

Regulatory asset base

Introduction

1. This appendix provides information on BAA's RAB (specifically for Heathrow and Gatwick), detailing its components, and how it has moved over the last two quinquennia. The appendix begins with the derivation of the opening balance for the year beginning 1 April 1997, and how this has been rolled forward to the BAA-derived balances of £9,108.1 million and £1,566 million for Heathrow and Gatwick respectively as at 31 March 2008.¹
2. This appendix also compares the actual rolled forward balances of Heathrow's and Gatwick's RAB with the projected balances set at the beginning of Q3 and Q4. Because of the size and uncertainty involved with large capex projects, there will invariably be a difference between the actual and projected RAB. This appendix describes the established procedure for dealing with these variances.

Function of regulatory asset base

3. The RAB is a proxy value of the airport's regulated operating assets, upon which the owners of the airports earn a return. It is one of the major building blocks of the price cap determination. The return (as proposed by BAA) on the RAB represents about 40 per cent of the total revenue requirement for Q5. The higher the RAB, the greater the level of airport charges revenue that the airports are allowed to earn.
4. Owing to the method of updating which is discussed below, the RAB for Heathrow and Gatwick will invariably differ from the value of assets in BAA's statutory accounts for these two airport subsidiaries. A generally accepted principle in UK regulation is that the RAB acts as a unit of regulatory value and accordingly does not need to correspond with the reported assets' values.
5. At each quinquennial review the CC and the CAA have to determine:
 - (a) The opening RAB balance for the beginning of the first-year control period (also known as the opening rolled forward balance). For Q5, this is the balance as at 1 April 2008.
 - (b) The closing RAB balances for each year of the new control period. These balances are calculated by taking the opening balance from (a) and adding forecast net capex and deducting forecast depreciation for each year, until the end of the control period (31 March 2013).

Calculating the opening RAB value

6. The MMC and CAA do not appear to have calculated an opening RAB figure when setting airport charges for either Q1 or Q2. Rather, the level of X was linked to the

¹Closing balance as at end of Q4.

need for returns on projected net operating assets valued at replacement cost to be broadly comparable with the cost of capital estimated to be appropriate for BAA.²

7. Following the recommendations from the Q3 MMC report, the CAA implemented an opening RAB value of £2,542 million and £941 million for Heathrow and Gatwick respectively for the beginning of Q3 (1 April 1997). These values reflected the individual airport accounts (prepared on current cost accounting basis) for the year ended 31 March 1991,³ updated for actual capex, depreciation and the RPI movements for the following five years to 31 March 1996, and projected capex, depreciation and the RPI movements for the year ended 31 March 1997.
8. The CAA and CC continued with this indexed historical cost-based methodology⁴ in Q4. By continuing to index the asset values for the effects of inflation, this approach limited the degree to which values of large airport assets with long service lives were understated. Indexation was also consistent with the application of a real (rather than nominal) cost of capital.
9. In setting airport prices for Q5, an opening RAB value needs to be calculated incorporating the capex undertaken by both Heathrow and Gatwick during Q4. This involves taking the opening RAB balance calculated at the beginning of Q4 and updating it for actual capex and RPI movements during the period. This will result in an opening RAB balance for Q5 that will more closely reflect the actual value of Q4 capex, rather than the capex projected at the Q4 review. However, for reasons outlined below, the RAB is updated using the projected depreciation applied during the Q4 price review, rather than actual depreciation.
10. As well as establishing the opening RAB, an estimate is required for the closing RAB balances for the five years of the Q5 control period. This involves projecting the capex (net of disposals) and depreciation for each year over the period. Given the relative uncertainty involved with large capex projects, there will invariably be a variance between actual and projected capex over the quinquennium, which means that the actual and projected RAB balances at the end of Q5 are likely to differ. However, this variance will be eliminated by rolling forward of the actual Q5 capex, which will be done at the Q6 review.
11. Although the CAA accepted the opening RAB value as at 1 April 1997, as calculated by the MMC, it did not institute a procedure for annually rolling forward the RAB for future control periods. Subsequently in the Q4 review, there were a number of disputed issues, initially between BAA and the CAA, and subsequently between BAA and the CC, which are summarized below.

