BA position on Q6 at Gatwick

June 2013

Foreword

Keith Williams, CEO
British Airways

It is a basic tenet of economics that where markets work and there is effective competition, the outcome is the best deal for customers and the best allocation of resources for society. It is also a truism that the 'white heat' of competition burns and destroys businesses that do not meet their customers' needs.

Where companies, such as airports, operate in markets that are not competitive, regulation replaces market forces, to protect and serve consumers. The purpose of regulation is to replicate market pressures, ensuring that companies with market power are run efficiently, deliver for customers and do not earn excessive returns.

The airline business is highly competitive and British Airways (BA) must deliver the quality product that our customers expect from us, at a price they are willing to pay. New competition has changed expectations and no airline can afford to stand still. BA has been listening hard to what our customers want from us. We have radically changed our Gatwick operation, delivering a much lower cost base, offering new routes and a highly competitive customer product, all under a dedicated management team. This has required painful actions, including a major redundancy programme and pension changes. Our new vision for Gatwick, including new low lead in fares of £39, is proving to be popular with passengers and is delivering improving results for our business.

We have no doubt that Gatwick passengers demand the lowest possible prices, quality products and an efficient service. Gatwick Airport Limited (GAL) can and must respond to this and provide an efficient base, if BA is to grow its Gatwick operation.

At the end of Q4 Gatwick charges were £5.61 per passenger, but at the end of Q5 they are £8.78: a 56% increase. This price increase took place during a severe recession when APD and fuel costs increased significantly and airlines were fighting for survival. The airport continued to price to the cap.

GAL now wishes to increase prices substantially in Q6, whether through regulation or deregulated "Commitments". This would enrich their shareholders, to the detriment of passengers using Gatwick now and in future. The CAA's current proposal for a settlement of RPI+1% would take an airport that is currently inefficient and ensure that five years later it is over-priced, over-rewarded and still inefficient. This is not in our passengers' interests or consistent with the CAA's statutory duties.

The CAA's Q6 decision will have far reaching consequences for passengers. While the CAA proposals would deliver prices less than GAL's demands, the proposals still represent a 1% increase in addition to inflation. We show in this response, how Gatwick Airport could be made a much more efficient airport, without undermining development of the airport, or creating detriment to passengers, with prices of RPI-10%.

The "Commitments" offered by Gatwick do not constrain the airport's market power and offer no net benefits for passengers or over a RAB based approach. Even if accompanied by a "light" licence, the legal framework of commitments is flawed and vital safeguards in the Airports Act would be removed, and passenger's interest would not be protected. We understand that the CAA would like to encourage bilateral contracts and BA did explore the scope for this. However, the terms offered by GAL could not possibly be described as commercial or competitive. There is already scope within a RAB based approach for GAL and individual airlines to agree contracts, for example to incentivise new services, growth or to provide premium services if required.

BA therefore looks to the CAA to put in place an effective, efficient RAB based regulatory settlement that protects passenger interests. Passenger interests are straightforward.

BA is proud of our heritage and proud to represent and serve our passengers. We have found that what has worked well in the past needs constantly to adapt to new realities. Dynamic market pressures on airlines also demand a response from airports and the CAA. The new regulatory regime and Q6 represent an opportunity to put the passenger first, and challenge the out-dated assumption that prices should rise if service improves. It is an opportunity that we simply cannot afford to miss if we are to continue to fly, to serve.

Keith Williams

CEO, British Airways

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Introduction and background

Gatwick Airport is the second largest operating base for BA and BA is the second largest customer of GAL, carrying over 5 million passengers per year. We are the only airline at Gatwick who combines short-haul and long-haul scheduled operations, operating regular flights to 4 continents.

BA has a long history of operating a base from Gatwick and has adapted its strategy to meet the changing requirements of the market. The 80's and 90's were a period of growth with long haul departures reaching their peak in 2000. The terrorist attacks on September 11th saw long haul services cut by two-thirds, as the airline recognised that it could not operate a second hub at Gatwick; the strategy changed to focus primarily on point-to-point traffic.

A further reduction in long haul services was made in 2008 with the EU-US open skies, when services to three key US routes were moved to Heathrow.

In 2011 BA installed a dedicated management team to focus on Gatwick strategy; many difficult decisions have been taken including outsourcing ramp operations, rationalising customer service and management support roles and reducing our fleet of aircraft. This has enabled BA to provide lower value fares to our customers and compete in a highly competitive market place. BA has built a platform for growth and our long haul network and fleet has grown at Gatwick from 7 to 9 aircraft. BA now flies 20 aircraft on short haul routes during the summer, with 17 flying in the winter.

BA competes with a mix of low cost, charter and full service airlines across this broad range of routes.

Delivering a Fair and Efficient Q6 Settlement

In the sections that follow, we take each of the regulatory building blocks and explain the scale of the problem shown by the evidence; and how the problem can be addressed.

In many cases we refer to the ACC response, rather than repeat the arguments at length. BA has worked hard with the other airlines to find as much common ground as possible, sharing material and coordinating positions where we can. Naturally, there are some areas where airlines disagree. The CAA might be surprised to see that disagreements are relatively few compared to the vast areas of agreement. This reflects the common desire of Gatwick's airlines to ensure the airport provides an efficient airport experience for our customers, and that our flights can depart and arrive punctually. Airport charges largely cover areas where airlines do not differentiate their products. We also operate similar aircraft types.

For the avoidance of doubt, and for the sake of absolute clarity, BA does not see the Q6 regulatory settlement as a zero sum game. We do not believe that taking money from GAL's shareholders will benefit our own. Our position is not driven by malice or greed, but out of an acute understanding of what our passengers want, and what is in their long term interests.

We share GAL's vision and desire to grow, but we do not agree that they compete, except perhaps in a very limited way. We want and need to see a sustainable Gatwick with a long term future. In order to do that, we want to invest in Gatwick and we want to see a fairly rewarded airport operator. However, it must be done in a sustainable way. GAL must become efficient as a business, it must earn only fair returns and it must invest efficiently.

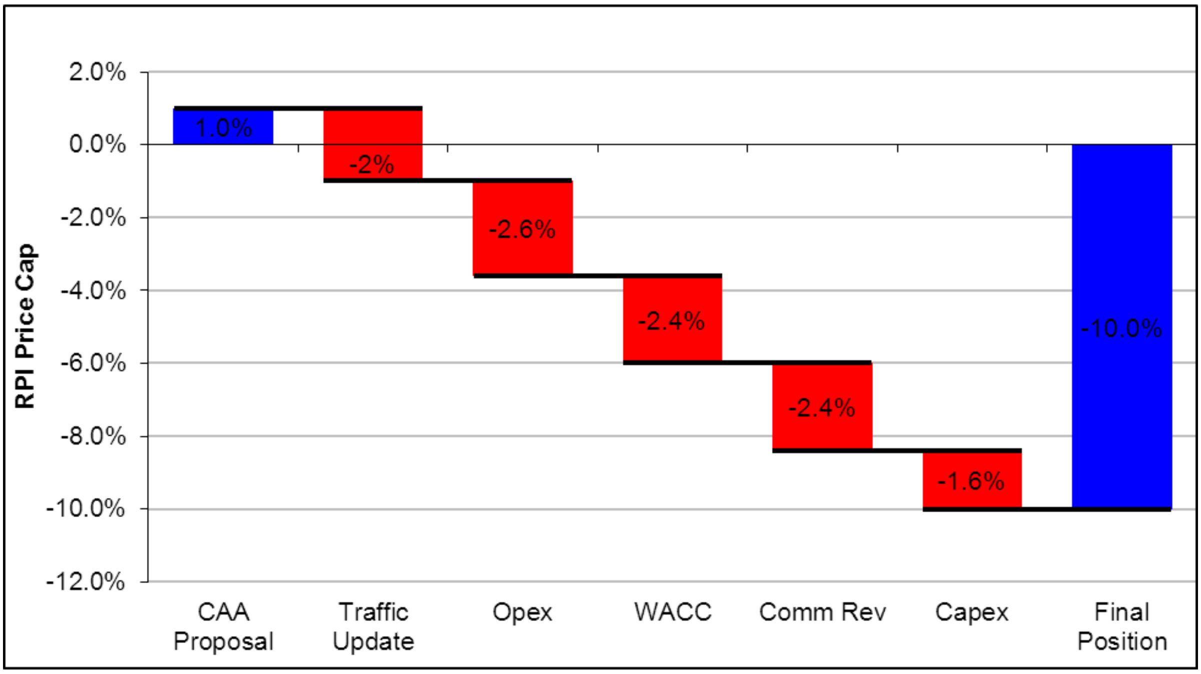
If it cannot do so, then ultimately it is the passenger that must pay (either directly or indirectly) for their inefficiency and excess returns. If this is the case, then we do not believe that such a state of affairs is in the passengers' interests. Consequently, GAL must be offered a choice – to become an efficient and fairly rewarded business, or to surrender the licence to run Gatwick to a business that can do it efficiently.

