Airport Consultative Committee – Gatwick Airport (ACC)

ACC

Response to CAA document:

Economic regulation at Gatwick from April 2014:

Initial proposals

25 June 2013

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1 Executive summary

1.1 This document is the Gatwick Airport Consultative Committee's (ACC) response to the Civil Aviation Authority's (CAA) initial proposals for the economic regulation of Gatwick Airport Limited (GAL) during the Quinquennium period from April 2014 to March 2019 (Q6).

1.2 From the outset we have welcomed the work that the CAA has conducted evaluating GAL's Business Plan including its wide-ranging exploration of alternative regulatory approaches for Q6. Not surprisingly, the ACC has been supportive of such an approach and we have comprehensively and pro-actively engaged in the relevant debates as we continue to support the CAA's process. Nonetheless, our analysis shows that the CAA has been systematically too conservative in its assessment of a fair price for GAL.

1.3 Gatwick airlines have the narrowest of variance on only 4 of the 29 capital projects that have been considered. Nonetheless, the consensus position reflecting the common view on the building blocks set out in this paper results in a price settlement of RPI-9%. This is within a price cap range from RPI-7½% to RPI-9% resulting from these individual positions. The ACC asks the CAA to put weight on the ACC consensus position, while also considering the additional arguments made by individual airlines where there are variances.

1.4 The analysis in this document builds upon the response we provided in January earlier this year as part of our initial retort to GAL's proposed Business Plan. Subsequently, we have revised further our position to reflect the CAA's initial 2013 proposals, the new information which has come to light since these proposals and finally, additional analysis that we have undertaken and commissioned to buttress our earlier view.

1.5 There are five major elements that drive the variance from the CAA's proposals of RPI+1% and that of our current thinking. These include:

- **Passenger Traffic Forecast Volumes** - the ACC's forecast is approximately 5% higher than the CAA's reflecting more contemporary information, especially easyJet's recent acquisition of Flybe's Gatwick slots from March 2014 delivering a one-off traffic increase of 4%.

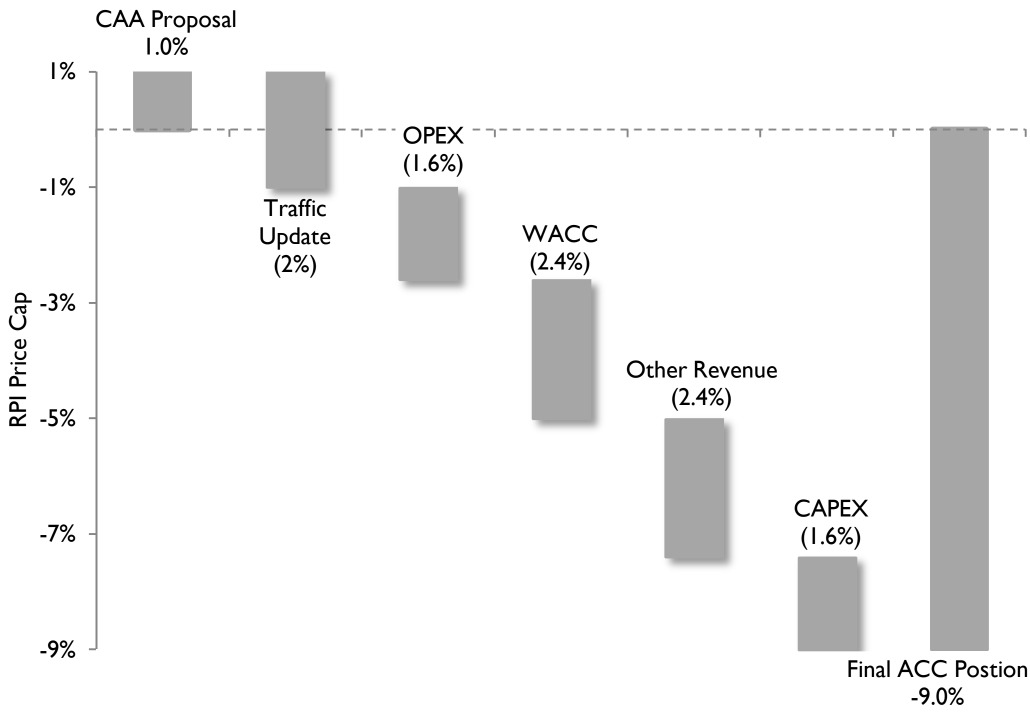
- **Operational Expense** - the ACC's projection of such costs is 4% lower than the CAA's reflecting our view that there still remain greater efficiency savings uncaptured by GAL or have yet to be identified by the CAA.

