and/or changes to the financial impact of other elements to allow for the inclusion of a delay measure.)

14.218. The formula could capture separate terminal differences (although BAA said that would be creating a fairly large compliance mechanism for what would be relatively small sums of money) and provide for the payment of sums monthly (although BAA suggested monthly reporting, to be aggregated to a yearly total for payment), and apply across a range of elements.

14.219. BAA also commented on proposals from ourselves, that would be based on the standard of service for some facilities provided to specific airlines, and with compensation paid to the specific airlines affected. BAA preferred a Q factor, applied generally, to attempting to identify exactly which airline was affected by any particular equipment not being available. First, the latter approach would require a lot of staff to work out; and second, BAA did not actually know which airline might have been affected or not affected had the equipment been available—for example, which airline would have occupied a stand had it been available and given that it was not BAA that did the allocation. A payment spread across all airlines would be equally effective in providing an incentive to BAA to ensure systems worked. BAA (as noted above in the context of Q) believed it was almost impossible to do anything about delays at this stage: but would be happy to work with others to research the data on delays and their attribution. BAA was also concerned there was likely to be decline in standards before the opening of T5 (by when up to 73 mppa could be handled in the existing terminals). It believed it in the public interest to maximize throughput as long as it did not breach safety and security standards; hence the risk referred to above that, if an airline wished to move from Gatwick to Heathrow, BAA would be penalized if quality of service declined as a result.

14.220. Many airport processes, moreover, were shared processes, where the attribution of service quality was very difficult. Legally, it was difficult for BAA to impose standards on others, for example ground handlers or airlines; all it could do was threaten to terminate a licence which would cause enormous disruption. Practical problems of attribution would lead to an increasingly litigious climate and airlines would be strongly opposed to being contractually obliged to deliver their part of service quality, just as they had refused to address reciprocity in SLAs. Problems with ground handlers often resulted from the poor terms they received from airlines.

### *Planning standards*

14.221. A number of airlines suggested service standards should include BAA's planning standards. In response, BAA said that the purpose of its planning standards and more recently planning objectives had been to help its managers in assessing the capacity of existing facilities and in identifying the appropriate size of future facilities: it had never been BAA's understanding that such standards or the planning objectives were an immediate and blanket obligation and there was no regulatory obligation around them. While it gave careful weight to its planning objectives in considering future airport developments, it did not and should not give excessive weight to any individual planning assumption in determining the best overall solution. There was no less importance attached to the planning objectives than to the previous planning standards: rather, the new terminology better reflected their longstanding purpose. The reference to other factors was an overt recognition of the way that these targets and guidelines have been used in planning.

14.222. BAA saw three difficulties with linking the regulatory regime to the planning standards:

- (a) the role of planning objectives was not to create an operational performance monitoring tool; SLAs had been developed for this purpose;
- (b) operational performance in many of the areas covered by the planning objectives was a shared responsibility; and
- (c) there were practical difficulties associated with assessing whether a planning standard/objective was being measured, for example the cost of monitoring queue times against a planning standard/objective for areas such as check-in, security or immigration. Calculation of space per passenger was highly dependent on assumptions as to traffic mix or dwell time, the latter of which was very difficult to measure in its own right.

BAA could reduce an airport's runway and terminal capacity to reduce demand so that the planning objectives were met but it did not believe this to be in the best interest of the airlines, consumers or themselves.

14.223. Service quality output was more important than any input figures—hence BAA’s Q factor concept and why it did not believe planning objectives should have greater force.

14.224. Facilities in existing terminals were not, therefore, systematically compared to BAA’s planning objectives since they were not and were never designed to be measures of operational performance: other operational performance measures such as SLAs and QSM had been developed for this purpose. It was also unclear whether such comparison would be helpful: for example, if passengers queued longer than the current objectives, this might be due to airline/handler check-in desk resourcing rather than to the number of desks.

14.225. The practical difficulties in developing a cost-effective performance measurement system were shown by the costs of obtaining even a reasonable sample of queuing times. There would also be difficulty in measuring the number of passengers on the concourse at any one time should BAA wish to compare space per passenger with a planning objective. Planning objectives were applied only to typical busy hours which did not occur in a controlled manner at airports, making a proper comparison of actual performance with planning objectives virtually impossible. Hence, it was more appropriate to use other performance output measures such as QSM. Passengers’ views of departure lounge overcrowding or seat availability were more telling than the amount of space or number of the seats provided.

14.226. However, recognizing issues of competitive advantage as well as BAA’s desire to provide the right level of facilities in each terminal to meet predicted passenger flows, BAA did undertake periodic capacity assessments which required as inputs its planning objectives and other assumptions such as traffic mix, process times etc. The output was an hourly passenger-flow rate which airport managers used to inform their decisions over the declared scheduling limits used in the slot allocation process, and the information was also used to inform investment plans.

14.227. BAA did not believe that it would be appropriate to attempt to generate a comparison of facilities in terminals with its planning objectives and include this within the improved CIP consultation process. It may, however, be possible to supplement the information in future investment programme consultations by setting out where it believed its analysis was showing additional capacity was required and where investment would need to be made.

14.228. We raised the issue of whether, unless planning standards were applied to existing as well as new assets, users of existing facilities (for example, the CTA) would be disadvantaged compared to new facilities (for example, T5) where they would be applied. BAA acknowledged that older facilities were never going to match newer facilities, but it tried to upgrade the old facilities as best as it could, for example converting the unacceptable in T2 to something that was tolerable: but, despite that, T2 (unless it was demolished and rebuilt) could never be of the same standard as T5. BAA would, however, maximize the possibilities of redevelopment and upgrading of all existing facilities at Heathrow—and where possible seek to offer airlines a degree of choice regarding space per passenger or location next to their alliance partners. Consultation was a necessary part of this process.

#### *Comments on BA’s detailed proposals*

14.229. BAA also commented on BA’s criticisms of the proposed Q factor and on BA’s proposals for service standards. BAA said that it recognized the concerns about a scheme whereby service quality performance did not affect airport charges until between 13 and 24 months later; however, it said that operational managers would be focused on performance from the very start of the scheme as they would be very well aware it would have a financial impact, albeit deferred. As to averaging, BAA said that it was important to have a basket of measures in any Q factor to reflect the range of BAA’s outputs: having set the maximum impact of a Q factor it would be inappropriate for performance of individual elements to give rise to penalties representing a large proportion of the maximum impact. It added there was a clear rationale for a symmetrical structure. The combination of a basket of measures, capping of individual elements and symmetry necessarily resulted in an averaging effect. BAA had sought to reduce the impact of averaging by retaining monthly rather than annual targets for many parts of the Q factor.

14.230. BAA said that it was disappointed and surprised to see the reference to tokenism by BA: BAA had taken a very constructive stance to developing a ground-breaking, practical and effective mechanism, which put at risk over 5 per cent of its post-tax profits. It certainly would not put airlines in a worse position: if they truly believed this was the case, it would withdraw its Q proposal.

14.231. It saw one further problem with BA's proposal, namely the need for a year's data for many of the elements listed (for example, number of monthly targets achieved for people movers). An approach whereby monthly airport charges invoices were adjusted using monthly service quality performance results would be very complex and administratively burdensome. BAA also regarded BA's proposal of targets of 100 per cent in some areas as unreasonable, and creating a very poor management incentive. The current infrastructure, for example, made a pier service target of 100 per cent unachievable, and an extremely large level of investment would be required to achieve it. Elsewhere, BA had proposed retaining existing percentage targets but changing the measurement definition to include planned maintenance: such a change in definition would require targets to be reduced. BA also referred to a six-minute generic standard, compared to the existing ten-minute queuing target of the SLA, also with significant resource implications. BA had also argued for inclusion of baggage systems and FEGP. BAA said that these should be excluded as they were not covered by core airport charges, and a single serviceability target contrasted with the range of measures which the joint working of BAA and BA concluded was necessary to judge the effectiveness of a particular baggage system. Were baggage system performance to be incorporated in a Q factor, then BAA would be forced to remove the financial incentives from the existing Heathrow baggage system SLAs to avoid double jeopardy.