1. Executive summary

BA would like to see a Q6 settlement that incentivises efficiency improvements and necessary capital investment, while maintaining service consistency. We have considered each of the RAB based building blocks and concluded that a price settlement of RPI-10% is readily achievable, allowing GAL to make a fair return on its current and future assets and furthering the clear interests of passengers. This proposal is not inconsistent with the ACC consensus position of RPI-9%, but reflects some minor differences in the capital programme, as well as a less conservative approach to WACC and Opex projections. BA's position is summarised in the following table:

Q6 totals	Passengers	Capex	Opex	WACC	Other revenues	Overall
BA	191m	£434m	£1,282m	4.8%	£1,352m	RPI-10%
ACC	191m	£434m	£1,323m	4.9%	£1,352m	RPI-9%
CAA	181m	£794m	£1,385m	5.65%	£1,257m	RPI+1%

The table below shows the price path changes between the CAA and BA proposals



We also set out a strong preference for continuing RAB-based regulation in a new licence. Despite the CAA's efforts to improve, we set out major concerns with the framework of GAL's proposed Commitments, and identify issues with some of the detailed terms and conditions. We do consider that a RAB based approach could deliver lower regulatory costs and more flexible and commercial relationships between GAL and the airlines.

Passenger interests

The success of BA depends wholly on our ability to understand our passengers and to deliver services that meet their needs at least as well as our competitors. Nowhere is this more true than at Gatwick where BA has had to adapt its operating model and restructure in response to passenger feedback about what they are and are not prepared to pay for.

GAL's Revised Business Plan recognises that domestic and short haul passengers will continue to account for the bulk of passenger's right through Q6 (89% at the end of Q6). These passengers, predominantly flying point-to point, focus strongly on price. Competition between airlines reflects this.

BA's new £39 lead in fare reflects clear passenger priorities and ensures we can compete. But low fares result in low margins. Gatwick currently charges £17 per passenger. Even a small increase in nominal terms could undermine the viability of marginal and off-peak services.

The CAA's passenger research, for example on the drivers behind airport choice, largely reflects BA's own research. The implications are clear. Passengers want low fares based on efficient costs, and this requires airports to play their part. Passengers will be happy to see improvements at the airport, but they are already largely satisfied now, so improvements would not change their decisions. Most would not be prepared to pay more, but simply expect that innovation and efficiency will result in better services, for less cost.

Capital investment

Airlines compete strongly with each other, but we generally want the same things from an airport, at least as far as the core regulated product is concerned. We also recognise that the airport must develop in a way that meets the needs of its diverse airline customers and that competition is blurring some of the sharp distinctions between airline operating models.

Therefore it has been relatively easy to coordinate our views with other airlines on capital, as on most other matters. The ACC reflects all types of operator and accounts for over 90% of passengers. BA endorses the ACC response to this consultation and deals here only with differences in substance or emphasis.

BA supports capital development of £434m (2011/12 prices) over Q6, including £277m for asset stewardship.

We are currently unable to support the North Terminal international departure lounge, because it fails to exploit the potential commercial benefits. Javelin has pointed out many areas where opportunities can be realised by GAL. BA therefore considers that passengers are entitled to benefit properly from the revenues that could be generated if there is to be investment in this area.

BA does support part of the upgrade check-in and baggage drop project but believes that much of the investment is unnecessary.

BA has considered carefully the arguments for extending Pier 6. Modelling shows that pier service can be delivered at 95% for most of Q6, though we acknowledge the risk of a small drop at the end of Q6. BA puts a particular priority on pier service, to ensure efficiency and to meet passenger expectations, but we cannot see that such a large investment is justified by relatively small benefits.

We do not currently support the Hold Baggage screening project because this late inclusion has not been subjected to proper scrutiny and significant uncertainties therefore remain over necessary costs. We understand the need for investment, but GAL needs time to develop an efficient solution. Therefore BA is in agreement with GAL that it is premature to include this project in the capital plan and further discussion is required before taking a position on this project.

Capital Spend by year

Capex	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**	**Total**
BA	£134.1m	£85.0m	£69.3m	£73.8m	£71.5m	£433.7m

Capital efficiency

BA would like to see a more efficient and effective way of dealing with uncertainties and change in the capital programme. We also consider that GAL needs incentives to invest efficiently. We explain in the section on WACC that part of the problem in the past has been that generous WACC settlements have incentivised airports to add to the RAB, undermining efficiency incentives. A fair WACC would go a long way to removing the perverse incentive to over-invest.

We welcome the removal of the 3 month buffer to trigger dates but do not support incentives to deliver early, as benefits may be small and this could cause problems.

The core and development proposal is of great interest, but there is no consensus on this at Gatwick. We have some concerns about the practical operation of applying the Heathrow model without change at Gatwick, given its resource requirements (and the dependence on having a good governance framework). However, we are attempting to see how the core ideas and some of the features of the Heathrow approach, such as employing a cost surveyor, can be adapted.

Cost of capital

BA considers that setting the right WACC is important. In past decisions, the CAA has erred deliberately on the side of generosity because the judgement then was that the cost of setting it too low was greater than the cost of setting it too high. This has resulted in structural inefficiency and perverse incentives to over-invest. We also consider that incentives to improve in other areas are dampened by the fact that it is so easy to outperform against the WACC.

This now needs to be addressed because it is the main area in which regulation has distorted normal commercial behaviour. We acknowledge that GAL needs to earn a fair cost of capital, if they perform well, but there is excessive headroom in the CAA's current proposed WACC of 5.65%.

CEPA have considered the main areas of uncertainty in PWC's analysis: airport riskiness (and its consequences for equity beta and gearing); the cost of debt; and which point in the likely range should be selected. BA also used airline data to assess key changes in Gatwick's traffic and to draw conclusions on the causes of variability. This has been incorporated into the CEPA work.

This work has concluded with recommendations to adopt an equity beta of 1 and to retain 60% gearing without a small company uplift in the cost of debt. Given the uncertainties in the future cost of debt, we present an indexation approach, with an initial value of 2.5% (real), being the trailing 10 year average of a mix of bonds. Automatic adjustments could be made annually or at the end of Q6.

This analysis results in an initial WACC of 4.8%, which is well within PWC's range.

Passenger forecasts

BA supports the work done by the Gatwick ACC on traffic forecasts. We agree with the CAA's April forecasts, but have made adjustments to take account of recent improvements in baseline traffic and future GDP projections and we have also estimated the uplift expected from the transfer of Flybe slots to easyJet. This assessment results in the following forecasts for Q6.

Pax (m)	2014/15	2015/16	2016/17	2017/18	2018/19	Total
ACC	36.8	37.3	38.1	38.8	39.6	190.6

CEPA also assessed traffic volatility as part of the WACC work and demonstrated resilient growth at Gatwick, especially of short haul traffic. That paper should provide additional confidence that these forecasts are realistic and achievable.

Much of the growth results from the transfer of Flybe slots to easyJet.

Operating costs

BA found it difficult to review the CAA's Opex projections because much of the data was redacted at GAL's insistence. We are therefore concerned that the airport has been given a significant advantage in its dealings with the CAA on an issue that has great bearing on the Q6 price.

A particular issue was that GAL's projections for Q5+1 (2013/14) are irrationally and unreasonably high. For this reason, they should not be used as a base year for the Q6 projections.

We also consider that the CAA has been unduly cautious in assessing the scope for improvement based on the evidence available, selecting a low point in the range.