- **Commercial Revenues** - the ACC projects an 8% higher revenue stream in line with both the views of our expert consultants that commercial revenues in Q6 will be higher than the levels assumed by the CAA and also the effects of our higher traffic forecasts.

- **WACC** - our view that the allowed return should be 4.9% rather than the CAA's assessment of 5.65%. The ACC's proposal is derived from the CAA's own analysis and the difference in the allowed return mainly arises from the ACC's view that the CAA should not bias the cost of capital estimate in favour of GAL.

- **Depreciation** - the ACC's projection of depreciation is 7% lower than the CAA's reflecting a smaller capital plan excluding costly unnecessary infrastructure spend proposed by GAL and currently supported by the CAA.

1.6 The chart below shows the relative impact of each of these building block differences from the CAA's initial Q6 proposal of RPI+1% leading to a price cap of RPI-9%.



1.7 In light of these variances discussions continue with GAL.

1.8 Additionally, the ACC and its member airlines have debated with GAL the prospect of commitments which we believe need to be incorporated within a licence framework. However, these debates progress slowly as the airlines learn more of what GAL proposes. This is complicated by GAL volunteering minimum supporting data of such commitments and a general belief that the terms of these commitments are currently inadequate.

1.9 The strength of the current ACC and this submission is its undivided view across the airline membership notwithstanding that there are four separate business models undertaken by Gatwick airlines; namely, the full-service carrier, point-to-point operations, inclusive tour charters and lastly the regional airline model. These business differences aside there is tight commonality in response to GAL's ideas and the CAA's subsequent proposal.

1.10 Ninety three percent of all Gatwick's passengers are carried by the ten largest of the 72 airlines leaving the residual 7% of passengers carried by the remaining 60 or so businesses. These latter operators generally revolve around single daily departures. The entire top ten airlines have participated within the ACC and as this document is the agreed view of these airlines it delivers an unrivalled opportunity for the ACC to speak with one voice. Where there have been airlines who have not participated as much as others in the ACC process then all have been assiduously and continually updated throughout.

1.11 If there are minor differences they rest with nuance rather than principle. Examples talked of earlier will include a ten-basis point difference on the final proposed WACC, the expense of upgrading ceilings and flooring on front-of-house projects and lastly, for instance, the provision of another A380 code F stand should one airline operate an A380 to Gatwick in the unlikely event of finding that the current under-used A380 facility is occupied.

1.12 Consequently, this submission is a clear, comprehensive and collegiate view of all the carriers that delivers and maintains improved passenger facilities absent of any of the excessive spend proposed by GAL and unwanted by our passengers at any cost.

Jason Holt
ACC Chairman
London Gatwick Airport

2 Introduction and background

2.1 This is the response of the Gatwick Airport Consultative Committee (ACC) to the CAA's initial proposals for economic regulation of Gatwick Airport from April 2014.

2.2 In preparing its response, the ACC has sought consensus positions that reflect the views of all the member airlines on each of the issues. This has been possible in the vast majority of areas, reflecting the fact that passengers on all airlines want an efficient airport experience. However, in a small number of areas airlines have formed different views on specific issues. Where this is case, we have clearly highlighted the different views within this document.

2.3 ACC membership is open to all airlines operating at Gatwick and we take time to communicate with airlines that do not attend meetings, both on formal positions, and if we consider that they may have different interests, on particular issues. The AOC chair attends key meetings and updates AOC members. We have also been mindful of the need to allow flexibility for the needs of future passengers, most of whom are expected to be customers of existing airlines.

2.4 Much of the Q6 work has been led by a working group comprising representatives from easyjet, British Airways, Tui and Virgin. These four working group airlines alone account for two thirds of passengers[1]. In addition, Aurigny, Flybe, Thomas Cook, Ryanair and Emirates have all contributed in various ways as work has progressed. The ACC is confident that the views expressed here properly and accurately reflect the views of the whole airline community at Gatwick airport and will allow allthe airline operating models to promote their own passengers' best interests.