Treatment of depreciation

12. The CAA proposed in its initial Q4 recommendations⁵ that projected rather than actual depreciation should be used when rolling forward the RAB from one quinquennium to another, ie the projected depreciation for Q4 would not be adjusted when setting the opening RAB for Q4 and Q5. The CC, in its subsequent recommendations to the CAA differed from this approach: it argued that the CAA's treatment involved some inconsistency between the resulting treatment of capex and

²BAA plc: *A report on the economic regulation of the London airports companies*, June 1996, paragraph 4.25.

³Capital employed values (unaudited) as shown in Tables 3.14, 3.15 and 3.16 of the 1991 MMC report.

⁴Other methodologies for establishing an RAB value for regulated entities may include pure historical cost, replacement cost or value-based methodologies such as fair market value or deprival value.

⁵Heathrow, Gatwick and Stansted Airports' Price Caps, 2003–2008: CAA recommendations to the Competition Commission February 2002.

depreciation. The CC added that there was no suggestion in the previous Q3 MMC or CAA reports that the RAB should be rolled forward in any way other than by using actual depreciation. Accordingly, when recommending the level of airport charges to the CAA at the end of Q4 review,⁶ the CC had used actual depreciation.

13. Despite the CC recommendations, the CAA in its final decision stated that it will apply projected depreciation when rolling forward the RAB. It argued that this was what customers had paid for, and that projected depreciation lowered the scope for gaming, ie that BAA could overstate projected depreciation in order to obtain a higher revenue requirement, but if the RAB was subsequently rolled forward using this overstated depreciation, there would be lower prices in future periods (lower RAB) and this would reduce any incentive to overstate depreciation in the original projections.
14. The CAA also argued that the use of projected depreciation would remove the disincentive on BAA to carry out additional non-revenue-earning capex (eg improving service quality) over and above that included in the projection, since BAA would not be penalized with a lower RAB in future reviews from rolling forward using the higher than projected depreciation.
15. During Q4, actual depreciation at Heathrow was projected to be £83 million greater than projected. At Gatwick it was £3.8 million lower than projected. The under-recovery of depreciation at Heathrow is consistent with the higher than forecast capital expenditure, and the over-recovery at Gatwick is consistent with the lower than forecast capital expenditure (see paragraph 34). Rolling forward the Q4 RAB using projected depreciation would overstate Heathrow's RAB and understate Gatwick's by the above amounts, relative to the RAB balances if rolled forward using actual depreciation. However, the overstatement of Heathrow's RAB is offset by the under-recovery in Heathrow's revenue requirement (for depreciation) during Q4.
16. Despite the CC's stated preference for actual depreciation in its Q4 recommendations, the CC said that using projected depreciation would be acceptable as long as the CAA made clear in its final proposals which approach it intended to use and put in place a procedure for calculating the rolled-forward RAB numbers annually. The procedure was subsequently included in CAA's final proposals,⁷ as outlined in paragraph 9.

Treatment of disposals and write-offs

17. On accounting for disposals, the alternatives are to roll forward the RAB subtracting either the net book value (NBV) or the proceeds of disposals. The MMC/CC in the Q3 and Q4 reviews rolled forward the RAB by deducting the proceeds value rather than the NBV. The CAA argued in its proposals that under this approach the airport should be relatively indifferent to retaining or disposing of the assets if the 'right' cost of capital had been set (ie they would earn similar returns investing the proceeds in other uses). It added that the treatment was also consistent with the single till in as much as any gain on sale (the amount of proceeds in excess of the NBV) would adjust the RAB in the next review and have the same effect on future charges as the continuation of the stream of net revenue from the disposed asset.