BA fully supports the ACC Opex assessment which has identified significant scope for efficiencies. There are a number of areas where the CAA has been clear in its April paper that it is choosing not to require GAL to make the full efficiencies put forward by its own consultants. BA believes strongly that this is not in the passenger interest and has therefore shown within this paper how the CAA could build upon the ACC Opex proposals and put the passenger at the forefront of the Q6 plan.

The CAA can put particular weight on the airline assessment because of the proven expertise of airlines in delivering significant cost efficiencies in a commercial environment. Many issues are similar, and BA has first-hand knowledge of the practicalities of achieving pension's reform and outsourcing.

Commercial revenues

BA has worked closely with the ACC to review the CAA's commercial revenue projections. The ACC drew on the independent expertise of a leading retail specialist, Javelin, to review their earlier advice in the light of recent information and the CAA's projections. Javelin brought in car parking experts ACTM to consider the car parking revenues. BA is confident that the Javelin and ACTM assessments provide a very strong basis for the CAA's Q6 projections and we would urge the CAA to adopt them.

Javelin/ACTM assessment

2011/12 prices	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**
Javelin retail income/pax	£3.92	£3.82	£3.76	£3.88	£4.02
ACTM car parking/pax	£1.09	£1.09	£1.09	£1.09	£1.09

BA supports the CAA's property and non-regulated charges projections but believes it is important that the existing protections for non-regulated charges should continue as this should prevent future difficulties and does not provide a regulatory burden for GAL.

The following Q6 projections for commercial and other revenues result from applying the ACC passenger forecasts to the Javelin/ACTM retail & car park income per passenger, plus the CAA property and non-regulated charges income.

£ '000	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**
ACC forecast	£259,847	£261,087	£265,238	£277,863	£287,855

Service quality

Service quality standards are important and have been one factor driving improved performance at Gatwick. BA endorses the ACC position, which is built on the proposed CAA approach. This can be summarised as follows:

- Rebates should be increased to a maximum of 14% of airport charges to ensure the airport has real incentives to deliver service standards (but this does not increase the airport's risk compared with Q5);
- We strongly oppose mandatory bonuses and believe that airlines and the airport should be left to negotiate these by agreement if and when they are appropriate and beneficial to both parties;
- The existing standards remain appropriate in most areas except where there has been investment and sustained performance improvements;
- We support new event-based measures for outbound baggage, 30 minute queues at central search and loss of airfield facilities;
- The weighting of different elements within the scheme should be varied to better reflect passenger interests.

Further work is needed to develop the detail, especially the definition of the new measures and measurement/time of day issues. We hope to continue this work during the summer in cooperation with GAL.

Q6 prices

The assessments contained in this document result in a Q6 price path of RPI-10%.

While this may seem challenging, we consider that it is a fair reflection of the genuine scope for improved efficiency across many areas. In assessing the scope for improvement, we have deliberately avoided taking the bottom end of ranges, so there would still be a realistic opportunity for GAL to outperform.

We also consider that there is a strong imperative from passengers to deliver much greater efficiency, innovation and lower prices. The CAA should be looking to replicate the forces that would operate if GAL operated in a competitive market, where reasonable profits are not guaranteed, but result only from great skill, endeavour, commitment and many unpalatable decisions.

Commitments and contracts

BA understands and supports the CAA's desire to reduce regulatory burdens where possible. We also acknowledge that the CAA has attempted to address the serious concerns raised earlier by airlines.

However, the whole approach is legally questionable given the new framework of the Civil Aviation Act 2012. This is especially true if GAL do not fully accept the CAA's proposed changes (which we believe to be the case) because the CAA would not be able to impose their decision. The approach also undermines key protections in the Act, including the right to appeal the terms of the initial Commitments, and any subsequent changes, to the Competition Commission.

We also have concerns that the four proposed licence conditions would not work as the CAA intends. We make recommendations for improvement but conclude that the only effective way to address the problems would be to include the Commitments in a licence. We also comment on some of the terms and conditions proposed which we consider to be unbalanced.

We understand that the CAA considers that the new Commitments might result in commercial contracts being developed between airlines and the airport. BA has discussed this with GAL, but the terms offered could not be considered commercial or competitive and we have concluded that GAL is not serious.

The Commitments approach, while superficially attractive, is therefore unable to substitute for RAB based regulation and deliver an effective remedy to constrain the airport's market power and cannot support this.

2. BA understands the needs of passengers at Gatwick

BA is a well-established carrier at Gatwick, operating in a highly competitive environment and understands that it must deliver a product that customers want at a price they are willing to pay. The GAL Business plan clearly highlights that Gatwick will remain a predominantly short-haul and point to point airport in the future. Short-haul passengers at Gatwick focus on cost/price when making their decisions and therefore market conditions drive airlines to offer the most competitive fares possible. At the recent Moscow Scarce Capacity Hearing easyJet highlighted the importance of having the lowest fares on a route and the decision to award the route to easyJet was based primarily on the benefit to passengers of lower fares. A greater level of detail on passenger priorities at Gatwick and how BA has adapted its business to meet these priorities can be found in the BA Q6 January submission[1].

BA talks to over 400,000 customers every year. It works with experts to carefully analyse this feedback and uses this to improve products and services and develop new services that customers are willing to pay for. To summarize, the key elements are:

- BA's "Think Customer Survey", which captures customers key priorities and concerns throughout the journey experience including elements not directly in BA's control such as finding your way round the airport, security and immigration
- BA's customer relations teams, its account management teams and colleagues serving our customers across the world
- 2.8 million Executive Club members
- BA's Travel Advisory Board comprised of key influencers and stakeholders across a range of sectors

2.1. Short haul is a low margin business and airport costs are material

Since BA's January Q6 paper, where BA was offering low lead-in fares from Gatwick to Europe starting at £47 one-way, BA has launched an even lower short-haul hand baggage only fare at Gatwick with lead-in fares starting from £39 one-way. BA introduced this new fare type as a direct response to large amounts of consumer testing carried out which clearly showed customers wanted lower fares to Europe, especially for the times when they didn't need to check a suitcase in. This new fare is allowing BA to compete aggressively in the highly price sensitive short haul market at Gatwick

[1] British Airways Interim Q6 Submission January 2013

International PSC for a departing passenger at Gatwick is £12.27 with landing and parking fees likely to account for a further £5 per passenger (airport charges are also incurred at the other end of route). Airport charges account for close to half of the fare the passenger pays on lead in fares with APD accounting for a further 30%; this has a significant impact on the fares that BA is able to provide for our passengers.

High airport charges can present a barrier to new entrants, make marginal and new routes unviable and threaten off-peak services. This reduces the range of flight timings, routes, competition amongst airlines and therefore choice to the customer.

Low airport charges mean that airlines can offer low fares. Low fares help make off-peak services viable and would increase volumes across the board. By growing off-peak the airlines and the airport can be more efficient with the result that costs are reduced and a virtuous circle established which has the effect of increasing choice to the customer.

It is in the passenger interest for the CAA to ensure that Gatwick addresses its efficiency and therefore the overall level of its charges in order to make them more affordable for passengers.

3. Passenger Interests

BA read with great interest the `Economic regulation at Gatwick from April 2014: initial proposals` paper and particularly Chapter 3: Passengers' Interest. Within this section of the paper the CAA highlighted a number of areas that support numerous pieces of research BA has carried out on consumer drivers of air travel purchase, which concludes the importance on price and lack of importance on airport facilities for customers in driving airport choice.