14.232. The suggestion of a delay term was also surprising given the flaws in the quality of data and the degree to which BAA was responsible for performance. A sample survey showed that some 35 per cent of BA aircraft pushed back more than 10 minutes after schedule time of departure; but the time between a push-back request and actual time of push-back was very much smaller: 92 per cent of flights had no delay and only 2.7 per cent had delays of more than three to four minutes. Variability in push-back request time itself caused delay in granting a push-back request. Peaking of the demand on the system imposed by airlines who would not forgo their grandfather rights also caused such delays with more flights being scheduled at times than could be handled. Similarly, delays in the stack would be caused if the rate of arrival exceeded service rate of the airport system, but stack delay was not a true measure of delay as flights could be rerouted or slowed as an alternative to circling in the stack. The stack also made it possible for controllers to pack aircraft on the approach path because the controller could select an aircraft sequence to maximize the flow rate on to the runway. NATS had a tendency to prefer stack management rather than inbound capacity restrictions: hence slot delay was not an appropriate measure of BAA's performance or influence.

14.233. As to BA's medium-term proposals, BAA said that it already had an incentive to increase airport capacity if the demand existed as this would result in increased income. However, it had to take a realistic view as to the individual projects. As to the longer term, BAA referred to its previous proposals that charges should in some way be linked to delivery.

### *Conditions of use*

14.234. We refer in Chapter 12 to complaints about the disclaimer in BAA's Conditions of Use. BAA said that the identical sentence was examined by the high court in the case of Monarch Airlines versus London Luton Airport in 1998. It was held that the exclusion clause was a fair and reasonable term to include, it being generally accepted in the market including the insurance market in that it had a clear meaning and that the insurance arrangements of the parties could be made on the basis of the contract. As regards the second sentence, BAA asserted that it was standard practice in commercial contracts to exclude economic loss arising as a result of negligence and breach of contract. Both parties would make their insurance arrangements on the basis of this condition. Under the law of negligence, it was not possible to cover for economic loss unless physical damage had been caused by the defendants negligence. Accordingly the airlines would not have been able to claim against the electricity company in the example referred to. The purpose of the conditions of use had been to promulgate charges information and operational requirements and restrictions with mutual rights and obligations. They were more appropriately considered as a licence setting out the terms on which an airline may use the airport. They were therefore more akin to the conditions of use for a public car park than to a contract for the supply of particular services. Where particular services were being provided, these were supplied by separate contracts for the reciprocal contracts and obligations.

## ***Airport charging issues***

### *Peak pricing*

14.235. We raised the issue with BAA of whether the limited degree of peak pricing could adversely affect the public interest. BAA said that there were peak- and off-peak charges for both runway and parking elements; and Stansted had a seasonal peak- and off-peak component to its runway charge. But peak international passenger charges were precluded at Heathrow until T5 opens. However, introduction of peak passenger charges only at Stansted and Gatwick would pose several problems. Given the ban on peak passenger charges at Heathrow there would be increased risk of legal challenge to any extension of this principal to Gatwick and Stansted; having a peak passenger charge at Gatwick and Stansted but not Heathrow would lead to perverse pricing differentials with higher peak prices at those two airports than at Heathrow; and peak passenger charges were very unpopular with airlines who usually claimed they had little choice but to operate at peak times.

### *Aircraft parking charges*

14.236. We note in Chapter 12 complaints about the basis of aircraft parking charges, based on average taxiing times. BAA said that an average had to be used because of poor data. If the average was too high, short-haul operators would benefit as a greater proportion of their parking time would be free. It was not apparent that T4 airlines would be systematically disbenefited, T3 airlines having longer taxi times when departing towards the West on R27L. T4 was also well placed for BA's maintenance area which would reduce fuel burn. Hence, there was little evidence average taxi times were discriminatory against T4 as this could only be established by looking at long- versus short-haul operators; different runway usage patterns; and other factors. It suspected that BA's estimate of its savings were actual times to be used also did not assume the yield equalization required for any change to the taxiing allowance and the savings were therefore miscalculated.

### *Pricing at Stansted*

14.237. We note in Chapter 12 complaints about charges at Stansted. BAA commented that predatory pricing had been investigated several times by the CAA, the MMC and the DGIV and no evidence ever found. The fact that Stansted's tariffs and average revenue yield had both increased since these investigations was in itself substantial evidence that predatory pricing was unlikely. However, BAA had a policy decision never to charge below variable costs and indeed in a single-till environment short-run variable costs net of retail revenues were extremely low. Stansted airport as a whole now met its full operating costs and was forecast to be making real pre-tax returns of 7.5 per cent by around 2010.

## ***Non-regulated charges***

14.238. In Chapters 12 and 13 we summarized a number of detailed complaints about activities not included in airport charges.

### *Ground handling*

14.239. We refer in Chapters 12 and 13 to a number of complaints concerning ground handling, first, the requirement, to be allowed to provide services at Heathrow in any terminal, for a minimum percentage of business in that terminal. BAA stated that this condition was intended as a protection against operational difficulty at Heathrow, arguably the most congested airport in the world, to avoid the unworkable congestion and safety risks that could arise from a plethora of small handling agents operating in a confined space. The condition was effectively waived if the new handler was able to demonstrate that taking over an airline's ground handling operation at a terminal would not add to congestion on the ramp or the baggage operation. It had only been cited in one case, where the existing airlines conveyed the very strong view that the proposed new handler would indeed worsen congestion.

14.240. On a number of other issues raised, BAA noted there had been a number of factors which had affected the overall size and shape of the market for third party handling, including BA's acquisition

of Cityflier, which had led to its operations being absorbed into the BA operation; the takeover of Virgin Sun by Air 2000 and the general downturn in traffic following 11 September. The loss of economies of scale whilst regrettable was a reflection largely of airline market conditions which BAA had little or no control over. GAL had worked with and in partnership with the airport users committee which had a formal consultative role under EC legislation. The selection criteria used had been agreed with the Airport Users Committee (AUC) who also played a significant part in the process, for example organizational standing, resources and training, relevant experience, financial etc. Following an initial assessment against these criteria the AUC had been asked to indicate which of the organizations they would wish to see appointed. The eventual appointment was made taking account of the AUC's views and the results of the initial assessment. GAL was, however, concerned that financial arrangements could have a broader impact on the operation of the airport and level of service, and was currently attempting to facilitate a debate with the airline community aimed at addressing this. However, it was not possible for GAL to police the business plans of ground handling companies, but reviews were undertaken on service and operational issues. It had no jurisdiction over issues of predatory pricing. As to the fourth ground handler, the selection process was now close to completion. The CAA had previously rejected GAL's proposals to limit the number of handlers to three.

14.241. On suggestions BAA would only deal with ground handlers on an individual airport basis, BAA said that the approach taken at individual airports towards ground handling and a wide range of other matters sought to strike a healthy balance between following group-wide policies while taking local circumstances into account. BA said it recognized handling agents had a critical role to play and they were already involved in discussions about airport development and operation. It believed it had adopted the correct general approach.

14.242. On the setting of service standards in ground handling licences, BAA said that it was important to set service standards at its airports to help ensure service provision to passengers was maintained at appropriate levels. These were encompassed within agreements each handling company was required to sign, and covered issues such as baggage delivery performance, check-in queuing etc. Handlers should refer to these minimum standards acceptable to BAA before entering into contracts. There were no specific financial penalties within the agreements relating to poor performance, although there was an escalation process which could ultimately lead to termination of a contract. The escalation process was intended to ensure specific issues of performance difficulties could be identified and plans put in place to resolve them. As noted above, however, BAA could not impose penalties if there was failure to meet the standards: merely threaten withdrawal of a licence, with adverse consequences for the airlines and risk of action in the European courts.