2.5 In some areas information2 has been provided to the ACC relatively close to the CAA's deadline and it has been difficult for the ACC to fully reflect its views in this document. In these areas, we have sought to provide our initial views and would expect to provide a more considered response before 25 July 2013, the deadline for responding to the CAA's market power assessment.

2.6 Our response to the initial proposals builds upon 9 months of Constructive Engagement (CE) between the ACC and Gatwick Airport Limited (GAL), as well as further consultation with GAL and wider discussions with the CAA and other stakeholders. The ACC continues to support the Q6 process and we remain keen to engage on outstanding issues over the next 6 months.

2.7 Nonetheless, we reiterate our view that there have been significant weaknesses with the CE process, in particular around information disclosure. GAL did not

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[1] 65% in 2012. Source: Fig 2.42 of CAA's Gatwick market power assessment, May 2013

[2] For example the service quality and price control conditions and GAL's updated proposal on commitments

provide sufficient information on either operating costs or commercial revenues for meaningful engagement. While the CAA's analysis has remedied some of these shortfalls, it remains difficult for the ACC to come to a fully informed view on the CAA proposals in these areas. Therefore our input is imperfect and based on either third party advice, or assumptions we have been forced to make in the absence of meaningful input from the airport.

2.8 This response also builds upon the ACC's January 2013 response to GAL's 2012 business plan although in some areas we have altered our view to reflect new evidence that has emerged. As with our response to the business plan we have proposed alternative numbers for price modelling purposes to reflect our assessment of a fair price for Q6 based upon our analysis for each of the individual building blocks.

2.9 The structure of this document broadly mirrors the chapter headings in the CAA's initial proposals.

2.10 Between now and the Q6 final proposals, we would urge the CAA to focus its efforts on the following outstanding issues:

- The on-going assessment of the capital plan including Pier 6.
- Working up a core and development model for capex.
- Traffic projections, to update for new information which becomes available.
- Operating costs, in particular by providing the results of the Helios study looking at central costs.
- Service quality, to work through the detail of the proposed changes and ensuring that rebate weightings reflect the key concerns of passengers.
- Cost of capital, including the appropriate regulatory treatment of ranges.
- The commercial revenue projections and the views of specialist independent consultants Javelin and ACTM.

3 Passenger interest

3.1 The ACC continues to believe that airlines are best placed to represent passengers' interests throughout the regulatory process. The ACC does not consider that the initial proposals put forward by the CAA (nor GAL's earlier business plan) on which the proposals were based, are in the interests of our passengers.

3.2 The ACC's approach to Q6 has been driven by the needs of our passengers. Evidence provided by both GAL and airlines shows that passengers place particular value on an efficient journey through the airport, and that they do not want to spend excessive time in queues. The CAA's work support this. However, it is also clear that passengers do not place a significant value on services they see as extraneous to a safe and efficient journey through the airport. The ACC has therefore focussed on ensuring that GAL's services and proposed capital projects deliver these outcomes.

3.3 The ACC remains committed to working with GAL to continue to improve the airport for our passengers and to drive operational efficiencies and resilience. However, it is important to remember the context for Q6. Research shows that after £1.2bn of expenditure in Q5 Gatwick already offers a good and improved passenger experience. The ACC believes that this investment has brought the airport up to an appropriate standard. We therefore see less need for improvement and consequent investment in Q6, rather the priority should be on maintaining existing levels of experience and performance.

3.4 The ACC notes that this view is re-enforced by the research in Chapter 3 of the CAA's initial proposals which not only shows high satisfaction, but also, that the perceived quality of an airport's services are not a strong factor in determining passengers choice of flight. This suggests that passengers do not place significant importance on an airport's ambience.

3.5 The ACC's member airlines have been active participants in the regulatory process with a view to driving a common understanding of our passengers' requirements and obtaining transparency on costs for Q6. The ACC also believes that the mix of airlines within the group helps to drive a detailed understanding of passenger needs across the different business models operating at the airport.

3.6 We continue to believe that to best deliver the interests of passengers, airports need to be run in an efficient and cost-effective way. In that context, the CAA's duties point towards replicating the outcomes that would exist in a competitive market. The ACC believes the CAA's initial proposals fail to address a number of issues for our passengers. In particular a price that is too high and does not address areas of efficiency savings found by the airlines and passengers, funding an overgenerous return to shareholders.