The table below highlights key findings from the CAA within Chapter 3: Passengers' Interest, along with BA' recommendation on how the CAA should respond to this insight:

Key findings from CAP 1029 – Chapter 3: Passengers' Interest	**The conclusion that the CAA should draw for Q6 at Gatwick**
3.1 the CAA has a strategic objective of improving the choice, value and fair treatment for consumers	The CAA would meet its objective by ensuring that GAL operates in an efficient and cost effective manner. Lower prices create choice, value and ensure the fair treatment of passengers.
3.9 the CAA places a substantial weight on the airlines' understanding of passengers' priorities And 3.43 Looks to the market (and therefore to airline views) to integrate the preferences of different kinds of passengers	• The CAA should put more weight on the airline view than they have done to date • The airlines do not support the level of investment that GAL have proposed • The CAA should reduce that Capital Expenditure Programme, removing unnecessary investment GAL proposes creating lower charges for passengers
3.14 airport service quality is not a key driver behind airport choice	The CAA should reduce that Capital Expenditure Programme, removing unnecessary investment that GAL proposes will create lower charges for passengers
3.14 at the airport, the overriding concern for the departing passenger is that they depart on time, and for arriving passengers that they leave the airport promptly once arrived	The CAA should promote projects that promote passenger process efficiencies at costs passengers are willing to pay. The improvements to NT Security are an example of this, Pier 6 South is an example where this does not happen
Fig 3.1 Drivers of airport choice	• Price and airport location are the two key drivers, representing >50% of the total • The CAA should ensure GAL charges are lowered
Fig 3.2 Passenger satisfaction at Gatwick, 2012 3.16 CAA passenger survey results showing that for the second half of 2012 86% of customers in the North Terminal rated their experience as `good` or `excellent	• The CAA should remove unnecessary Capital Expenditure that GAL proposes and ensure GAL charges are lowered
3.25 and figure 3.4 (YouGov Reasons for Airport Choice) the relatively lower importance of the	• "Convenience –distance" is the key driver in this survey, the airport is well situated

airport facilities in the passenger decision	with good access to major centres of demand • The CAA should remove unnecessary Capital Expenditure that GAL proposes and ensure GAL charges are lowered
3.26 (YouGov Reasons for Airport Choice) “past good experience” of an airport is second on the list	As the CAA points out, it is not clear what the good experience relates to, and we would suggest it could relate to good customer service from the airline they used, it should also be viewed in context of for the second half of 2012 86% of customers in the North Terminal rated their experience as `good` or `excellent
3.28 (CAA Q6 Gatwick research) 60% responded with “no improvements required”	The CAA should remove unnecessary Capital Expenditure that GAL proposes and ensure GAL charges are lowered
3.35 Accent research, commissioned by GAL showed around 90% of passengers would only pay £1 extra for improvements tested that had an average value of £11.94. 3.42 (Impact Research) the results indicate average WTP levels of £1.45 for departing passengers and £1.12 for arriving passengers to bring service levels up to a “middle” level of service	• Willingness to Pay (WTP) results are skewed by outliers • Whilst passengers gave an average value of £11.94 for improvements they would only be prepared to pay £1 extra to achieve what would be a substantial change programme • The reason people visit an airport is to catch a flight. If GAL believes there is a market for people to visit their building and spend time there then they should use their own money to develop this business and not ask the airlines to pay
3.42 It is notable that three quarters of those surveyed believe Gatwick is already at this level and therefore presumably would not be willing to pay any extra	• The majority of passengers are not willing to pay for improvements • The CAA should reduce that Capital Expenditure Programme, removing unnecessary investment GAL proposes and ensure GAL charges are lowered

4. Capital Investment

BA recognises that Gatwick has a broader range of airline models than many comparator airports, and in order to find capital solutions that work for passengers at acceptable costs it is important that the airlines work together in an effective manner. The ACC represents approximately 90% of the passengers and all of the airline models using the airport. BA has worked together with the ACC airlines to ensure it has put forward a capital plan that benefits the majority of passengers focusing on efficiency within the passenger journey and value for money. Due to the success of the work undertaken at an airline community level BA and the ACC has been able to agree a vast majority of the capital plan with its airline partners.

The detailed explanation of projects supported or otherwise where the ACC has a common position is in the ACC Q6 submission and therefore this paper is limited to areas where there is not a common position or BA wishes to provide further information. For ease a copy of the supported capital plan is also included.

BA supports a capital development programme of £434m (2011/12 pricing) over Q6 on the basis that efficiencies and improvements outlined in this paper will be delivered.

Summary table of BA's position on capital development projects in Q6

2011/12 Pricing	ACC	Reason For Support
Asset stewardship	£276.6	Maintains an efficient and safe airport, value based on Atkins report
Consol Car Rental	£4.7	Improves Passenger Proposition
Bridge +Car Parking Prod Dev	£4.5	Improves Passenger Proposition
NT Security	£17.9	Improves Passenger Proposition
Landside NT Coach Bays	£2.2	Improves Passenger Proposition
Upgrade check in & bag drop	£12.0	Improves Passenger Proposition
ST IDL Reconfiguration Ph1	£6.8	Passenger Proposition & Reduces Passenger Charges
CIP Arrivals	£1.8	Passenger Proposition & Reduces Passenger Charges
CIP Departures	£1.9	Passenger Proposition & Reduces Passenger Charges
ST Public Access & DDA	£7.6	Health & Safety Compliance
Digital Media	£4.5	Reduces Passenger Charges
Stand Reconfiguration	£8.9	Cost effective Stand Creation
STB& P1 (Carry Over)	£83.6	Carry Over Project
Pier 5 (Carry over)	£0.7	Carry Over Project
	£433.7	

The Capital Plan

NT IDL Extension

BA is unable to support the NT IDL reconfiguration and expansion project within the Q6 capital plan put forward by GAL. Whilst BA is pleased that GAL has improved the business case we believe that GAL has failed to maximise the commercial revenue opportunities that already exist and the same level of passenger benefits could have been achieved within GAL's current estate, without the need for an expensive extension. The ACC consultants have already identified that the NT IDL offers equivalent space per passenger to its comparator airports and therefore there is no requirement to build an extension to the current facility. By concentrating on maximising the retail incomes from the existing footprint GAL would be able to reduce capital spend and reduce charges for passengers. GAL should focus their management time on maximising commercial revenues that currently under perform. CAA survey data supports BA's position when it states that for the second half of 2012 86% of customers in the North Terminal rated their experience as `good` or `excellent` (section 3.16)

Upgrade Check In and Baggage Drop

BA supports the inclusion of new technologies in the Q6 capital plan that will improve the passenger experience in the future. BA and four other airlines have worked extensively with GAL to prove that this innovation can work and that it can be implemented in a way that is intuitive for passengers and improves their experience. BA has learnt from the trials that extensive IT connectivity is required to ensure that the self-bag drop machines are able to work alongside airline systems. IT connectivity requires an airline to invest time and money in setting up the required infrastructure and networks to support this. For this reason BA believes that GAL's assessment of 240 self-bag units at the airport is over ambitious and would be an unnecessary investment.

Therefore BA's support for this project extends to the implementation of 165 self-bag drop machines. The project also includes extensive upgrades to floors, ceilings and mezzanine areas that are not required as a result of the implementation of the self-bag machines. BA is not supportive of these changes as they represent only ambience and do not offer passenger benefits, they have not been identified in any of the passenger research undertaken by BA, EZY, GAL or the CAA.

GAL has put forward the concept of using machines in a common user environment where passengers of multiple airlines would use the same machines. BA are working with GAL to understand if this will enhance our passengers experience and or improve operational performance, at this time this requires further work. BA offers differentiated products to other airlines at Gatwick therefore common user processing is unlikely to benefit our passengers.

Pier 6 South

CAA passenger survey data highlights that "for the second half of 2012 86% of customers in the North Terminal rated their experience as `good` or `excellent" yet GAL is seeking to spend £152m on an asset that as the CAA showed in their initial proposal will only benefit circa 9% off passengers at the airport, this cannot be in the interests of anyone except the airport who will earn a guaranteed return on the investment. Unlike Heathrow where there is a consistent volume of traffic throughout the day, Gatwick has a very peaky operation and therefore infrastructure build costs need to be weighed against the benefits that these would provide. Where significant infrastructure costs only benefit a disproportionately small number of users then operational processes should be used to provide an improved passenger experience. It is pleasing to see that the CAA is aware of the limited benefits associated to this project.

In order to understand pier service levels forecast for Q6 BA has worked extensively with GAL and the other ACC airlines. This has included reviews using the current pier infrastructure, adding Pier 6 South and a range of alternative options. As this process developed it was clear that GAL's methodology for calculating pier service was flawed leading to lower levels of forecast pier service than would be achievable. After much debate agreement was reached between GAL and the airlines on a calculation method and also a schedule to be used. BA does not agree that the high case forecasts should be used to calculate pier service however to ensure that progress could be made it was agreed to use the high case schedule GAL provided for S18. During constructive engagement easyJet put forward a request to have their operation combined into a single terminal (south) and this has increased the range of options that required modelling.