⁶BAA plc—A report in the economic regulation of London airport companies, October 2002.

⁷Economic Regulation of BAA London Airports (Heathrow, Gatwick and Stansted) 2003–2008 CAA Decision February 2003, Annex 6.

18. Under this approach (deducting proceeds) the airport would not have a normal incentive to dispose of assets where the market value exceeded the capitalized value of expected future revenue (assuming future allowed rate of return is equal to the cost of capital, the capitalized value of expected future revenue associated with an asset is equal to the asset's RAB). This removes the incentive which would otherwise exist for the airport to transfer assets to non-aeronautical uses when the non-aeronautical value is greater than the RAB but less than the economic value in aeronautical uses. With assets disposed of at market value, the effect of disposals on airport charges will depend on the assets' current revenue (net of costs and any depreciation) as a percentage of market value. For instance if the cost of capital is 7 per cent and an asset with a net yield of 4 per cent is disposed of for £100 million, the required airport charges revenue is reduced by £3 million (£100 million (7–4 per cent)) a year after the next review. Thus, as long as the net yield on the disposed-of assets is lower than the cost of capital, airport charges will be lower after the next review as a result of disposal.
19. Of course, under this assumption, the airport also has an incentive to defer any disposals until after a regulatory review since this means it continues to receive higher airport charges revenue for up to five years. BA also argued that the current regulatory policy allowed BAA to earn an immediate profit by disposing of regulatory assets at full market value, but at the same time benefit from a 'holiday' until the next review. It also maintained that BAA should obtain prior approval before taking assets out of the RAB as this could constrain flexibility in relation to future airport development.
20. The CAA does not have serious concerns regarding the treatment of disposals but it will take into account the CC's views before coming to firm position for dealing with disposals in Q5.
21. In relation to a capital write-off, the current policy is that no adjustment is made to the value of the RAB, ie it retains the same value as if the write-off had not taken place. The CAA argued that apart from the consistency with the policy on disposals (sale of assets with nil proceeds), this approach would avoid the situation where airports were encouraged to keep inefficient or outdated assets. Penalizing airports (through a reduction in RAB) when they write off outdated assets may act against the efficient operation of the airport.

Profiling adjustment

22. At the previous CC review, adjustments were made to the projected RAB to produce a constant value of X for Heathrow throughout Q4 and Q5 and a value of X for Gatwick that varied slightly between the two quinquennia, such that these airports together along with Stansted achieved a 7.75 per cent return over ten years.
23. The CC chose to profile charges over a period of ten years in order to avoid the significant increases in charges from Q4 to Q5 from the construction of Terminal 5. Accordingly, the RAB adjustment included into the calculation of X effectively allowed some advancement of revenue, which was estimated to be about £300 million (NPV) in the case of Heathrow. This advancement would need to be reversed over Q5, and thus there will be a cumulative profiling adjustment that will be included in the Q5 RAB projections (see Table 3).
24. Gatwick did not receive any revenue advancement because, as it did not propose any significant capex programmes over Q4 and Q5, no similar step up in prices was projected.

RAB—Q3

25. This next section looks at the movement in the RAB balances since April 1997. As stated in paragraph 7 the opening balance of £2,530 million for Heathrow and £941 million for Gatwick was derived from BAA's accounts in 1991, updated for actual capex, depreciation and RPI adjustments. The MMC Q3 report noted that this value was somewhat greater than the value implied by rolling forward the market capitalization at the end of the first day's trading after privatization.
26. The rolled-forward RAB balances, reflecting actual capex and inflation adjustments over Q3 are shown in Table 1. The Q3 control period was extended one year in order for the CC Q4 inquiry to take into account the Terminal 5 planning decision.