The ACC's submission is based on the best interest of our passengers

3.7 The ACC has considered the best outcome for passengers in Q6. The mix of airlines across the ACC ensures that the ACC's view represents the widest possible range of passenger priorities. The key points which reflect the passenger interest in the ACC's submission are:

- An efficient airport – we consider that operating costs should be some 4% lower than the CAA proposals to reflect the scope for greater efficiency savings. Similarly, the evidence we have adduced on commercial revenues suggests that the CAA's proposals are too conservative and that this income is likely to be around 8% higher than the CAA projection.

- Continuing to support investment which will improve the passenger experience. However this does not mean supporting all investment. The ACC has only included in its plan investments with strong business cases. It is not in the passenger interest to support inefficient or unnecessary capital expenditure. Whilst the ACC recognises that not all projects will have a positive financial NPV, for example mandatory compliance projects and maintenance projects, given the much improved condition of the airport, and the high levels of investment in Q5 designed to cater for growth, the ACC would expect most discretionary projects to reduce airport charges by generating more non-aeronautical revenue, lowering operating costs or by accommodating passengers and airlines that would not otherwise come to the airport.

- Driving consistent service performance by increasing the level of charges exposed to rebates, introducing new event-based measures and by reweighting the scheme to better reflect current passenger priorities. The service regime at Gatwick is a vital part of Q6 regulation. The ACC has set out its view on what that regime should deliver including:

    - a greater focus on the key measures that affect passengers;
    - increasing the total potential rebate to airlines;
    - a rebate for failure on key events; and
    - the removal of a bonus element for Gatwick

3.8 The ACC therefore believes its proposals address the key areas of our passengers' priorities as well as the areas identified by the CAA in its initial proposals. Moreover, our proposals do this at a significantly lower price than has been proposed by the CAA.

4 Traffic

4.1 The ACC welcomes the analysis the CAA has presented on the traffic forecasts for Q6. Due to the way the forecasts were produced by SH&E, the ACC had little visibility over the assumptions made in GAL's initial forecast, particularly for the first three years of the forecast and we welcome the assessment the CAA has provided.

4.2 Since the ACC forecasts were produced at the end of 2012, updated traffic growth figures have been released for Gatwick which show higher growth than the forecast. Given the significant impact that changes in the first year have to the traffic numbers over the Q6 period, the ACC noted that its forecast would likely be revised up and the ACC has therefore reconsidered its traffic forecast in that context.

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

- easyJet has announced the purchase of flybe's slots at Gatwick from 2014 – the ACC's conservative calculation is that this on its own will add an additional 1.6m passengers per year and has a large impact on the overall traffic forecast as well as the ACC's estimate of the price. This is new information since the CAA's decision and the ACC has shown a transparent and cautious estimate of the impact in this section;
- the medium term GDP growth forecast has edged up (see table 3.1 below); and
- the CAA has produced a bottom up assessment for the short term at Gatwick – higher than the one produced by SH&E.

4.4 All of these factors point to higher traffic forecasts from 2014 onwards over the Q6 period. The impact on the appropriate traffic forecast is discussed below.

easyJet's purchase of flybe slots

4.5 On 23rd May, easyJet announced the purchase of 25 slot pairs from flybe at Gatwick[3] from summer 2014. The ACC has estimated the impact of this on traffic over the Q6 period.

[3] http://www.ft.com/cms/s/0/cd02faee-c380-11e2-8c30-00144feab7de.html

4.6 Based on the CAA's data, Flybe's annual departing passengers at Gatwick in 2012 was just under 0.55m, if this is doubled to take account of arriving passengers the baseline for these slots is around 1.1m.

4.7 easyjet has not yet announced the size of aircraft that it will introduce so an average load per flight has been used based on easyJet's average passenger number per flight over the last year of 149. If this is multiplied up, this suggests these slots will generate 2.7m passengers per year.

4.8 This is therefore a positive increase of passengers per slot over the Q6 period of 1.6m passengers per year.

A higher base

4.9 Since the ACC produced its previous traffic forecast at the end of 2012, GAL has released its traffic outcomes for 2012/13. The ACC has therefore revised up the base year of its forecast to reflect these new numbers. This has an impact of 0.2m passengers per year over the Q6 period.