Airlines asked GAL to model a range of scenarios to ensure they were as well informed as possible before taking a decision and whilst GAL were unable to satisfy all requests due to the workload required, a suitable range of information was provided. The key elements are shown in the table below and these all relate to pier service for passengers in the North Terminal under the scenarios shown, for the purposes of pier service calculation GAL have advised that that South Terminal passengers continue to achieve 95% or greater.

	Option 1	Option 2	Option 3
	PSL	Plus stand reconfigurations*	Increased towing**
EZY Split	92.4%	93.0%	95.9%
EZY North	92.0%	93.5%	96.7%
EZY South	92.9%	92.9%	94.4%

- Based upon High Case S18, peak day, peak week schedule
- Uplift for 12 month rolling average would be additional
- Operational improvements would be additional

The results in the table clearly identify in option 3 that 95% is achievable even based upon the high case, peak week schedule and do not reflect that PSL is calculated using a rolling twelve month average. Historic data shows that the twelve month pier service average can increase by up to 1% versus the peak summer week.

This would lead to PSL in the peak scenario's reaching close to the 95% threshold in all scenarios and is above the current North Terminal baseline in Q5. It was also agreed, post internal analysis presented by GAL, that an expectation of process improvements across all areas of the airport was appropriate to consider and would have an impact on PSL of up to 1% by 2018. Therefore looking at the forecast data and using the high case schedule it shows that 95% PSL is achievable without the need for costly infrastructure that would not be required in the early years of Q6 and would most likely not be needed at all. The BA position is that Pier 6 is an unnecessary and expensive infrastructure project that would benefit only a small number of airports users and therefore BA does not recommend this project going into the Q6 capital plan. Should the CAA accept GAL's assertion that PSL will dip below 95% late in Q6 then BA would propose a small adjustment to the PSL target in the North Terminal; as raising charges for the majority of passengers creates an unnecessary burden and is not in their interest?

Hold Baggage Screening

A project to improve the level of Hold Baggage Screening from standard 2 to standard 3 was brought into the capital consultation very late. Therefore there has not been sufficient time for either the airport or the airlines to understand the exact requirements and costs attached. Moving to standard 3 screening is a DfT compliance requirement that must be implemented currently by 2018. BA is supportive of standard 3 however not enough is currently known about how an optimal solution could be made to work within Gatwick's existing infrastructure. Therefore BA is in agreement with GAL that at this time it would be premature to include this project in the capital plan and further discussion is required before taking a position on this project.

5. Capital Efficiency

BA has put forward its initial views on how capital efficiency could be taken forward in Q6. However to date GAL have not entered into any meaningful dialogue on how this could be developed. BA agrees that the current process of constructive engagement needs to evolve in Q6 but does not believe that wholesale change is required. In order to find an effective consultation process moving forward GAL and the ACC airlines should engage in this process as soon as possible. BA welcomes the CAA proposal to remove three month lagging on triggers and also not having a pre-determined ceiling on the proportion of capital subject to triggers. The CAA proposals to adjust late delivery of projects with a cash flow mechanism making GAL inter-temporally indifferent is a positive move that will ensure passengers benefits are not effectively "gamed" and will also ease the CE process in Q6. BA does not support this mechanism being symmetrical as this would create an opportunity for GAL to play the system and also promote an alternative form of RAB grab.

BA is supportive of the inclusion of support from capital development expertise in Q6 as currently the airlines rely on GAL pricing projects correctly, supported by a review process from the CAA that may not be undertaken until years after the project has been completed. A process whereby any capital expertise is neutral would need to be assured otherwise this would undermine the consultation process.

Core and Development

BA is supportive of developing a core and development approach to capital projects for Q6 as we believe it could provide a platform to establish a capital plan that is flexible and can accommodate the needs of passengers, airlines and the airport operator. The CAA has proposed that airlines at Gatwick use the same approach as agreed at Heathrow and this has some merit. However BA believes that a similar but alternative approach needs to be found as the capital plan at Gatwick is far smaller than Heathrow and therefore the requirements are different. BA is not yet ready to put forward a detailed proposal and believes that this consultation should be held at a community level.

6. Commitments & contracts

BA understands and shares the CAA's wish to reduce regulatory burdens where possible and to facilitate a move towards more normal commercial arrangements, as competition develops. We have therefore considered the CAA's position and GAL's proposed Commitments to see whether they can be made to work and whether they would meet these objectives.

However, a serious weakness with GAL's Commitments regime is that it was designed by GAL, on the basis that they have little or no market power and the constraints are merely precautionary. BA believes that GAL does have significant market power. Therefore, the Commitments need to be much more than a precautionary back-stop.

We understand that the Civil Aviation Authority shares our broad concerns about the weaknesses of GAL's initial proposal and we appreciate their attempts to address BA's and the ACC's earlier comments on the framework and terms of the Commitments. However, as we explain below, and more fully in Appendix 1 which includes the advice of our lawyers, even with the CAA's proposed changes to the structure and substance of the Commitments they remain unsatisfactory and would continue to provide GAL with too much opportunity to benefit improperly from its market power.

We cannot see how further changes could be made to overcome these problems in a way that would provide benefits over a RAB based approach. We have also considered the changes proposed by GAL to the ACC on 7th June, which respond to some of the CAA's proposed changes. Disappointingly, GAL has not proposed a new Commitments price and remains of the view that a licence is unnecessary. In short, there is nothing in the GAL Revisions that fundamentally alters our view that the Commitments are an inappropriate way to proceed.

In this section, we summarise our concerns with the proposed framework and the proposed licence conditions. Appendix 1 contains further information on these points and also explores the terms of the Commitments more fully. BA's concerns are also reflected in the ACC paper.

We conclude that the CAA's proposed half-way house of Commitments backed up by four licence conditions suffers from significant problems, even it were to be acceptable to GAL, which it seems not to be. It is unlikely that these problems can be overcome in a way that would provide any real advantages over a traditional RAB-based price control.

The proposed framework

The CAA proposed that GAL's commitments would be supported by a licence. This licence would contain only four conditions, to give reassurance that the terms would be enforced by the CAA and could not be changed or withdrawn easily by GAL. However, we have identified significant problems with this approach and consider that the whole approach of having the Commitments backed by a licence is questionable as a matter of law. The CAA acknowledges in the Initial Proposals that:

"*Given the lack of an express statutory power to accept voluntary commitments, the CAA would need to be satisfied that accepting commitments was a suitable exercise of its discretion under the Act.*"

The first problem is how the CAA will ensure the initial terms of the Commitments adequately address the airport's market power and deliver outcomes in the passenger interest. The CAA has a number of duties under the Airports Act that would need to be satisfied before it could accept that the terms of the Commitments were adequate. It is clear to BA that the terms currently proposed by GAL are inadequate. BA's main concerns are summarised below and explored more fully in the attached paper and in the ACC paper. If GAL is not prepared to offer reasonable terms, it is difficult to see how the CAA could either impose terms or agree to GAL's proposal.

The second main problem is that by not including the Commitments themselves in the licence, the CAA would remove vital protections available under the Civil Aviation Act 2012:

- the CAA might forego some its enforcement powers under the Act; and
- the process for varying the terms (whether at GAL's behest, at the behest of third parties or on the CAA's own initiative) differ from those provided under the Act, removing for example the essential airline right of appeal to the Competition Commission.

The CAA must exercise its discretion consistent with the policy and objectives of the Act. It cannot have been the intention of Parliament that price controls are implemented in a way that avoid or render obsolete important processes and protections afforded by the Act. Yet it seems to us that this is what the hybrid approach is liable to do.

These problems could be overcome in theory if the Commitments were included in the licence, or if the licence conditions replicated all the key safeguards provided in the Act. We cannot see how it would benefit the users of air transport services to go to the effort however of constructing alternative processes to replace those established by the Act.

The licence conditions

In addition to the structural problems and the absence of the Commitments within the licence, we have specific concerns on the proposed conditions themselves as summarised below and detailed in Appendix 1.