TABLE 1 Roll forward RAB—Q3

	<i>outturn £ million</i>					
	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03
<i>Heathrow</i>						
Opening basic RAB value	2,529.8	2,923.9	3,093.3	3,235.8	3,418.83	3,662.3
Capital expenditure	382.1	226.6	176.6	242.6	364.2	648.3
Proceeds from disposals	-1.3	-1.7	-1.4	0.0	-23.7	0.0
Depreciation charge	-78.5	-106.3	-127.6	-142.8	-162.8	-163.9
Intercompany transfers	-23.6	-18.1	-8.3	0.0	0.0	0.0
Depreciation written back	13.9	14.4	13.9	16.3	14.9	0.0
RPI adjustment	<u>101.5</u>	<u>54.5</u>	<u>89.3</u>	<u>66.9</u>	<u>50.9</u>	<u>108.6</u>
Closing basic RAB	2,923.9	3,093.3	3,235.8	3,418.8	3,662.3	4,255.3
Centrally capitalized costs and HEOC	<u>29.1</u>	<u>42.1</u>	<u>47.3</u>	<u>56.0</u>	<u>56.2</u>	<u>56.9</u>
Closing RAB value	2,953.0	3,135.4	3,283.1	3,474.8	3,718.5	4,312.2
Projected balance*	2,997.9	3,400.8	3,842.8	4,337.6	4,818.3	5,347.3
<i>Gatwick</i>						
Opening RAB value	940.6	1,016.5	1,046.6	1,122.9	1,183.9	1,224.6
Capital expenditure	79.6	59.3	86.5	85.6	74.1	29.8
Proceeds from disposals	4.0	-11.8	-0.6	0.0	0.0	-6.2
Depreciation charge	-38.4	-42.6	-46.4	-54.0	-57.1	-65.0
Inter-company transfers	-9.0	0.0	0.0	0.0	0.0	0.0
Depreciation written back	3.0	6.4	6.1	6.2	6.4	0.0
RPI adjustment	<u>36.7</u>	<u>18.8</u>	<u>30.7</u>	<u>23.2</u>	<u>17.3</u>	<u>34.0</u>
Closing RAB value	1,016.5	1,046.6	1,122.9	1,183.9	1,224.6	1,217.2
Projected balance*	1,033.7	1,099.8	1,129.8	1,190.3	1,224.4	1,258.6

Source: BAA regulatory accounts, CAA and CC 2002 report.

*Projected profiled RAB from the CCA's decision adjusted for inflation.

27. The closing RAB value for Heathrow increased from just under £3.0 billion to £4.3 billion over the Q3 period, reflecting the start of Terminal 5 construction and the completion of Heathrow Express. Despite the increase, the RAB balance was over a £1 billion less than the projected balance (made at the beginning of Q3) as at 31 March 2003. This was due to a very long planning delay to Terminal 5, the most important aspect of BAA's Q3 investment programme. As a result of delays in the planning inquiry, Terminal 5 construction did not start until the summer of 2002, but some preparatory expenditure of £700 million was incurred during the Q3 period. The under-spend in Terminal 5 expenditure was partially offset by increased expenditure on non-Terminal 5 projects.
28. In contrast to the large variance in the actual versus projected RAB balance for Heathrow, the actual RAB balance for Gatwick at the end of the Q3 period was only marginally less than the projected balance.
29. The effect of capex under-spend was that over Q3 BAA earned a return on assets that were not yet built, and that airport users would effectively pay twice if the amount of the under investment was also included in the calculations of Q4 airport charges. At the Q4 review, the CC felt that there should in principle be some recovery for

under investment in Q3, but acknowledged that full recovery might result in BAA investing in projects even where it became apparent they were not necessary. Accordingly the CC, in its recommendations to the CAA, suggested clawing back about £400 million for under-investment in Q3,⁸ based on offsetting the additional non-Terminal-5 capex at Heathrow against under-spend on Terminal 5. This claw-back was made through an annuitized charge to the revenue requirement in Q4.

RAB—Q4

30. The rolled forward Q4 RAB balances, as suggested by BAA⁹ in its latest submission, reflecting actual capex and inflation adjustments are shown in Table 2. The capex and depreciation figures for the year ended 31 March 2008 are based on latest projections provided by BAA.