Higher GDP growth

4.10 Since the ACC produced its last forecast at the end of 2012, medium term growth forecasts, as measured by the HM Treasury independent average are slightly higher, see table 3.1. These forecasts are used for the medium term traffic growth forecasts.

4.11 The ACC therefore believes there is a case for the traffic forecast being based on a higher rate of forecast economic growth in the medium term than the CAA has allowed for in its initial proposals.

Table 4.1: HM Treasury independent forecasts

	2012	2013	2014	2015	2016	2017
Nov independent average	-0.2	1.1	1.7	2	2.1	-
May independent average	-	0.8	1.6	2.1	2.2	2.2

Source: HM Treasury: Forecasts for the UK Economy May 2013[4]

4.12 The table below shows the comparisons between the CAA's initial proposal and the ACC's December forecasts. The forecast growth in traffic by the CAA was noticeably lower than that of the ACC.

Table 4.2: A comparison of the ACC December forecast and the CAA's initial decision

	ACC December forecast		CAA forecast	
	totals	% change	totals	% change
2011/12	33.8		33.8	
2012/13	34.3	1.5	34.3	1.5
2013/14	34	-0.9	34.6	0.9
2014/15	34.5	1.5	35	1.2
2015/16	35.2	2.0	35.5	1.4
2016/17	36	2.3	36.1	1.7
2017/18	36.8	2.2	36.8	1.9
2018/19	37.6	2.2	37.6	2.2

Source: ACC analysis and CAA initial proposals

4.13 Given the higher GDP forecasts the ACC believes the CAA should revise up its rate of growth in the forecasts and has applied a growth rate to the passenger forecasts between that used by the CAA and the previous ACC rate from 2016/17 onwards.

The revised ACC traffic forecast

4.14 These revisions combined result in a revised forecast for Q6 of 190.6m passengers over Q6, compared to 181m in the CAA's initial decision, an increase of around 5%.

[4] https://www.gov.uk/government/organisations/hm-treasury/series/data-forecasts

Table 4.3: Breakdown of impact of revised assumptions on traffic levels

	CAA forecasts	Higer base	easyJet slot purchase	Higher growth	Revised ACC forecast
2013/14	34.6	34.8	34.8	34.8	34.8
2014/15	35.0	35.2	36.8	36.8	36.8
2015/16	35.5	35.7	37.3	37.3	37.3
2016/17	36.1	36.3	37.9	38.1	38.1
2017/18	36.8	37.0	38.6	38.8	38.8
2018/19	37.6	37.8	39.4	39.6	39.6
	181.0				190.6

Source: ACC

Table 4.4: revised ACC 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

Source: ACC

The use of the traffic forecast

4.15 The ACC agrees that it is important to have a central traffic forecast (the base case) on which to base Q6 capital planning. We recognise that it may be necessary for contingency purposes to assess the resilience of infrastructure to traffic greater than the base case forecast, however, capital planning should not automatically be based on an assumption that projects should be developed to meet a high case traffic forecast, but this should be reviewed project by project.

Traffic shocks

4.16 The ACC notes the use of adverse shock generators by other airports in their traffic forecasting and the CAA's partial acceptance of this methodology. This has not been proposed at Gatwick and we would strongly reject any proposed inclusion. In our view, the inclusion of a shock generator would potentially double count the way that the CAA deals with risk and reward in the context of the WACC. Moreover:

- We consider that traffic demand at Gatwick is relatively stable and has plenty of room to grow due to (i) larger aircraft size, and (ii) greater load factors.

- As a community we also do not believe that the full residual effects of any shock should be charged to the airlines. At present, if actual passenger numbers exceed forecast then the airport is deemed to have outperformed the settlement and it keeps the financial gain. Similarly if volumes are lower than projected, it bears the costs. The inclusion of the adverse shock generator seems to us, at a conceptual level, to shift the risk such that the airport would still bear the upside risk, whilst the downside risk would be borne by the airlines. This seems asymmetric, unless it were reflected in a lower WACC, or unless the airlines were to share in the upside risk too.

5 Capital expenditure

Summary

5.1 Since the initial proposals in January the ACC airlines have continued to work with GAL to develop and refine an agreed capital programme for Q6. Significant progress has been made in many areas and there is now agreement between the ACC and GAL on many of the projects put forward. To date the ACC has reviewed close to £1.5bn of capital projects, which have been refined as the process has progressed.