The enforceability condition suggests that the CAA would be able to enforce the Commitments, but it is unclear how this would work. BA believes the condition should simply require GAL to comply with the terms of the Commitments. Such a formulation would provide the CAA with the full range of enforcement powers available under the Act. Anything less would reduce confidence that the terms would be enforced or could undermine the CAA's ability to deal properly with any breaches.

A condition preventing GAL from altering the Commitments without good reason and from withdrawing the Commitments. This unfortunately does not provide adequate protection because GAL could still make changes unilaterally if it could prove "good reason" and this term would be open to interpretation. As discussed above, any changes – even if the reasons are very good, would then not be subject to important Airports Act safeguards, including the right of airlines to appeal, which we consider to be an essential safeguard to support passenger interests.

In the GAL Revisions, new suggested wording for the Conditions of Use would exclude unilateral variations to the clauses on Indicative Price Yield and Service Standards. However GAL's suggestion does not provide a satisfactory response as it would still permit them to unilaterally vary or withdraw the Commitments in other respects and the drafting also assumes some ability to vary the Indicative Price Yield and Service Standards clauses in certain unspecified circumstances. Further, GAL could, at least theoretically, vary the provision preventing variation to the clauses on Indicative Price Yield and Service Standards.

A condition allowing the CAA to direct changes to the Commitments in response to a dispute where the Commitments are operating against the user interest

This would permit the CAA to make licence changes without having to follow the statutory license modification procedure and removing the airlines (or GAL's) right of appeal to the CC. This also refers to a dispute resolution power for the CAA without clarifying the process or circumstances under which it would operate. We have several concerns about how an effective remedy would be delivered in practice under such an informal approach and we remain unclear about the scope limitations that would be imposed.

The GAL Revisions introduce a new dispute resolution mechanism in terms of a temporarily binding expert determination. This would not allow disputes to be referred over the terms of the Commitments, only over compliance with them. Further, it is unsatisfactory since it leaves matters in the matters of a private expert rather than a statutorily appointed regulator with duties to the wider public

A condition allowing the CAA to introduce a freeze on charges if it is undertaking an investigation

This power would be necessary but the CAA would also need the power to order a lower charge especially if prices had risen above the Commitments price or if there was a significant shortfall in outputs. Merely freezing current charges may not be enough. The temporarily binding expert determination proposed by GAL in the GAL Revisions could potentially go further but we also have concerns that there would be no guarantee the outcome would be quick or in the interests of passengers.

The benefits of Commitments

Finally, it seems that there would be no price or other advantage to consumers from Commitments, other than the advantage arising from a longer control period (but this option is equally available under a RAB based approach). This is because for the commitments to be workable they must largely take the form and character of a full licensing regime and the obligations would therefore closely resemble the RAB approach. This would be coupled with the uncertainty and risk of adopting a new unfamiliar regime. GAL's January proposals do appear to offer a cost advantage, in that their Commitments price is lower than their RAB price, but as neither of these prices are credible or remotely efficient, it is difficult to understand what the realistic price would be on a comparable basis. GAL has not, for example, offered to reduce the RAB based price by Y% or £Zm to reflect lower regulatory costs.

BA does not think it is any more likely that the Commitments approach would lead to bilateral contracts, judging by our own experience, which is discussed below. This approach would therefore offer significant disadvantages and no real benefits over a RAB based approach.

Terms of the Commitments

The commitments themselves contain a number of unacceptable features, even after GAL's latest revisions of 7th June (which we have not had time to study in depth). Our most serious concerns are that:

- The price offered is unacceptable, exacerbated by an initial price jump, excessive bonuses and no obligations to improve efficiency;
- There is too much opportunity for GAL to vary prices unilaterally, for example via the cumulative revenue difference mechanism and cost pass throughs;

- There are no guarantees of outputs, creating a risk that desirable capital investment, that customers believed they are paying for when prices were set, will not take place;
- The service quality regime on its own is not strong enough to compensate for the loss of investment incentives in a RAB based approach;
- None of the benefits of the reduced regulatory costs would be passed on to consumers;
- GAL's dispute resolution mechanism might not deliver results consistent with the CAA's duty to passengers.

Contracts

Through the constructive engagement process, and bilaterally, BA have discussed with GAL potential alternatives to the regulated environment.

GAL have proposed a contractual framework, where they publish a rack rate of fees & charges applicable to all airlines, with the opportunity for the airline to agree a discount from those rates. ✂

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It is clear that GAL already has considerable scope within the current regulated approach to incentivise airlines to grow by publishing discounts or by varying the structure of charges. Equally, there is nothing to stop GAL from tailoring airport services for individual airlines under bilateral contracts. It is therefore not evident that a RAB based approach prevents the transition to more normal commercial relations between airports and airlines or that adopting Commitments would facilitate this.

7. Cost of Capital

In this section, BA makes the case for WACC to be set at 4.8% in Q6. This draws heavily on further work done for us by CEPA which are described in more detail in the annexes.

BA has also worked with other ACC airlines to develop a coordinated position. We are aware that the ACC position is to support a cost of capital of 4.9%. This is not inconsistent with BA's position but merely reflects a slightly more conservative approach based on the fact that other airlines have considered this topic in less detail.

Policy issues in setting the WACC

WACC is an important component in the CAA's price decision for Q6, with relatively small changes having a large impact on price. While calculating the WACC is an inexact science and a degree of regulatory judgement is required, it is also important to ensure the calculation is as objective as possible, based on a clear methodology (the CAPM model) and market evidence.

The ACC acknowledges the importance to the airport of being able to earn an adequate return on necessary and efficiently incurred investments, past and future. However, it is equally important that the CAA promotes economy and efficiency in investment and addresses the major risk of RAB based regulation; that of inefficient and over-investment.

We do not accept the CAA's assumption in the Q6 proposals that there is a greater risk from under estimating WACC than from over estimating it, certainly to the extreme extent proposed. This needs to be examined to ensure that regulatory discretion furthers the passenger interest.

Capital investment at airports rarely delivers new capacity and very little of the Q6 investment at LGW will increase capacity. While most projects will have benefits to passengers, these may not be sufficient to justify the costs. There is therefore a risk if a generous WACC is allowed, that the airport will over-invest, especially in low risk areas, as a means of increasing the RAB, and thereby returns to shareholders. In this way, long term structural inefficiencies will build up in the RAB.

Structural inefficiencies are passed on to airlines in higher airport charges, increasing airfares, reducing profits and thereby reducing investment in new aircraft, new routes and additional frequencies. Therefore there is significant potential for detriment to passengers from over-remunerating Capex via the impact on airlines operating in a competitive market. The CAA needs to balance and minimise risks of both over and under investment in order to further passenger interests.

GAL themselves confirm that inefficient Capex investment can result from a RAB based price control. Their comments below assume, of course, that the previous generous regulatory approach to setting the WACC would continue.

The generic dangers of a RAB based framework are well documented and include:….

"3. Dulled incentives to deliver outputs cost efficiently, with skewed incentives to substitute operating expenditure with capital expenditure;

4. Mixed incentives on Capex with, on the one hand, RAB-based returns potentially encouraging airports to build bigger and earlier than required but, on the other, the lack of a long term framework (given periodic reviews of returns) meaning that there may in practice be more focus on lower risk, incremental investments;"

…..Without a RAB, shareholders would have to consider investment without guarantees of the recovery of sunk costs. The removal of regulation would not take away the investment risk to shareholders who, if anything, would be even more interested in capital planning and effective programme management. ……The detailed scrutiny of projects will shift largely to the airport management and its shareholders, as in other competitive sectors…..

As we have outlined earlier, RAB based regulation provides mixed incentives on Capex with, on the one hand, RAB-based returns potentially encouraging airports to build bigger and earlier than required but, on the other, the lack of a long term framework (given periodic reviews of returns) meaning that there may in practice be more focus on lower risk, incremental investments.[2]

The ACC agrees with GAL that the current regulatory approach leads to significant over-investment problems and that this needs to be addressed by the CAA. However, unlike GAL, we do not think these problems are inherent in a RAB based approach, but rather that the main problems result from a lack of appreciation of the risks of over-incentivisation. Two particular policy approaches adopted in past reviews have exacerbated the RAB incentive problems:

1. The assumption that WACC should be estimated generously (to guard against the greater perceived consequences of under-investment); and

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[2] "Assessing the Adverse Effects and Benefits of Regulation" GAL Oct 2012 (GAL website)

2. The policy of adding all investment into the RAB without serious scrutiny by the CAA, subject only to bureaucratic procedural consultation requirements and a limited review of a few sample projects.