14.243. On delays in finalizing ground handling licences, BAA acknowledged that the agreement and signing of handling licences had been a slow and arduous process for the main ramp and baggage handlers, including BA and Virgin and at Gatwick GHI and Service Air. The latter were largely due to the fact that both handlers were already operating at Gatwick and there was no pressing need to conclude documentation. A further complication was stripping out of property elements which were placed under separate agreements, the work on which was largely complete.

14.244. On the conditions for rent of check-in desks, BAA said that operational accommodation such as desks was often on a one-month notice period. However, the terms of occupancy were subject to individual negotiation and agreement: it was important the handling agent advised the airport management team on its particular requirements bearing in mind its own contractual arrangements with airlines.

14.245. On rents for cargo facilities, BAA said that it was not the case that cargo tonnages at Gatwick had fallen: rather, they rose by 9 per cent in 2001/02 and 24 per cent over Q2 as a whole. It also noted there had been no significant deterioration in demand for transit shed warehouse accommodation, nor had it experienced any voids. However, cargo volumes had been affected by 11 September and guide prices had been reduced from £12.50 to £12 reflecting the difficulties experienced by this sector (guideline rents for warehouses had increased from £9 to £12 over seven years, a compound growth rate of 4 per cent a year).

14.246. Rents for business lounges were also subject to the same approach of published prices, but again each was subject to individual negotiations; BAA tried to operate a level playing field and did not distinguish between airlines and handling agents. Rent reviews were negotiated individually in line with open market rental value; all reviews had been agreed by negotiation.

### *Check-in desk charges*

14.247. On cost recovery of check-in desks, BAA said that the operator bore the risk. GAL had never fully recovered costs although cost recovery remained its long-term intention. Whatever BAA's charging policy on desks, the agent had to charge the airline; if the agent structured his agreement to pass through desk charges this was entirely a matter of his choice.

14.248. As to the North Terminal check-in desk used by BA, BA had its own systems and these desks were incapable of common use by other handling agents. Other desks in the North Terminal benefited from common user terminal equipment and were capable of common use. The total cost to be recovered had therefore been split equally to arrive at a cost per desk across the terminals; only the costs associated with desks on A and B had gone into the calculation of the hourly charge in the North Terminal.

14.249. BAA acknowledged that with the present charging by row, variation in utilization of different rows resulted in higher charges on relatively under-utilized rows and lower charges on more highly utilized rows. Under-utilization had been recognized in certain circumstances with reductions in liability agreed with users. The issue had been addressed through rebate/reduced charges agreed with handling agents to account for low utilization.

14.250. However, the hourly charges it was proposing to introduce would reflect only the differences in the types of check-in desks depending whether they were fully mechanical or semi-mechanical, location and queuing depths etc. Otherwise, recovery of costs would be dependent on actual use: only if one desk was used for a greater number of hours would the cost recovered be higher. BAA said that it was recognized that hourly charging was the fairest means of charging. BAA believed that hourly charging would assist new entrant ground handlers by creating a level playing field on charges for check in. This did alter the balance of charges, hence, while some of the Gatwick community had welcomed the proposal, others had objected. BAA had, however, now deferred hourly charging until winter 2002.

14.251. BAA acknowledged a number of assumptions that had gone into the hourly charging calculations which had been openly communicated to airlines and handling agents alike, and for this reason made provision that revised hourly charges could be introduced on one month's notice in the circumstances of significant over- or under-recovery. If not significant it would be carried forward to subsequent years: hence there was no incentive to understate usage and over-recover revenues.

14.252. BAA told us that it had historically charged handling agents for the use of check-in desks; in the most recent consultation with airlines, the AOC confirmed it wanted this arrangement to continue. It was unaware of any approach from an airline wishing to be charged direct for check in desks on zone A.

14.253. BAA said the principle of lower rates of charges when amortization had expired was agreed and would be the basis on which charges were levied. The discussion with BA on lines E and F were ongoing and transparency would be provided as part of the process of concluding this discussion with BA. On the issue of transparency generally, GAL produced annual pricing statements on specified activities. Further evidence on the consultation process included several examples where GAL had invited further discussion; hence, it was not clear to BAA where it had moved away from previous transparent arrangements. It was not aware of any outstanding requests for information.

14.254. BAA said that it was correct to say that the different basis of calculating non-check-in desk licence fees had applied at Heathrow relative to Gatwick and Stansted: Heathrow using a site fee plus amortization plus outgoings, and the latter a market rate forming part of rental guidelines. BAA said that non-check-in desks could be described as both relevant and specified activities, hence, there was a requirement to be transparent and the inclusion in the rental guidelines at GAL and of STAL with revisions in accordance with Property Challenge criteria, ie market-based. These also formed part of the annual consultation process for specified facility charges. BAA believed that the market rate approach was the correct one, especially since desks were in many cases used for commercial purposes and customers had a degree of choice: at Gatwick the charging on non-check-in desks had been market-based since at least privatization. Discussions had been taking place with a view to changing the Heathrow approach to market rates, with transitional relief where this resulted in any increased charges and incorporation of increases into the rental formula.

## *Rents*

14.255. BAA said that overall rents had grown by 1 to 3 per cent a year for offices, 3 to 6 per cent a year for apron accommodation, 2 to 6 per cent a year for industrial/cargo and 5 to 6 per cent a year for CIP facilities; applying Heathrow guidelines to Gatwick would have produced mostly higher rentals for a range of projections. The criteria on which BAA's rental policy was based needed to be market related—it was inappropriate to review it only in line with the handling agents profitability, it must reflect the climate across all business types. There was no evidence to support any allegation of curtailing supply: it was also not clear how BAA was failing to meet its transparency obligations.

14.256. As to lack of explanation of how GAL had reviewed its rental levels, BAA said that revised rental guidelines had been produced at Gatwick annually and new guideline rents openly communicated to main customers. It had recently circulated a customer report supporting its approach to the April 2002 guidelines, in response to requests for greater explanation on the basis of setting guide price rents. However, it re-emphasized that all rents at Gatwick were subject to individual negotiation and published guide prices were merely a guideline to assist the negotiation process.

14.257. BAA said that the 53 per cent increase in rents at Gatwick related to the quantum of rents rather than individual rentals, and was in the main due to the supply of new infrastructure and buildings not allowed for in the projections. Growth by asset varied from property to property but all were significantly below 53 per cent. The trend in rentals would have been no different if the Heathrow formula had been applied.

14.258. BAA said that CIP lounge rents at Heathrow were covered in their entirety by the formula: an approach which had been maintained throughout Q3 and applied to virtually all accommodation within the terminals. Perimeter properties were mainly on an open market rental basis; where these leases included provision for rent reviews, such reviews were generally to open market rental value and required agreement between the parties or in absence, reference for independent determination: it did not believe any reviews had been referred to arbitration other than in the instance of HAL and bmi jointly agreeing to refer the value of a stand to expert opinion upon a new letting.

14.259. On Virgin's complaint about the conditions BAA sought to negotiate when Virgin wished to share a CIP facility, BAA said that it was entitled to negotiate to reach agreement to realize some of the increased value to Virgin for itself: the likely loss of retailing, particularly if the direct lift were used, was pointed out as an opening negotiating position, which it believed was understood by the airline. It would not be fair or reasonable for BAA to be forced to accept changes to its financial detriment, which would ultimately be passed on to other airlines, while other parties made additional profit. However, it agreed to moderate its claim, but negotiations lapsed for other reasons.