TABLE 2 Roll forward RAB—Q4

	<i>out-turn £ million</i>				
	2003/04	2004/05	2005/06	2006/07	2007/08 (projected)
<i>Heathrow</i>					
Opening basic RAB value	4,312.2	5,405.5	6,327.6	7,596.6	8,834.2
Capex	1,133.9	1,162.9	1,304.5	1,051.2	786.4
Proceeds from disposals	-2.4	-247.8	-11.2	-0.3	0.0
Depreciation charge	-162.2	-178.2	-184.7	-196.9	-220.0
RPI adjustment	124.0	185.1	160.5	383.6	252.5
Closing basic RAB	5,405.5	6,327.6	7,596.7	8,834.2	9,653.1
Profiling adjustment (cumulative)	-146.2	-274.8	-373.6	-468.7	-535.3
Closing RAB value	5,259.4	6,052.8	7,223.1	8,365.5	9,117.8
Projected balance*	4,969.4	5,843.5	6,881.8	7,873.1	8,899.9
<i>Gatwick</i>					
Opening RAB value	1,217.1	1,308.4	1,364.0	1,416.8	1,515.7
Capital expenditure	121.7	130.6	84.0	101.0	91.2
Proceeds from disposals	-0.1	-52.4	0.0	-0.6	0.0
Depreciation charge	-62.7	-65.3	-63.8	-70.4	-80.3
RPI adjustment	32.4	42.7	32.5	68.9	42.7
Closing RAB value	1,308.4	1,364.0	1,416.7	1,515.7	1,569.3
Profiling adjustment (cumulative)	15.9	20.9	15.9	3.5	0.0
Closing RAB value	1,324.3	1,384.9	1,432.7	1,519.2	1,569.3
Projected balance*	1,263.4	1,328.2	1,409.7	1,540.3	1,690.6

Source: BAA regulatory accounts, CAA and CC 2002 report.

*Projected profiled RAB from the CCA's decision adjusted for inflation.

31. The actual RAB balance for Heathrow is projected to increase from £5.3 billion to £9.1 billion, reflecting mostly the £3.8 billion spent on the Terminal 5 project. In contrast to the outcome in Q3, the final Heathrow RAB balance at the end of the Q4 period is projected to be slightly above the projected value used when setting Q4 airport prices. For Gatwick, the actual RAB balance of £1.57 billion is projected to be about £120 million (or 7 per cent) below the projected balance.
32. The disposals in the year ended 31 March 2005 reflect the transfer of a number of BAA-owned properties into a joint venture vehicle called Airport Property Partnership (APP)—see Annex 1. The portfolio of assets included both airport assets ('regulated properties' within the RABs) and BAA Lynton assets (outside the RABs). A significant adjustment to the relevant airport RABs was made by BAA in its submission to the

⁸This included a clawback for revenue advancement in Q3, which was implemented at the Q3 review to ensure a smoothing of charges over Q3 and Q4 and avoid significant step-changes in prices that would otherwise result from major investments.

⁹The final Q4 balances for both airports shown in Table 2 are above the balances suggested by CAA in its March proposals (£312 million for Heathrow and £34 million for Gatwick) due to increases in the value of RPI adjustment in the year ended 31 March 2007.

CAA. BAA provided the CAA with its valuations of the relevant properties, which were based upon the values at which the properties were initially transferred out of the RABs in advance of their sale into the joint venture. The CAA commissioned Atisreal (real estate specialists) to undertake a review of BAA's property valuations to ensure that the proposed adjustments were consistent with the requirement to adjust the RAB for the proceeds of a disposal on the open market. Atisreal concluded that the value attributed by BAA to the properties individually represented an acceptable market value as at the date of transaction. Accordingly the CAA was minded to adopt the RAB adjustments proposed by BAA.