5.2 Previous regulatory periods have identified that fixing a long-term capital plan several years in advance is not an ideal scenario. Experience suggests that it is unlikely to be in the passenger's interest and therefore the ACC believe there is merit in developing an alternative regulatory approach for the treatment of capital projects where there is doubt over the exact timing and need for the projects.

5.3 To date the ACC airlines and GAL have not engaged on what form this regulation may take and therefore the comments in this chapter focus on the merits of each individual project and not how these should be remunerated under a RAB based regulatory framework. We consider the regulatory treatment of capital projects further in chapter 15.

5.4 The remainder of this chapter, therefore, sets out views on the current capital plan under 4 headings:

- Projects Supported (By all ACC airlines)
- Projects with No Common ACC View
- Projects Not Supported (All ACC airlines are in agreement)
- Other Projects

5.5 Within each section we have included a summary table.

5.6 In line with the CAA proposals the ACC capital plan is based pre-dominantly upon projects put forward within the GAL plan which assumes easyJet's operation is split across both terminals, however there are some projects that the ACC believes warrant support irrespective of which terminal(s) easyJet operates from.

5.7 The ACC has continued to assess potential projects based upon the criteria stated at the outset of this process:

- Projects must be value for money for passengers
- Projects need to be supported by individual business cases
- The ACC has agreed it cannot fully support capital projects before they have reached an advanced tollgate stage

- When dealing with commercial projects (justified on the basis of increasing commercial income) they need to be at least NPV positive and wherever possible not increase the price cap in Q6

5.8 The ACC welcomes the work undertaken by the CAA and its consultants ahead of the April initial proposals and is pleased that the CAA has acknowledged that some of the projects put forward are too expensive and do not offer passenger benefits commensurate with their costs. However it is the ACC's view that the CAA has proposed an overly generous capital plan that does not deliver sufficient passenger benefits to justify their costs.

5.9 We welcome the CAA's acknowledgment that the Pier 6 South project does not justify its costs, but are concerned that despite this the CAA included it within the proposed price cap. The rationale for this is unclear and we believe that GAL should seek alternative options to meet the requirements put forward by the ACC airlines.

5.10 Where the CAA's April assessment has indicated that project costs should be different to those proposed by GAL the ACC has included the CAA's recommended costs within this section[5].

5.11 In some cases the CAA has referred to survey information on passenger willingness to pay. We recognise the value of this work, however, we are concerned that too much reliance has been put on the willingness to pay work by the CAA in making its capital recommendations. The CAA's own research said that "The CAA Q6 research even showed that 60% of customers interviewed responded with "no improvements required" when asked what single improvement would they like to see at the airport (section 3.28)". The range in views on willingness to pay for airport improvements is an issue the CAA has acknowledged, and simply relying on averages may not be a robust approach.

5.12 The CAA's analysis of GAL's proposed investment plan has led to a proposal from the CAA of a capital programme of £794m. We note that this is on top of the £1.2bn of capital investment in Q5. This is almost equivalent to the entire current RAB value of the airport in just eleven years.

<u>Projects Supported by the ACC</u>

5.13 The ACC has undergone significant analysis of the supported projects alongside GAL and is pleased to be able to support their inclusion within the Q6 capital programme. They are listed below.

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[5] All prices have been converted to 2011/12 using an index of 0.944 for consistency with the CAA proposals.

Table 5.1: ACC supported projects

		ACC Supported Projects
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	

Source: ACC analysis of GAL plan

Asset Stewardship **£276.6m**

5.14 In January 2013, the ACC submitted to the CAA evidence that GAL's Asset Stewardship budget should be £300m (£283m in 2011/12) pricing) based on saving identified following work carried out for the ACC by Atkins. These reductions mainly came about through refined on-costs forecasts, assessments of the base cost data (using benchmarking etc.) and refinements of the inflationary adjustments applied to forecast casts.

5.15 Following further assessment of the Atkins work and taking into account the issues identified below, the ACC believes that the Q6 Asset Stewardship budget should be £276.6m (2011/12 prices) given that:

- The ACC supports the view that that the GAL Asset Stewardship budget of £331.3m includes a further £33m of unnecessary on-costs that could be saved.