14.260. On complaints about access via retail outlets to CIP facilities in T4, BAA said that this complaint related to designs 14 to 22 years ago. The design of the extension, developed shortly after the terminal was open, would not have permitted a direct route through to the CIP lounge. At the time the extension was designed, passengers were also still subject to outbound passport controls, hence it was not in BAA's gift to provide a short cut security route. The point currently made by BA was not raised in 1991 or 1996 reviews.

14.261. BA controlled most of the check-in desks at T4 and if it wished to reduce the walking distances experienced by its first class passengers it could simply reallocate the economy desks closest to the central zone to first class.

14.262. BAA had, however, considered requests from BA for direct access to the CIP lounge, in the light of additional capital operating costs, the option of relocating the first class desks to meet BA's needs, and what BAA appeared to acknowledge were legitimate concerns over loss of retail income, which would work through to higher charges under the single till. It noted a similar issue had arisen in the context of the current T1 future concept project and BAA had incorporated a separate route from the new premium check-in area to the international departures lounge close to the CIP lounge.

## *Waste*

14.263. There were complaints about arrangements and charges for waste disposal. Refuse disposal was one of the items listed by BAA in Appendix 3.2 of the last MMC report as covered by airport charges but BAA argued that did not cover airlines' waste oils and lubrication or waste food off aircraft. It was fairly normal practice for tenants to pay for their own waste disposal. To the degree this had been free in the UK and charged elsewhere, BAA had experienced tankering of waste—waste for an outbound flight being brought back to the UK to avoid controls elsewhere.

14.264. BAA said that it wished to undertake a review of its current waste management policy and charging methodologies. The overall aim would be to establish a uniform operating and consultation procedure; a data monitoring system; and a charging policy to facilitate cost recovery and provide incentives under a polluter pays principle.

14.265. At HAL prior to 1997 the airport provided a foreign object debris (FOD) and pollutants, oil and lubricants (POL) bins for all aircraft stands, which was continually abused by users who refused to segregate their wastes at source and led to duty of care issues. New procedures were introduced in 1997 and POL bins removed, empty oil cans being placed in the FOD bins and part full oil bins to be disposed of by the producer.

14.266. At Gatwick, GALs waste contractor in 2001 received a prohibition notice for transporting waste oils in an unacceptable manner. Attempts to address the issue by introducing systems which separated the oil from the can failed due to misuse by users. When the prohibition notice was served, GAL worked with the waste contractor to identify a compliant method of collection and disposal. The solution adopted was relocation to a single managed airport waste collection site, for oil waste to be deposited at that site in a compliant manner whence GAL's waste contract managed and disposed of it at no direct additional cost to the user, and GAL taking responsibility for legal compliance for the airport waste collection site. A consultation meeting was arranged to communicate this, all airlines and aircraft maintenance companies agreeing in principle to the proposal and accepting the marginal increase in travelling time to the site. At no time was the waste collection service suspended.

14.267. Subsequently, BA asked GAL to consider the possibility of installing a dedicated facility within BA's waste areas at stand 59, BA not wishing to use the centralized facility due to additional travelling time. GAL agreed to do so for the sole use of BA (at no additional direct charge) provided facilities were used in the manner that was compliant with GAL's requirements. This was not an attempt to shift responsibility for compliance to BA since the airline already had a responsibility under the duty of care to ensure it disposed of any waste in a safe and compliant manner. The conditions were an attempt by GAL to ensure the site was used in such a manner. BA had raised a number of issues; a trial arrangement had been agreed and the equipment was due to be installed shortly. GAL's waste contractor would collect the oil waste from the site and transport to it to the airport waste collection site for disposal. It would also monitor the use of the site to ensure it conformed with GAL's instructions. If the trial was successful BA would formally agree to GAL's conditions.

14.268. On increase in terminal waste charges, a review of HAL's waste contracts showed that cost was being under-recovered by approximately £200,000, and rates needed to be increased by some 50 per cent. Some seven weeks' notice was given on that. As part of the waste management review undertaking, BAA was prepared to include review of the consultation process on waste charging issues to ensure users had adequate time to adapt to any new proposals. It would undertake to provide transparency on the charges if it had not already done so. However, the element of check-in charges associated with waste/refuge collection was identifiable with the check-in desk charge calculations.

14.269. It was BAA's policy to ensure that it delivered a value for money service to all airport users, which had meant charging the users the cost to BAA and not a commercial rate which would be significantly higher. The rates were based on direct costs apportioned to each business area in a transparent manner and charged according to the amount of waste collected from each source.

14.270. BAA's view therefore was that separate charges for aircraft waste disposal should now be instigated to provide incentives to minimize waste; assist with safety FOD issues; provide fairness to users (user pays principle); and help with its general neighbourhood obligations on environmental issues. Hence it had been signalling to users for some time the desirability of a waste disposal charge, and had proposed amending the airports charges definition correspondingly. A question of compensation did not

arise. It subsequently added that its charging strategy had not yet been fully developed. It would support a defined list of operating procedures for waste collection on airports; where there was no choice for the customer but to use BAA's managed collection services, it would undertake to provide full transparency for any direct charges levied.

### *Staff car parking*

14.271. On complaints about charges for staff car parking, BAA said that BA's analysis of staff car parking was simplistic given the dynamics of staff car parking; charges were not levied on a per diem basis and were not time-related. Charges were based on total cost divided by the total estimated consumption, ie the number of passes. BA recently raised the issue of reduced charges for part time staff, but BAA explained that within the pricing mechanisms the consequence of this would be lower charges for some passes, but higher charges for others.

14.272. The nature of the aviation business was of peaks by both hour of day and seasonally; HAL needed to provide sufficient spaces to satisfy peak demand and to allow for overlaps of staff levels as shifts changed. Hence the main cost driver was not time parked, but the need for space to be available when required. Hence part-time employees put exactly the same demands on the provision of space as full time employees. Significant proportions of cost were also incurred in provision of coaching services to and from car parks. Differential time-based charges would also require suitable control mechanisms, which could cost £1.5 million plus annual operating costs: the community had been very reluctant to accept further increases in parking charges. Hence, the present method of charging was, administratively, reasonably cost-effective and gave the customer greater flexibility.

14.273. Heathrow was significantly under-recovered, £4 million over five years; airlines had full flexibility to apply for or return passes to match seasonal or business demands. Allocated costs included rates. Allocation of constabulary costs was based on rateable value: it has been discussed with the AOC pricing committee at Heathrow and to include all police costs within airport charges would mean the whole burden of these costs would fall on airlines rather than be spread across all airport users. Heathrow prices compared favourably against other local car parks. The comparison of annual car parking costs showed Heathrow to be some 10 per cent of Brewer Street, and below or comparable with areas around Heathrow. Consultation on recent charge increases did take place with the AOC Secretary who should have communicated the price increase to users; users did have the opportunity to return rover passes and not incur the increase. Rover passes were for public car park facilities and therefore separate from staff car park permits. Their prices were set on a more market-based approach and reflected the very high demand for public car parking within the Heathrow CTA.

### *FEGP*

14.274. On complaints about the basis of charging for FEGP, BAA said that the time-based system had been in operation at Heathrow for ten years; moving to a meter-charging basis would be possible but expensive and in overall terms increase cost per unit in the order of 8 per cent. Charging would be more accurate but costs merely be moved around between airlines: there had to date been no response from the AOC pricing committee who had been asked for their views on metering. The example quoted by BA was not representative. The current method of charging came about partly because of practicality and cost, but also charging for time acted as a direct incentive for the airlines to use more environmentally friendly services. BA senior operations personnel had agreed this point in previous pricing consultations. It took the total cost and divided it by total estimated aircraft parking units to derive an average cost per time unit: it had not therefore taken account of the consumption characteristics of different aircraft types. BA's point as regards taxiing time applied equally to charging for parking. A move to more accurate time-based charging would simply lead to a reduction in the denominator and an increase in average cost per time unit. It also required the upgrade of HAL ground systems and that aircraft be fitted with aircraft communications and reporting system equipment (ACARS). Even for metering, the majority of equipment in use recorded the time FEGP was being used and not the power consumed: hence operators of larger aircraft would still be favoured. BA's calculations on savings also needed to be treated with a very high degree of caution, being based on a sample period of one day.