33. If we exclude the effect of disposals, the actual RAB for Heathrow was £450 million above the projected value, and for Gatwick the RAB was £65 million below the projected value.
34. These RAB variances are mainly due to the projected versus actual capex. The higher than projected capex spend at Heathrow was due to the accelerated spend on Terminal 5, mainly to meet the requirements from BA for all of its operations to be located within Terminal 5 from its opening in March 2008. According to the CAA, the lower than projected capex spend at Gatwick was due to the lower than expected passenger volumes and the resulting deferral of much of the previously projected spend on NW Zone works.
35. In addition to the APP assets disposals, in 2004 BAA also raised the issue of the appropriate treatment of the transfer of the Terminal 5 hotel site. BAA proposed that this be transferred out of the RAB according to the cost of preparing that portion of the overall Terminal 5 site. Its proposal was based on the 1991 MMC determination that hotel sites and operations were outside the single till and the RAB.
36. The CAA was unclear about the regulatory framework for dealing with the disposal of land for a hotel, and sought clarification on this matter from the CC. However, in its own proposals, the CAA adopted BAA's assumption and reduced the RAB by £8.35 million in the year ended 31 March 2006.

Projected RAB for Q5

37. When assessing the higher than projected Q4 capex spend into the opening RAB for Q5, the CAA concluded that BAA was converging on best practice in capital management and that the performance in its consultation with airlines was 'acceptable and improving'. For this reason and because of the significant risks to future investment incentives of disallowing past capex, the CAA included all the actual capex from Q4, for both Heathrow and Gatwick, into their respective opening Q5 RABs.
38. The projected roll forward movements in the RAB over Q5 for both airports are shown in Table 3. The projected values of capex, depreciation and profiling adjustments are those provided by BAA in the latest version of its GSM, and assumes BAA's estimates of the opening revenue yields (which affect depreciation) and construction price inflation (which affect capex).

TABLE 3 Projected RAB—Q5

	2006/07 prices £ million				
	2008/09	2009/10	2010/11	2011/12	2012/13
<i>Heathrow</i>					
Opening RAB value	8,747.1	9,511.2	10,275.5	10,898.6	11,097.5
Capital expenditure	832.3	942.6	910.8	621.1	333.7
Proceeds from disposals	0.0	0.0	0.0	0.0	0.0
Depreciation charge	-267.2	-324.9	-391.0	-499.5	-601.2
Profiling adjustment	199.0	146.6	103.2	77.4	-12.7
Closing RAB	9,511.2	10,275.5	10,898.6	11,097.5	10,817.3
<i>Gatwick</i>					
Opening RAB value	1,505.5	1,588.6	1,746.8	1,921.2	1,986.9
Capital expenditure	135.9	219.1	245.5	155.2	112.2
Proceeds from disposals	0.0	0.0	0.0	0.0	0.0
Depreciation charge	-50.7	-64.8	-74.7	-89.7	-110.8
Profiling adjustment	-2.2	4.0	3.6	0.2	-5.6
Closing RAB value	1,586.6	1,746.8	1,921.2	1,986.9	1,982.7

Source: BAA's GSM.

39. There are £4.5 billion in proposed capex and RPI uplifts during Q5; however, the RAB is expected to increase by £2.1 billion over the period as there is a doubling in the depreciation charges from Q4 to Q5. These annual charges feed directly into the revenue requirement for each year.
40. Most of the increase in depreciation comes from the anticipated opening of Terminal 5 in 2008.¹⁰ This asset's total cost of £4.3 billion will be depreciated over an average book life of 35 years, which equates to an annual depreciation of over £120 million a year.
41. When calculating its proposed price caps for Q5, the CAA included an allowance for depreciation for Heathrow and Gatwick in line with the levels projected by BAA in its submission.
42. According to BAA, the projected depreciation from the existing assets has been calculated from the regulatory fixed asset register, based on the individual asset lives and the remaining NBVs of the individual assets. BAA argued that the asset lives used to calculate depreciation were consistent with statutory asset lives with the exception of investment properties, which are not depreciated in the historic accounts, but are depreciated in the regulatory accounts.