- Further analysis of the benchmark cost work should identify savings to both the base costing for the Asset Stewardship estimate and the inflationary adjustments applied to this. It is not unreasonable to expect that a saving of 10% would be achievable against the base construction costs, equating to savings in order of £21.7m against the overall asset stewardship budget of £331.3m.

5.16 Therefore the ACC supports £276.6m being included in the Q6 capital plan.

South Terminal Baggage & Pier 1 **£83.6m**

5.17 The ACC supports the inclusion of the cost of this project in the Q6 capital plan

Pier 5 **£0.7m**

5.18 The ACC supports the inclusion of the cost of this project in the Q6 capital plan

NT Security Reconfiguration **£17.9m**

5.19 The ACC has worked with GAL to investigate if the NT Security Reconfiguration and NT IDL projects would be delivered in a more efficient manner using a programme approach, as well as challenging the level of commercial revenue contained in the original NT IDL project plan. GAL has reviewed this request and presented the project with a new combined business case that improves the return by re-phasing capital costs and reducing the operating costs, this will also reduce passenger inconvenience.

5.20 Based on the information provided, all ACC airlines support the inclusion of the NT Security Reconfiguration in the Q6 capital plan.

Upgrade Check-In & Bag drop **£12m**

5.21 GAL has proposed a reconfiguration of the check-in area within both terminals including automated bag drop machines and updated self-service kiosks based upon common user processes. There are a variety of airline business models operating at Gatwick with each potentially having different requirements for their check-in services. In order to assess these requirements GAL has worked with a number of airlines leading to self bag-drop trials with five airlines with different business models. These trials have shown that bag drop machines offer passenger and airline benefits and the ACC is supportive of their inclusion in the Q6 capital plan.

5.22 Currently airlines support the inclusion of self-bag drop machines in the Q6 capital plan on the basis that these would be installed in replacement of current check-in desks in dedicated airline zones. GAL has put forward the concept of using machines in a common user environment where passengers of multiple airlines would use the same machines. Airlines are working with GAL to understand if this will enhance the passenger experience and or improve operational performance; at this time this requires further work. It is likely that common user processes will only work for a proportion of passengers and airlines.

5.23 The airlines also do not support the complete reconfiguration of the check in areas as this does not offer passengers value for money. To date airlines have only received provisional costs for the bag drop units and have used these costs in its calculations. The original proposal put forward by GAL only included 138 self-bag drop units however this has increased to 240 units as the project has progressed. GAL has explained that 240 units are based upon expected usage by 70% of all passengers by the end of Q6. The ACC believes that this figure is too ambitious because:

1. Not all airlines will use the new machines as they require IT connectivity that may be uneconomical for smaller or away based carriers.
2. The trend is that volumes of baggage carried are reducing (with passengers going straight to security and not requiring bag-drop) and there is no evidence to suggest that this will not continue.
3. Different airline models will have different requirements from their check-in product therefore it is expected that standard check-in desks will still be required.

5.24 The ACC believes that a figure of 50% of all eligible customers is a more achievable volume of passengers who are likely to use this technology within Q6 and that the installation of 240 self-bag drop units would be an over-supply. Therefore the ACC supports the replacement of half of the check in desks (330) with self-bag drop units and proposes that 165 machines go into the capital plan.

<u>Cost calculation</u>

165 bag drop units @ mid-range cost £77k [6]including installation = £12m

5.25 The ACC does not support the refurbishment of the proposed changes to mezzanine levels as they believe this is unnecessary and not in the passenger's interest. However, one airline is supportive of improvements to the North Terminal floors and ceiling therefore this element is in the no common view section.

ST IDL Reconfiguration £6.8m

5.26 The ACC has worked alongside GAL to retime the phasing of this project and remove some elements of the scope. This has led to an improvement in the business case and the commercial return of the project, whilst reducing disruption to our passengers. Therefore the ACC supports this project being added into the Q6 capital plan.

Stand Reconfigurations £8.9m

[6] Figures supplied by GAL including an assumed £30k per unit for installation

5.27 The ACC supports the development of the stand infrastructure specified within this project as it believes that these represent a cost effective solution to pier service levels. The reconfiguration of stands 41-43 will enable carriers to improve towing performance and will lead to an increase in pier service levels for our passengers.

Product Development Car Parking **£4.5m**

5.28 The ACC is supportive of the developments proposed by GAL relating to this project as it improves commercial revenues and reduces operating costs. The passenger will benefit through an increased range of parking opportunities and a reduction in airport charges.