### *Water and sewerage*

14.275. On complaints about charges for water and sewerage, BAA said that in BA-solely-occupied areas, BA could provide its own infrastructure if it wished. It further argued that water and sewerage charges were cost-based, and were under-recovered against the fully costed charge. It was the case that the assets were also included in the base on which the airport earned an overall return, but that did not mean users were being charged twice, only that the income earned and costs associated with water and other activities was taken into account when deriving the residual allowable charges income.

### *Wayleaves*

14.276. On complaints about introduction of new charges for wayleaves, BAA said that it was perfectly normal practice for any landlord to charge a wayleave for running cabling across his property. Tenants had a choice between using the BAA infrastructure product, or their own.

14.277. BAA was, however, examining the viability of establishing an improved charging strategy for wayleaves. BAA said that rampant cable installations by airport occupants/tenants had led to changes to the fabric of the building and non-removal of redundant and life-expired cabling which may not comply with fire, health and safety instructions, and increasingly poor documentation and housekeeping arrangements. BAA claimed it must improve on this situation, to incentivize occupants to be more efficient and responsible with the increasingly limited cable-storage space available and most importantly to be compliant with fire, health and safety guidelines. It believed that installation and removal of cabling with accommodation which was specially demised to its property tenants was adequately covered within its existing agreements, but it was reviewing its policy on the installation and removal of cables in BAA cable trays within ceiling voids and ducts outside demised premises and was considering whether to have a consistent approach across its airports. Use of common infrastructure would allow customers to use existing circuits within the ceiling voids and ducts without the need for laying their own cables.

14.278. It also noted that a charge of £1 per metre run a year had been in existence for some considerable time. This policy was supported through GAL's rental policy, ie where a tenant required additional rights beyond those granted within its existing leases, it should pay a market consideration for the grant of such rights; GAL regarded it as fair and reasonable to negotiate an appropriate consideration for the grant of such rights. Its charges covered the granting of rights over land owned and maintained by GAL; a management fee to cover documentation, monitoring, access requirements and space; provision of sufficient cable trays and other infrastructure; security arrangements and controls in respect of contractors and health and safety, protective and preventative measures.

14.279. BA had asked to lay significant amounts of cabling to floodwire the North Terminal and provide BA with an Ethernet network: BAA said it appeared that BA was arguing for free installation rights, contrary to established and accepted principles of land ownership. The right should not be treated as a free good. Finally, BA was seeking rights in addition to its granted 'standard lease' rights by wanting to lay entirely new infrastructure outside areas demised to it at Gatwick: GAL's view was that standard leases would not grant a tenant automatic rights to lay new infrastructure across large areas which were not defined or specified in any way: any other view could lead to an unsustainable conclusion that any third party tenant could expect or demand rights over land not in its ownership or defined.

### *Fuel fees*

14.280. On complaints about fuel levies BAA said that Gatwick Airport Service Hydrant Company Ltd (GASHCO) was formed in 1994 to facilitate the raising of external finance for new development on airport. It owned and operated the storage and hydrant facilities of the airport and was obliged to allow a supplier to use the facilities. Its fees and GAL's throughput levy were shown separately on invoices to customers to ensure transparency. Changes to the throughput levy were advised to the airlines annually through the specified activities consultation process: BAA did not therefore accept there had been no involvement or discussion with airlines. Although not a cost-based charge in the sense of being directly derived from actual annual costs, it said the levy took into account both actual costs and opportunity costs. The latter included rental forgone from land including underground pipelines and loss of revenues from GALs inability to build aircraft and commercial facilities at or near storage facilities.

14.281. Subsequently, however, it told us that there were very few costs associated with the levy: the levy was on a turnover basis, in effect a commercial rent, not related to costs; it could be justified by reference to opportunity costs, but that had not been done. This was, however, no different to practice at the time of the previous report (or before that); meterage charges were custom and practice at virtually every airport worldwide. Prices had been established by reference to annual increase in RPI for several years at Gatwick. BAA therefore believed that the throughput fee represented a fair charge for the facilities provided. In a single-till environment, if the fuel levy did not exist, BAA's income shortfall would be met by an increase in airport charges, which would be borne by all airlines using the airport, rather than those who used the fuel system. This would disadvantage those airlines who chose to fuel their aircraft elsewhere. BAA believed that this would be less efficient than the current arrangement, transferring cost burden to airlines not using the facilities and resulting in airlines who did not take fuel subsidizing those that do. The levying of fuel charges on the throughput basis was standard at airports throughout the world.

14.282. The current transparent charging structure had served the industry well. London airports had some of the lowest fuel prices in the world: Gatwick and Heathrow were about the 11<sup>th</sup> and 12<sup>th</sup> cheapest airports for jet fuel prices out of about 130 or so airports compared. Gatwick also had one of the highest levels of competition and one of the best developed and most efficient fuel infrastructures.

14.283. As regards Stansted, BAA invested in infrastructure as necessary to support the growing business at Stansted: it was the only one of BAA's three south-east airports that owned the infrastructure and it was entirely appropriate and fair that this was recovered via the throughput charge. Stansted had consulted fully with its airline customers on this issue: there was no evidence to support the allegation of excessive capex on the fuel infrastructure. It had said to the airlines that the annuity rate per litre would be reduced once the shortfall (£3.1 million in March 2001) had been recovered. It did not accept the argument that under-recovery of the capital element of the fee for prior periods should not be carried forward. Its formula did not work on the basis the rates of return were applied strictly to each year or indeed to any five-year period, rather they were smoothed over five- to ten-year periods. Such smoothing was necessary to increase prices gradually, especially when assets were under-utilized in early years. Recovery in later years was therefore required, otherwise the asset would never be fully remunerated. BAA also noted that Stansted did not achieve breakeven for specified activities as a whole in any of the five years to 2000/01; the all-in price of fuel at Stansted was among the cheapest in the world; this was a competitive market and airlines had the option of tankering and could choose to take up fuel at the most competitive end airport—hence, Ryanair had started to take up fuel equally at Dublin and Stansted as a result of suppliers giving the airlines substantial reductions on fuel costs and would do so elsewhere; and in a single-till environment it was Stansted's total income from chargeable activities which underlay its price cap. Airlines would naturally try to cherry-pick charges to reduce costs, but in order to achieve its allowable income the airport would need to recover any shortfall from other activities, in the event of the fuel levy being reduced. BAA believed that it was appropriate for Stansted to earn a reasonable rate of return on its investment and infrastructure within the single till. BAA's regulated business performance had not demonstrated profits systematically exceeding allowable returns over any regulatory period.

#### *Extending the scope of regulated charges*

14.284. BAA said that it had always been clear about what was charged for separately, and this policy had been unchanged since privatization.

14.285. Seeking to include all operational activities in airport charges, on the other hand, would be difficult to implement and incorrect from an economic standpoint. Many were for activities which airlines had differing requirements for, so to have a common charge could be discriminatory; BAA would find it impossible to react to airline needs on some of these services and facilities if they were defined as airport charges and had no separate revenue stream. This was particularly the case where the requirements were not anticipated or anticipated but not costed at the time of the quinquennial review, for example additional check-in desks or baggage enhancements. This could also conflict with ground handling legislation and destroy the competitive market in baggage handling, since only the airport operator could levy such charges. Hence, BAA took the view that separate charges were appropriate, but usually checked with the CAA.