The main disadvantages of a RAB based approach identified by GAL and others could be addressed by balancing the risks of over-investment with those of under-investment and by rejecting the previous practice of adding headroom to all variables and then selecting a number high in the range.[3]

Overall estimate of WACC at LGW

BA previously submitted evidence that the cost of capital at Gatwick should be in the range 4.5%-5.5%. BA strongly disagrees with the CAA's proposal to apply an effective rate of 5.65% at Gatwick (compared the effective rate of 6.3% in Q5). We consider this would be excessive and unbalanced, and would harm passenger interests by reducing airport efficiency incentives, increasing air fares and harming airline growth and investment in new aircraft, routes and frequencies.

British Airways has considered the CAA's basis for selecting this number, along with the PWC report and we are grateful to the CAA for providing BA, and our advisers CEPA, with the opportunity to meet the CAA and PWC to review this assessment in more detail.

BA commissioned further work from CEPA to consider some specific issues in order to narrow the uncertainties identified by PWC and the CAA and to take account of recent market evidence. They have provided papers on:

- Indexation and the cost of debt;
- Equity betas at Heathrow and Gatwick;
- The use of estimation points in the upper quartile of the WACC range; and
- Gatwick specific issues.

CEPA has also written an overall summary paper which draws together the conclusions of their work. The five CEPA papers are attached to this response[4]:

[3] We also consider that the costs of regulation can be reduced for GAL and the airlines by moving away from procedural requirements to determine what is added to the RAB

[4] All but one of the CEPA papers are relevant to Heathrow and Gatwick and have therefore also been included in our separate LHR submission.

The key conclusions can be summarised as follows:

- Cost of debt can be subject to indexation, based on a 10 year trailing average of market rates, to remove excessive headroom in a way that remains fair to the airport. This would give an initial value of 2.5%;
- CEPA estimates that the equity beta for Gatwick is 1, reflecting reduced risks in Q6;
- The basis for reducing gearing from 60% to 55% and adding a premium to the cost of debt is unsound and there is no basis for taking a different approach at Gatwick;
- The CAA should select the midpoint of the range where there are uncertainties, consistent with approaches taken by other regulators and taking account of the actual risks and consequences.

Calculation of LGW WACC:

Element	**Q6**
Airport beta	1
Equity risk premium	5.00%
Risk free rate	1.50-1.75%
Post tax real cost of equity	6.5-6.75%
Corporate tax rate	20.20%
Pre-tax real cost of equity	8.15-8.46%
Equity gearing	40.00%
Debt gearing	60.00%
Pre-tax real cost of debt	2.50%
WACC	4.76-4.88%

WACC midpoint: 4.8%

(NB while the ERP & the RFR differ from PWC's assessment, the total is the same and we agree that it is the total rather than the individual elements that are important.)

8. Passenger Forecasts

BA welcomes the approach taken by the CAA in reviewing the GAL traffic forecasts, particularly given the lack of visibility the ACC was able to obtain regarding the SH&E process. BA was a significant contributor to the forecast produced by the ACC and believes that it is a fair representation of the traffic that will use Gatwick in the period.

Since the GAL forecast was produced by SH&E at the end of 2012, Gatwick have released traffic data highlighting that traffic is already exceeding the first year of the forecast and given the significance that out performance in the first year will have, the forecast has been updated to reflect this. Our estimate is that will increase passenger volumes by 200,000 passengers per year from the beginning of the Q.

Furthermore, since the ACC submitted its previous forecast other factors have changed that will likely impact on the overall number.

Medium term GDP forecast have improved and these also need to be reflected in the traffic forecasts.

easyJet has purchased 25 slot pairs from Flybe and BA has worked with easyJet to assess the impact that this will have on traffic volumes. As easyJet are yet to announce the size and type of aircraft they will introduce on these routes we cannot be sure of the capacity that will be available. Therefore using a mid-point approximation based upon their current mix of aircraft was deemed a sensible approach[5] and easyJet advised BA that a load factor of 149 pax is appropriate. Using this as a baseline and after reducing the forecast by the known Flybe passenger volumes[6] we see that the upside in passenger volume is a positive of 1.6m passengers per year.

The business plan put forward by GAL in January clearly shows that they anticipate the airport remaining a predominantly short-haul point to point airport in the future and previous BA analysis on the London short-haul market has supported this as it shows that Gatwick has out-performed the other London airports consistently in the previous ten years. Taking a forward view of airline fleet orders for short-haul aircraft, there is no reason to expect that this will not continue in Q6.

All of these factors point to higher traffic forecasts from 2014 onwards, over the Q6 period and their impact on the appropriate traffic forecast is shown below.

The revised traffic forecast

[5] http://www.independent.co.uk/news/uk/home-news/budget-airline-easyJet-plans-airbus-fleet-upgrade-8663139.html
[6] Data supplied by the Gatwick AOC

These revisions combined result in a revised forecast for Q6 of 190.6m passengers over Q6, compared to a number of 181m in the CAA's initial decision.

Revised Q6 traffic forecasts

	Passenger numbers (millions)
2012/13	34.3
2013/14	34.8
2014/15	36.8
2015/16	37.3
2016/17	38.1
2017/18	38.8
2018/19	39.6
Total Q6	190.6

9. Operating Costs

Operating costs have a significant impact on Gatwick's price cap, and therefore the fares paid by passengers. Consequently, it is critical that operating costs are properly assessed as part of the regulatory process and that they are as efficient as possible, it is not in the passenger interest to subsidise inefficiency.

BA has been disappointed by the refusal by GAL to share a level of operating cost data that would have allowed a comprehensive analysis. BA does feel that intervention by the CAA and their efforts to ensure that a suitable level of data was provided were helpful but could have gone further. For these reasons BA has been unable to undertake an independent review of GAL's operating costs and it has been difficult to assess the number put forward by the CAA in their April proposals as not enough clarity has been provided about where the CAA chose in the range for individual line items.

BA is supportive of the ACC work undertaken on operating costs and the operating cost proposal it has made, therefore BA will not seek to repeat these arguments in this paper. However, BA believes the operating costs assessment could have been taken further in a four areas and that in order to truly work in the passenger interests the CAA should ensure that the savings are made available; these will lower airport charges and reduce fares for passengers. The table below identifies where BA believes these incremental savings are available.

		CAA 2018/19	ACC 2018/19	BA 2018/19	Information	Incremental Savings
Frontier shift		£7m	£10m	£14m	Incremental £4m p.a glide pathed over the Q	**£12m**
Sickness Improvements		N/A	N/A	£1.8m	Incremental savings from reducing sickness	**£5.4m**
Pensions Improvements		£5m	£4m	£5m	Incremental £1m p.a not glide pathed	**£5m**
M & A		£4m	£4m	£8m	Incremental £4m p.a not glide pathed	**£20m**
						£42.4m

Frontier shift

The CAA consultants have identified that a company at the frontier of efficiency would be able to make 1% efficiency savings year on year. Previously the CAA have been clear that GAL is not an efficient company yet only proposes that GAL are tasked with half of the savings put forward by their the CAA's own consultants. BA cannot see how this is in the passenger interest and is quite frankly illogical.

Sickness Improvements

The CAA consultancy studies identified that sickness levels in GAL are running at 10days p.a versus an industry standard of 6 days p.a. BA along with other companies working in competitive markets have addressed sickness issues internally and GAL should be expected to do the same. Rewarding a poor sickness culture is not acceptable and should not happen.

Pensions Improvements

The IDS study for the CAA has put forward a number of measures that could be taken to reduce the costs associated with the GAL pension scheme. These are measures that BA has taken previously as have the vast majority of public companies. Giving staff the opportunity to increase contribution rates to maintain current pensionable age or increase accrual rates are now common practice and should be implemented immediately.