Our views regarding Q4 disposals and Q5 write-offs

43. With regard to the treatment of disposals, we see no reason to discontinue with the existing policy of RAB deductions using the proceeds value of the disposed asset rather than the written down value. We feel that airport users should be entitled to the gains arising from the sale of airport assets. The proceeds value is more likely to reflect the capitalized value of the lost non-aeronautical revenue that would have been included in the single till at the next review.
44. We queried the valuation of the transfer of property interests from the airport operating companies (HAL and GAL) to BAA partnership and the subsequent transfer to the joint venture known as APP. Although the market value of these assets has increased from the date of the transfer from BAA subsidiaries (including HAL and GAL) to the date of disposal to APP, it would be difficult to argue that a

¹⁰For regulatory purposes, assets are only depreciated once in use.

further reduction in the RAB was warranted, given the view of CAA and its consultants that the transfer from the airport companies was reasonably valued at the time.

45. However, we considered whether the deduction from the RAB of the APP assets should be made at gross proceeds or net of tax payable on the gain. The estimated tax payable arising from the sale was about £65 million at Heathrow and £5 million at Gatwick. Income modelling indicates that the NPV of the change in airport charges arising from a sale of airport assets (equating to the NPV of the asset's cost of capital net of its net income) is equal to the airport's capital gain net of any tax on the capital gain. This would suggest that deducting the gross proceeds from the RAB would be detrimental to BAA and would also be to airlines' disadvantage if it discouraged BAA from making disposals. Accordingly, we use the net proceeds measure when deducting asset values from the RAB.
46. We considered whether BAA was entitled to a return on these assets as they were disposed of early in Q4. The CAA argued that the revenue allowance in Q4 would have been calculated assuming that rental income from those assets would be received by BAA during the period. The loss of rental income (due to the asset disposal) would have somewhat offset the return BAA received on these assets. Accordingly, we do not regard it as appropriate to make an adjustment for the sale of these assets.
47. With regard to the sales of Terminal 5 hotel site BAA argued that this should not be deducted from the RAB at market value since income from hotels has previously been treated as outside the scope of the single till. BAA referred to the MMC 1991 report; there had also been a £14 million loss from the opening of hotels in the accounts:

In July 1986 the Secretary of State approved a scheme which provided for the transfer to the new airport companies of property, rights and liabilities of BAA. Interests in non-operational land and buildings were retained by BAA. The land, around the periphery of the airports, vested in BAA was identified as being surplus to immediate operational requirements, or having development potential. Following the acquisition of Lynton, the majority of this land was transferred from BAA to Lynton, although it was decided that some of the land was not appropriate for development by Lynton, or generated income predominantly from airport users, and this was transferred back to the airports. BAA said that all such transfers were at market value, except for hotel sites in the course of development which were transferred at their value prior to commencement of development in accordance with BAA standard accounting practices. Lynton therefore owns a number of sites around the airports in its own right, which were bought from BAA at market value. Income from these areas is excluded from the SEAL profitability cash flows discussed in Chapters 3 and 7.

48. In the current case of the Terminal 5 hotel, the land for the hotel was in the RAB, and its value can be attributable entirely to the Terminal 5 development to which it is adjacent. Also, we do not see the disposal of land to a hotel developer as a sale of hotel assets. BAA did not bear any risk from the development of the hotel (undertaken by Arora International) but rather benefited from the increase in land value arising from the Terminal 5 development, which was totally funded by airlines through higher airport charges. Accordingly airlines should in our view receive 100 per cent of the benefit from the increase in land value of the Terminal 5 hotel site.