14.286. Following discussions with IATA, which concluded that Heathrow transfer baggage was the main change of scope for airport charges, BAA undertook to review the scope of facilities and services

covered by airport charges. The position on inclusion of local ANS was being dealt with separately by the CAA who, it was believed, was consulting with the industry to establish if there was a common viewpoint. By the time this was finished and the matter determined by the DfT, it was likely the current regulatory review would already have set airport charges for 2003–08: hence, there was little scope to change the current arrangement. However, BAA said that should users wish to change the scope of activities covered by airport charges BAA was always willing to consider these provided that there was a clear majority airline view requesting any change; that airport charges were adjusted to take account of any lost revenue or additional costs (hence this could only be done as part of the quinquennial review); that no perverse incentives were introduced; that other stakeholders were not comprised by any changes (for example, abolishing utility charges would clearly be perverse in economic terms as well as being environmentally unfriendly); and that the expansion of BAA responsibility did not tend to reduce competition and the provision of services (for example, baggage handling).

14.287. On including ANS within charges, BAA thought it relevant to note that NATS itself was 46 per cent owned by a consortium of UK airlines, led by a former BA director. The consortium had a management control of NATS. They and not BAA had direct responsibility for the effective management of airport ATC. To put BAA in the position where it was paying airlines for airport ATC delays, while airlines were responsible for the company that provided the ATC would create a structural moral hazard. This would simply be compounded if airport ATC provided by NATS was incorporated in BAA's cost base.

- *Transfer baggage systems*

14.288. Since our last report, BAA said that it had significantly improved Heathrow transfer baggage systems and introduced a per passenger TSC. However, BAA claimed that management of this process took excessive amounts of management time for both the airlines and the airport.

14.289. BAA agreed with the general airline view that transfer baggage infrastructure should be included within the scope of airport charges. There were varying views among the airlines, however, as to how much of the infrastructure (particularly the transfer baggage system (TBS) tunnel) should be dealt with in this way.

14.290. BAA would like to move to a per bag charge for all transfer baggage infrastructure at Heathrow (including the TBS tunnel) from 1 April 2008, to deal with remuneration of all baggage infrastructure in an integrated manner.

14.291. Following the TIFGAH agreement on 27 May, BAA intended to incorporate TSC within airport charges from 1 April 2003 onwards with limited transparency available via an apportionment of the passenger charge. However, BAA also believed that BA should continue to meet its rental obligations on the TBS tunnel until migration to T5 in 2008.

14.292. BAA believed that the TIFGAH group had been driven too much on cost and not on transfer baggage performance. BAA advocated the revision of the governance of the transfer product at Heathrow to a group whose members were drawn from an airline/airport operational or customer service.

14.293. The remuneration of direct baggage systems would form the subject of separate discussions with airlines with the aim of implementing and changes as part of the next regulatory review.

### *Specified activities*

14.294. We noted in paragraph 14.19 that BAA was currently required to produce annual statements on the cost, revenues and basis of charges of a number of specified services. BAA agreed with a CAA suggestion that the CC consider whether disclosure of information be best handled by the current arrangement, or through an enhanced information disclosure and consultation commitment. It listed a number of additional charges outside of airport charges which had been informally outlined to users. (Revenue from specified activities amounted to £126 million, from other charges to airlines excluded from this requirement £77 million in 2000/01.) It stated that for all new charging activities it would ensure there was full consultation and transparency on the pricing methodology, and for market-based charges they were fair and reasonable and linked to recognized external market benchmarks. It was also

willing to undertake that the total revenues from all specified activities and other similar charging activities were capped in real terms on a per passenger basis.

14.295. BAA proposed categorization into cost base and market-based charges; the former either using PCR or simpler direct cost plus percentage overhead. Cost-based charges would be retained for financially significant activities such as check-in desks and utilities including FEGP; and could include charges for transfer of baggage (TIFGAH) if agreement was not reached to include this activity within airport charges. The market-based approach would be used for charges for which a competitive rate could be readily obtained (benchmarked where possible), and other charges which could be increased in line with RPI. This was subject to consultation with the CAA and IATA. It would ring-fence the forecast revenues from these activities with a revenue cap based on passenger yield linked to inflation. (The approach was similar to that of our proposed U factor, except the U factor would have linked the cost to airport charges, the BAA proposal to a separate form of price control.)

14.296. As to whether there was adequate transparency in the information it provided on specified activities, BAA said that its PCR cost allocation system was introduced to deal with the conditions, and ensured that costs were allocated on a consistent basis for activities and prevented double counting of cost to more than one activity. Considerable time had been spent going through the specified activities statements with the airlines and explaining all the numbers with them. BAA was, therefore, disappointed about users complaining about the extent of information. It was not aware of any instance where reasonable request for further information or clarification has been denied. It believed that confusion of users about the PCR cost allocation system and how this related to the single till formula for airport charges and overall rates of return for the regulated airports could be explained by staff changes within the consultative committees. It had offered individual coaching sessions for new members to explain pricing methodology and how the single till operated: if a user wanted to see the full apportionment of overheads, this would in theory be possible. The PCR system, as had been explained to users, was fully reconciled with the statutory accounts and independently audited, particularly recently in the context of its use in the dual till. There was certainly no question of double counting: under the single till all revenues from these other charges were credited against airport charges anyway.

14.297. It believed information provided to users was sufficient to discharge its responsibilities under the specified facilities conditions, and the CAA had never queried the quality, accuracy or sufficiency of the data provided. It believed queries by users had always been dealt with in a timely fashion and as comprehensively as possible, within the bounds of commercial confidentiality.

14.298. It believed airlines (and BA in particular) would always try and cherry pick charges to challenge on the basis that too much cost was allocated. They would always take the view that was most beneficial to themselves, which may not be in the interest of the airport community in total, however, which was BAA's interest. Within the single-till framework, and with a cost-allocation system which was independently audited and based on consistently applied allocation bases, if costs were taken out of charging for one activity they would reappear in another: as all activities were taken into account in the single till there was no overall gain to be had by forcing costs into one or other activity. Recent reviews of the system on behalf of the CAA confirmed this was the case.

14.299. However, the CAA conditions did not require charges to be set with regard to costs. Where charges were not established in relation to costs, BAA was obliged to provide a statement of principles on the basis of which the charges had been set, with which it believed it fully complied. Where an external market for any product or service could be established, a market-based price competition was therefore theoretically superior to a cost base.

## ***Other complaints***

### *Charges to disabled passengers*

14.300. BAA shared the concern in Chapter 13 about any instances where passengers with reduced mobility were directly charged: it did not believe this was an acceptable practice. This was made clear in the European airports' voluntary commitment on passenger service. However, a very small number of airlines persisted in directly charging passenger of reduced mobility, which led to the suggestion a better approach would be for airports to organize the assistance services to these passengers. A trial at Gatwick, however, had failed; a sufficient proportion of airlines when faced with higher charges resulting from a

better specified assistance service indicated they would prefer to continue with their existing arrangements. BAA remained concerned about a centrally organized approach, as the assistance service had always formed part of ground handling services procured by airlines. Airlines were always going to be in the best position to determine the appropriate assistance required as they had the initial contact with those passengers. However, such an approach could not prevent individual airlines from adopting their own arrangements for the assistance service and continuing to charge directly should they wish to. This was also a matter on which the European Commission had been consulting. In conclusion, although understanding the concerns expressed, BA did not believe that a centrally organized service was necessarily the appropriate solution.