M & A

BA believes that GAL should fully close the gap to the benchmark comparators identified by its consultants and should not be insulated simply because iyt is a regulated company. In a competitive market GAL would have no option but to address any area where it did not operate efficiently.

Central Service cost data has not yet been provided however BA welcomes the CAA notification that BA and other airlines will be given a suitable amount of time to undertake analysis on the Helios outputs once they are published.

The table below shows how these savings would flow in to the operating costs as savings, to calculate a price BA has taken the figures put forward by the ACC and reduced these by the amounts below;

	2014/15	2015/16	2016/17	2017/18	2018/19	
Frontier shift	£0.34	£1.03	£2.06	£3.43	£5.14	£12.00
Sickness Improvements	£0.15	£0.46	£0.93	£1.54	£2.31	£5.40
Pensions Improvements	£1.00	£1.00	£1.00	£1.00	£1.00	£5.00
M & A	£4.00	£4.00	£4.00	£4.00	£4.00	£20.00
	£5.50	£6.49	£7.98	£9.97	£12.46	£42.40

Updated BA operating costs table

11/12 prices	Dec-13	13/14	14/15	15/16	16/17	17/18	18/19	Q6 Total
Actual costs from CAA document	282							
Baseline less 2.5% efficiency & BA incremental saving		275	263	256	247	239	231	1,236
Costs of traffic growth[1]		1	6	7	9	11	13	46
Update BA Opex		**276**	**269**	**263**	**256**	**250**	**244**	1,282
CAA projection			283	280	277	274	271	1,385
Variance			-14	-17	-21	-24	-27	-103

[1] Based on ACC projection of traffic and CAA Q5 assumption that opex grows with a traffic based on an elasticity of 0.3

CAA's scale of potential efficiencies, choice of point in range:

However BA believe that there is a strong argument that says that that the range of savings available and the CAA's choice of point within the range; are greater than that put forward in the CAA April proposals. This assessment is based upon the limited data made available to BA and we would welcome the opportunity to meet with the CAA to discuss this further. To assist the CAA in understanding our concerns on the range of savings available we have listed these out in the table.

When adding up all the areas that GAL could be challenged upon; BA estimates that the mid-point would have been far in excess of the range identified by the CAA and that the task presented by the CAA to GAL is lower than the 25th percentile. BA would welcome the opportunity to meet with the CAA to discuss this further.

If we accept the argument that the range of efficiency savings is as put forward by the CAA then we must still question how only setting proposals at the 25th percentile is supporting our passenger interests. GAL should be tasked to tackle inefficient Opex in the same way that competition ensures non-regulated are driven to improve efficiency.

BA does not believe that the CAA analysis should have been conducted using GAL's forecast for Q5+1 as the basis. GAL have inflated their forecasts for this period to ensure that any subsequent reduction due to the work undertaken by the CAA consultants has nothing more than the effect of counter balancing the realistic savings that are available. This leads to GAL being excessively compensated and higher charges for passengers, using the last year of GAL's regulatory accounts and rolling forward with RPI would be a more practical and accurate way of assessing GAL's Opex. Allowing GAL to base their Q6 forecasts on a forecast of their Q5 costs is effectively asking passengers to continue to pay for an inefficient airport operation; it is difficult to see how this can be in their interests.

The significant investment undertaken in Q5 should also have had a material impact on GAL's operating costs. It is unclear that this has flown through as savings from the proposals put forward by the CAA.

10. Commercial and other revenues

BA has worked closely with the ACC and appointed Javelin to assess the scope for commercial revenues in Q6, addressing the SDG analysis that accompanied the CAA's report, and new material that was not available at the time of their earlier report. We will not repeat the analysis here, but simply summarise the conclusions.

Retail, advertising and car parking

Javelin found a strong basis to confirm their previous projections for retail revenues per passenger. They did concede that car park income per passenger could be lower than previously forecast, but did not believe it would not fall as low as SDG has suggested. The results of their assessments are shown below.

2011/12 prices	2014/15	2015/16	2016/17	2017/18	2018/19
SDG retail income/pax	£3.68	£3.52	£3.69	£3.68	£3.82
Javelin retail income/pax	£3.92	£3.82	£3.76	£3.88	£4.02
SDG car parking/pax	£1.09	£1.06	£1.02	£1.00	£1.00
ACTM car parking/pax	£1.09	£1.09	£1.09	£1.09	£1.09

BA agrees with the ACC that that there is plenty of upside potential if these forecasts were to be adopted and we would also note that baseline years have been affected by the loss of retail space during refurbishment works.

Property

British Airways provided input to SDG before they provided their report to the CAA. We support the CAA's property projections and offer no further comment here.

Non-regulated revenues

BA also agrees with the ACC and CAA decisions to use GAL's forecast non-regulated revenues for the same reasons. We also strongly support the ACC position that existing

Q5 protections for non-regulatory charges have worked well, did not create unreasonable burdens, and we would like them to continue. (Alternatively, there is no reason why some of the charges could not be included in the price cap, although there is no obvious reason to do this if the Q5 regime is extended).

Applying the ACC passenger forecasts to the Javelin/ACTM retail & car park income per passenger and adding property and non-regulated charges income gives the following updated Q6 projections for commercial revenues.

£ '000 (2011/12 prices)	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**
ACC forecast	**£259,847**	**£261,087**	**£265,238**	**£277,863**	**£287,855**
CAA forecast	£242,200	£240,500	£250,400	£257,200	£266,800

11. Service Quality

BA has worked closely with other airlines to coordinate positions on the service quality regime and our position is therefore reflected in the ACC response. In summary, BA supports the evolutionary approach adopted by the CAA, subject to the following changes:

We propose that 14% of airport charges should be set as the maximum rebate;

We consider that bonuses are not in the passenger interest but suggest that GAL should be free to negotiate bonus payments with individual airlines where this is in the interests of both parties;

We support a revised weighting of individual elements which puts greater emphasis on measures that have the greatest effect on passengers and reduce the risks of disruption;

We identify areas of detail, especially measurement issues, where further work is needed among airlines and with GAL.

12. An affordable Q6 settlement at Gatwick

BA proposes a Q6 settlement of RPI-10% at Gatwick based on the previous chapters.

Totals over Q6 period	BA proposal	Notes
Opening RAB	£2,370m	Opening RAB prices are based on capital expenditure of £1.172m in Q5
Capex	£433.7m	BA Proposal is based upon the Capex we support with easyJet split terminal
WACC	4.8%	Based upon CEPA
Depreciation	£610m+£67m =£677m	Assumed Figures
Opex	£1,282m	BA proposal is based upon detailed work undertaken by the ACC
Commercial revenues	£1,351.9m	BA proposal based on Javelin consultancy estimates and adjusted to ACC traffic figures
Pax forecasts	190.6m	The ACC believes GAL have understated short haul growth in the base forecast
Price	**RPI-10%**	

13. Conclusions

- BA has identified how Gatwick could achieve RPI–10% whilst maintaining sufficient investment in the airport.

- CAA & airline passenger research clearly identifies that after the significant investment in Q5 (£1bn+), the passenger is happy with the experience and facilities offered at Gatwick.

- BA supports a capital programme of £433.7m for Q6, not including HBS.

- GAL's own analysis shows 95% pier service in North Terminal is achievable without Pier 6 south, GAL should focus on efficiency not infrastructure.

- CAA and ACC consultant analysis shows operating costs are significantly overstated and £103m savings are readily available, allowing GAL to retain this inefficiency is not in the passenger interest.

- Javelin has shown that the CAA has under estimated commercial revenues by £95m across the period, the under estimation is across retail, car parking and property revenues.

- CEPA has shown that a WACC of 4.8% is appropriate for GAL, using an indexation approach.

- Commitments are not legally founded and offer no protection for passengers or airlines.

14. Appendices

The following appendices are to be read in conjunction with this paper, these will be sent as separate attachments.

Appendix 1 - Baker & Mackenzie Legal Advice dated 24th June 2013 (legally privileged)
Appendix 2 - CEPA Legal Note 130625
Appendix 3 - CEPA WACC June Summary Note 130624
Appendix 4 - CEPA Cost of Debt indexation note 130624
Appendix 5 - CEPA equity beta note 130624
Appendix 6 - CEPA 80th Percentile note 130624