49. In relation to the policy on write-offs, BA argued that the CAA's position could lead to overstating the RAB and to excessive pricing by BAA, particularly relevant at Heathrow in Q5 if the HET project goes ahead. This is due to the demolition of Terminal 2, which will be written off for accounting purposes but not against the RAB. BAA estimated that the effect on its statutory fixed asset register from the demolition of assets for the HET project would be £48 million in asset write offs and £380 million in accelerated depreciation in the period to 2017/18, mainly in relation to Terminal 1, Terminal 2 and Queen's Building assets. Treating write-off as regulatory depreciation would imply adding them directly into required revenue as well as deducting them from the RAB. The effect would be to increase prices to customers in the short term but to reduce prices in the longer term (due to the reduction in the RAB). It would also add additional uncertainty to the setting of the price controls.
50. We recommend that the current policy be maintained, and that the RAB remain unaltered, which is consistent with the policy of deducting the RAB using the proceeds value. This is in line with the CAA's proposal to us and is appropriate where an asset needs to be replaced before the end of its planned economic life in order to enable a more beneficial activity to replace it. However, we also agree with the CAA's comments in its initial proposals¹¹ that protecting the RAB despite poor management, planning and forecasting could encourage poor behaviour. Consequently, if there is evidence that write-offs are the result of poor management practice or wasteful investment, there should be an appropriate deduction from the RAB (without including directly in required revenue).

¹¹Airport Regulation: Price control review—initial proposals for Heathrow, Gatwick and Stansted airports.

Background information on BAA Lynton and Airport Property Partnership

1. BAA Lynton is a division of BAA responsible for asset managing APP.
2. Lynton plc was acquired by BAA in 1988 in order to provide BAA with property expertise to develop more fully the property potential of its airport sites post privatization. Lynton owned some investment properties, and in 1998/99, these assets and Lynton's property businesses were transferred to the parent company BAA.
3. In the early 1990s BAA also diversified into the construction of hotels through its BAA Hotels Ltd subsidiary, but the programme was subsequently scaled down and the hotels that had been developed, and were operated by third parties on lease, were sold to the individual airport operating companies concerned in 1994/95. In 1999/2000 the hotel assets were sold to Airport Hotels Partnership (AHP) for £194 million. BAA retained a 10.2 per cent holding in AHP which was then transferred to APP in 2004/05. The remaining holding was sold to the Arora Family Trust in January 2006.
4. In 2000/01 BAA sold some of its airport-related warehousing and industrial properties to another partnership; Airports Industrial Limited Partnership (AILP) for a net cash inflow of £107 million, in which BAA retained a 7.3 per cent holding. AILP was then transferred to APP in March 2005. Assets included 15 light industrial, distribution warehouse and catering base properties, of which nine are located around Heathrow; two at Gatwick, two at Stansted and two at Glasgow.
5. In 2004/05 BAA formed APP, a 50/50 joint venture with Morley Fund Management. BAA sold £793 million worth of airport property assets to this partnership, which were primarily the cargo centres at Heathrow, Gatwick and Stansted and offices located across BAA's UK airport sites. Some of these assets were in the RAB of both Heathrow and Gatwick (worth £276 million at the time of the sale). The remaining properties were outside the RAB.
6. The BAA Lynton division now has various management/advisory contracts for the three partnerships above. The combined value of these assets, according to the BAA Lynton web site, is about £1.2 billion. BAA records its share of these assets in its statutory accounts as 'investments in joint ventures', and as at 31 December 2006, valued this share at £401 million.
7. As well as the share in the above assets, BAA owns significant investment properties which have been valued as at 31 December 2006 at £3 billion. These properties include un-developed land, non-terminal buildings and facilities at each of the airports which derive rental income from airport users, such as hangars, car parks and storage units.
8. In August 2004, BAA sold the rights to construct and operate a 600 bedroom hotel at the Terminal 5 site to Arora International, which signed a 150-year ground lease on the site. BAA realized an exceptional profit of £41 million on the grant of the lease, from about total proceeds of about £60 million.
9. BAA announced on 4 June that it had hired Morgan Stanley to handle the sale of its 50 per cent share of APP.