### *Car hire*

14.301. A number of complaints were made about arrangements for car hire (see Chapter 13). BAA said that all car hire contracts were tendered on the open market or sometimes negotiated individually. This process ensured that the market assessed the value of the on-airport rental locations. The only additional costs imposed were for backup areas, concession fee and utility charges. The MAG was based on 80 per cent of the concessionaire's own forecast; with a predetermined threshold relating to the passenger clause of 15 per cent: so if the threshold was met there was still a 5 per cent gain for the concessionaire on their original forecasts.

14.302. Historically, most concession fees were payable on gross turnover, including fuel, which was stated at the outset as a contractual stipulation and should have been taken account of by the bidder (more recently fuel had been excluded). Similarly, car rental companies had always been responsible for road fund licence fees. In 1998 the Government announced this fee would be charged based on the fuel efficiency of the car, this was an additional cost to the operators which they chose to pass on to the customer, and then included in the concessionable sales, and the car rentals company paid their concession fees on this.

14.303. As regards pricing, BAA's policy was designed to ensure the customer was charged no more than a comparable downtown location. The requirement only applied to walk-up prices, a small part of the market, the rest being highly competitive. It was nonsense to suggest BAA was artificially holding prices high. BAA only set maximum prices, allowing companies to discount from that price if they risk.

14.304. As to Stansted, BAA had gained planning permission for a new car rental turnaround facility, designed with input from the car rental companies and to be complete by spring 2003. The car rental companies were responsible for managing the health and safety of their employees and BAA tried in every way to assist.

14.305. As to the basis of the concession fee, historically car rental companies preferred negotiating, although BAA insisted on tenders from time to time and tenders still made up the majority of contracts awarded. It provided a clear indication of market forces. Tenders allowed access to the market and in a fair and transparent way. Tenders on the basis of price were the most suitable way of rationing scarce resource of land, and if higher than elsewhere this could only be because of desirability of airport locations. There were also many off-airport operators. Profitability to BAA was bound to be high, since the assets and costs involved were low; if charges were set only to cover costs, there would be a rent acquisition by the companies with no benefit to users (the same principle applied to other retail facilities), and—under the single till—higher airport charges.

14.306. BAA provided the basic facilities required to fulfil the car rental products, but companies may invest in improving the product to suit their customer requirements. The contracts were tendered or negotiated based on their investment being written off over the period of the contract to ensure their writing off investment met their own accounting requirements. It expected the concessionaire to write off all capex over the life of the contract. If concessionaires had a sizeable investment then the contract period may be extended. If an operator went bankrupt, the current provision allowed for BAA to get hold of the site for a nominal sum rapidly; the value of any assets would be offset by outstanding tender fees. These terms were included in the tender, but BAA sometimes took a pragmatic view, allowing the assets to be recovered.

14.307. The concession agreement was made up of a fixed element and a variable element; the fixed element was broken out of the total concession income according to a split agreed between

concessionaires and BAA. This element was not directly related to property rents: some concessionaires preferred a higher level of fixed costs than variable and others vice versa.

### *General aviation*

14.308. On complaints about facilities for GA, ie international business, private and air taxi traffic, BAA said that Stansted had arguably the best dedicated GA facilities of any major south-east airport. There were two fixed base operators whose primary business was to supply facilities and services to general aviation. BAA did not actively market the airport to GA, preferring to rely on the fixed-base operators to do so, but it did ensure that both operators could develop their facilities in line with growing demand. In most cases GA operators were required to file for runway slots, for which regular commercial services took precedence. If Stansted became busier, particularly at certain times of the day, it was likely that GA taxi operators would find it more difficult than previously to gain runway access at peak times. However, at other times they had full and open access to the airport.

### *Taxis*

14.309. On complaints about recent changes in arrangements for taxi services at Gatwick, BAA said that up to February 2001 there were two taxi operators at each terminal. However, it became apparent that this did not work in the best interest of the customer. The drivers of one operator being self employed and being licensed by the local authority had been able to derive their livelihood from a mix of journeys both local and longer distance; appointing two operators operating side by side had created an imbalance in the job mix and confusion for the customer. Controllers from both operators were under some pressure to allocate work evenly between the drivers and competition was effectively abandoned, in order to ensure drivers were retained at Gatwick. Service declined as drivers were supplementing Gatwick work with local work, often resulting in drivers being unavailable at peak times. Hence, when the contract was retendered in February 2001, tenders were sought on the basis of a single operator in both terminals, and one operator at each. Contracts were awarded on the basis of one operator per terminal. However, the uneven and seasonal split of passenger numbers between the terminals and the very different profile/mix led to a similar situation and the drivers working solely from the North Terminal were disadvantaged in their earning capabilities. It became apparent that one operator with one pool of drivers serving both terminals was the best option providing flexibility and better service to the customer. The incumbent operator now operated under a very comprehensive SLA ensuring standards were kept to a high level from cleanliness and appearance through to safety of vehicles. Every private hire vehicle was also subject to stringent checks by the local licensing authority. The most significant improvement had been the prequoting of fares prior to boarding the taxi. Customer research showed that 70 per cent of customers preferred this. This afforded the customer the real choice before getting in the taxi between using the airport taxi service, telephoning off-airport companies, using public transport or alternative means. Gatwick airport now received only about ten complaints per 10,000 journeys a month with regard to taxis, a significant reduction on complaints under the previous contractual regime. Both operators and drivers were also now able to invest in the phased introduction of new vehicles and a computerized booking facility.

14.310. Commenting on the complaint about taxi services at Heathrow, BAA confirmed the present charge was now £2.55, comprising the operation cost of the system of £1.75, the HALT levy of £0.49, and VAT. The increase was discussed with trade bodies and published when due. HAL had not made any profits from the collection of its fee, and currently under-recovered by approximately 50 per cent. As there were 7,500 current individual taxi users registered to go through the taxi feeder bar, HAL met only representatives at the trade quarterly meetings to discuss policy, improvements, management issues and increases of use for the taxi feeder. This was done to establish formal communications with taxi drivers and to do so on an individual basis would lead to nothing being agreed. A number of trade bodies were invited which were recognized as the major taxi representative bodies, and also the joint radio taxi association, public carriage office and the metropolitan police. All minutes were published and placed on the taxi notice board.

14.311. HALT had received funding from the Heathrow taxi drivers since the early 1990s. This was primarily to fund the taxi information desk in the terminals and was in response to an original request from the taxi trade. It was agreed that HALT would be set up as a company formed by the trade as a registered friendly society. All of the original documentation went missing in the Heathrow tunnel

collapse. Although there had been no contractual documents entered, the system had worked well for many years and only two of the registered users had complained. Legal proceedings had been issued by one or more of this group against HALT which BAA believed were unsuccessful.

14.312. HALT had informed HAL that all drivers received the same service and benefits from HALT whether they were HALT members or not: the only difference was the opportunity to vote at the AGM. It was HAL's understanding that all trade organizations agreed the desks were of benefit to the trade as a whole; if the majority view changed or circumstances altered then HAL had said it would review the HALT funding but at present HAL had no evidence to this effect. BAA had asked for proof of the allegations of corruption and malpractice within HALT: this would clearly concern HAL who would obviously investigate this in conjunction with the police. This had not been forthcoming. HAL had made representations to the register of friendly societies concerning the management of HALT following allegations about HALT's AGM, but had been advised there was no statutory regulatory function to intervene or make an interpretation of the rules of society. In the event of a dispute to the rules HALT members could enforce under County Court; HAL had no knowledge of any action taken.

14.313. BAA was of the opinion that the operation of the taxi feeder park and the charges made were legal; no other documentation existed; individual taxi drivers had the choice of plying for hire outside of the airport, but by entering the taxi feeder park accepted the terms and conditions of use and this had been accepted by one driver in his withdrawal of his legal action.

#### *VAT refunds*

14.314. On complaints about arrangements for VAT refund operators, BAA referred to a special arrangement now in operation for over two years at T3, in which Travelex staff had manned the HM customs desk. Hence, the second check at the cash refund desk was not required and the customer could be given the cash refund straightaway, reducing queuing time; and the landside customs desks was being consistently staffed, which was not the case before, also improving customer service. This had also allowed HM Customs to redeploy staff to focus on more important issues. This arrangement was dependent on an independent company processing the cash refunds, since HM Customs were not able to work with that company directly involved in the business due to concerns over confidentiality. It also required only one company to process all the cash refunds.

14.315. The Travelex contract had recently been extended due to the successful operation of the business over the term of the previous contract. BAA said that it was under no obligation to retender the contract, its code of practice stating it was acceptable to negotiate an extension if criteria such as good service were satisfied. A further reason for extension was the exceptional circumstances of the contract, Travelex being the sole bureau operator present at every terminal at Heathrow and Gatwick, and able to provide the service in a more cost-efficient manner than any other operator and without the requirement for additional space, and having a working relationship with HM Customs.

14.316. BAA believed that having more than one refund point would substantially detract from customer service as customers with vouchers from different operators would have to queue at three different desks (HM Customs, Global Refund and VatBack). There would be potential customer confusion; and the arrangements with T3 would no longer be viable. BAA currently subsidized the current operation at T3 landside because of the implications for customer service.

14.317. Customers did not pay extra for the current service because there was only one operator; it was irrelevant to the customer who they obtained their cash refund from, hence to provide the customer service it was important simply to ensure the process was as simple as possible, which was best achieved with one location rather than multiple locations; if dedicated VAT refund operators were to be provided space, this would also take up valuable space that could be better utilized for other services. BAA also insisted no surcharges be made for cash refunds although this was a higher cost than post or credit card: hence there was no detriment to the customer from the current arrangements.

14.318. There was also no obligation for VAT refund operators to provide a cash refund service; if charges were too high, neither Global Refund nor its competitors would agree to do business with Travelex or BAA. The fee structure for all VAT refund operators was the same to ensure those who wished to offer the service could do so on a level playing field; the level of the fees charged to Global Refund by Travelex was also similar to the level of fees charged to Vatback when Global Refund held

the contract at Gatwick to provide cash refunds on behalf of itself and other operators. It was also similar to the amount that Global Refund proposed charging its competitors when it tendered for the Heathrow business. The cost of doing business was also probably no higher than when Global Refund operated the cash refund desk itself, as the fee it paid to Travelex should be the equivalent of the cost of building, fitting out and staffing and managing a unit and paying a concession fee to BAA.

14.319. Quality of customer service in T3 had also improved substantially since BAA commenced provision of VAT cash refund service from an independent operator, queuing time being reduced and goods being able to be checked landside and stored in hold luggage rather than taken airside as hand luggage.

14.320. Hence, BAA believed that the current method of providing the VAT cash refund service did not operate against the public interest, as there was no increase in cost to customers; quality of service was improved; having one VAT cash refund point was a simpler solution for a customer and was the most efficient and cost-effective solution; and operation of the service through an independent operator meant all those refund operators who wished to offer their customers the option of receiving their VAT refund in cash were able to do so on a level playing field. Hence, BAA believed that the provision of the service by a sole operator was essential to derive and develop the substantial customer service benefits arising from the close working relationship that had been developed with HM Customs.

### *Fire training*

14.321. On complaints about fire training arrangements at Stansted, BAA said that the training of BAA staff was previously undertaken by various trained facilitators on a departmental basis. In order to improve efficiency, enhance consistency and effectively increase the number of fire training sessions available to staff it was concluded that all such training should be led by BAA fire service personnel. The number of airlines, concessionaries and tenant staff was increasing as the airport grew, and BAA was keen to ensure that they undertook the appropriate legally required training. Given the courses being run for BAA staff, the offer was made to third parties to book their staff on these two-hour courses at £10 a head if spare places exist. This had the effect of ensuring that frequent courses accommodating around 40 people were available on predetermined dates throughout the year, thereby assisting all occupants of the airport by providing opportunities for the many new staff being recruited. As a result the marginal costs of providing third party training were very low and therefore there could be no question of cross-subsidy. The course was not obligatory for non BAA staff: indeed BAA also offered a 'train the trainer' course to enable other organizations to undertake the regular annual training themselves in future. The primary objective had been to approve BAA processes and take the opportunity of contributing positively to fire safety at Stansted. Since the new procedure for fire training commenced in September 2001, STAL had billed £9,050 to external companies for attendance at the regular session and £6,400 for train the trainer courses. One other company offered fire and evacuation training, charging more than STAL but more flexible as to dates and days and providing a full tour of the terminal which STAL did not.

### *Travel agent outlets*

14.322. BAA asked the CC to recommend to the CAA that the formal conditions from the previous report relating to travel agents at Gatwick be revoked. One agent terminated the contract two months before it was due to expire in March 2002; the other contract was due to expire on 31 May 2002. Sales were down 21 per cent in 2000, and a further 45 per cent in 2001. Various factors were mentioned for this, including rapid growth of LFCs selling direct to passengers, the amount of discounted sales by airlines through affiliated tour operators, the very significant increase in internet sales, tour operators improving their own late sales systems, use by tour operators of large call centres, and airlines paying lower levels of commission. The remaining agent wanted the guaranteed minimum payment to be reduced by 50 per cent for it to extend the contract.

14.323. BAA explained that the concessionaire paid the higher of the agreed minimum fee or an agreed percentage of sales as the concession fee: the figure for the guaranteed minimum was calculated as a percentage of expected income to BAA (less than 100 per cent) based on the concessionaire's sales forecast. BAA had not considered the rental of desks alone for these contracts: when the two travel shops were open the concessionaire requirements were for space for four to six staff who could both deal face to face and answer phone calls. However, methods of booking holidays had dramatically changed. A

change to rental of a desk would not offer any financial advantage to a travel shop operator—Flightlines current minimum guarantee payment was less than the amount they would pay using the rate applied to airline or handling agent ticket sales desks—even if the existing frontage was reduced by 25 per cent and did not have any office behind the desk. BAA would, however, consider a change in the form of space requirement, subject to availability of desk space. The old operator did not have an ATOL licence but did have other licences enabling it to offer travel products.

14.324. BAA's strong preference was for the condition requiring it to have two outlets to be removed; but it believed the market for the service had changed to such an extent there should be no condition at all governing the number of travel outlets at Gatwick. Its intention was to tender the existing FIL unit as a travel outlet concession but it would have to review this plan if there was a disappointing level of interest in the tender; or if the concession proved uneconomic for the concessionaire. At the end of the three-year contract it would review the market and identify whether a further contract was appropriate both in terms of the demand for airport-based outlets and the potential alternative uses for the site. If the demand was similar to that today, its intention would remain to retender a single unit for this purpose.

### ***Separation of ownership of the three airports***

14.325. BAA said that this had been reviewed many times by third parties who had all concluded in favour of the current system framework. Hence, it said that there was little to be gained in giving further consideration to this topic, but acknowledged that if it did not operate in the national interest, or blatantly did not carry out what it had agreed to do, there was always a threat of being broken up.

14.326. As to not allowing third parties to invest, BAA said that this was incorrect in fact and in policy terms, and there were numerous examples of such investment such as maintenance hangars, cargo sheds, transfer baggage facilities; furthermore it was unaware of any cases where airlines had required investment and the company had been unprepared to undertake this. However, it would seek to build to its planning guidelines and in a manner which complied with its sustainability objectives.

D J MORRIS (*Chairman*)

R HOLROYD

P MOIZER

J A REES

J RICKFORD

R FOSTER (*Secretary*)

31 October 2002