Digital Media **£4.5m**

5.29 The ACC and GAL have worked together to improve the commercial returns associated with this project and it now delivers a positive return both in Q6 and over the asset life of the project. The project delivers customer benefits and is in line with the ACC principles for commercial projects and is therefore supported by the ACC.

CIP Departures / CIP Arrivals **£1.8/£1.9m**

5.30 The ACC continues to doubt that there is a commercial demand for these projects and is unaware that GAL has signed any contracts to support these developments. However GAL has assured the ACC that it will be able to make a commercial return on these projects and therefore the ACC supports these proceeding, provided the commercial revenues are included in the single till.

Additional NT Coaching Bays **£2.2m**

5.31 Since the January submission GAL has provided further data and worked with the ACC to improve the business case of the project. This has included removal of the scope to re-provide car parking spaces that were no longer required and agreeing to recover revenues from the coach operators to ensure that the project did not increase costs to passengers in Q6. However on the basis that the business case does not increase prices in Q6 and that the revenues are put into the settlement then the ACC supports this project being included.

ST Public Access & DDA **£7.6m**

5.32 The ACC has worked with GAL and taken independent advice on the requirements for disabled passengers accessing the Public transport facilities in the south terminal. The independent advice is clear to the ACC that this project is required to ensure all passengers are able to access the facilities in a non-discriminatory way and therefore the ACC supports this project going into the Q6 capital plan. The costs of this project appear to be high and no independent verification of the costs has taken place. Therefore, the ACC recommends that the CAA challenge these costs to ensure that they are appropriate.

Consolidated Car Rental **£4.7m**

5.33 The ACC continues to be supportive of this project moving forward in Q6

Projects with no common ACC View

Table 5.2: Projects with no common ACC view

2011/12 Pricing	
Pier 6 South	£152.0
NT IDL	£85.0
Upgrade check in & bag drop	??
Early Bag Store	£11.3

Source: ACC analysis of GAL plan

Pier 6 South **£152m**

5.34 There have been extensive consultations between the ACC and GAL to ensure that all parties understand and agree on the pier service levels that will be delivered by existing infrastructure and potential pier service projects over the Q6 period.

5.35 This process revealed several areas of initial disagreement between the airlines and GAL on how pier service should be calculated and the parameters that should be used. To come to a consensus position is was necessary to work through a large number of options and understand the impacts of each parameter.

5.36 As the process evolved GAL agreed that their previous method of calculating pier service only using departing passengers was no longer suitable and that modelling pier service on the basis of both arriving and departing passengers was a more suitable method. This led to an increase in predicted pier service forecasts.

5.37 The ACC do not agree that a high case forecast should be used to calculate pier service. However, to ensure that progress could be made and to keep the work broadly consistent with the updated ACC traffic forecast the ACC agreed to use the high case schedule provided by GAL for Summer 2018.

Table 5.3 Analysis of PSL

	Option 1	Option 2	Option 3
	Baseline Pier Service Level	Plus stand reconfigurations	Plus increased towing
easyJet operation Split	92.4%	93.0%	95.9%
easyJet consolidated in	92.0%	93.5%	96.7%
easyJet consolidated in South Terminal	92.9%	92.9%	94.4%

- Based upon high case S18, peak day, peak week
- Uplift for 12 month rolling average would be additional
- Operational improvements would be additional

5.38 Airlines asked GAL to model a range of scenarios to ensure they were as well informed as possible before taking a view on pier service projects. While GAL was 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 above 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 the ACC that South Terminal passengers continue to achieve 95% or greater pier service throughout the period.

5.39 The tables show that under several scenarios 95% pier service could be retained in the North Terminal throughout Q6, without Pier 6 being extended. While the stand reconfigurations in scenario 2 are not yet finalised, we would expect them to occur whether or not Pier 6 is extended. The increased towing in scenario 3 matches the level of towing that is in place for Gatwick this summer.

5.40 Gatwick Airport has a very peaky operation and therefore infrastructure build costs need to be weighed against the benefits that these would provide as they are often only benefitting a small number of individuals unlike airports such as Heathrow where the consistency of traffic allows a much better utilisation of infrastructure and therefore makes justifying investment easier. It is pleasing to see that the CAA has identified this within its proposals citing that only 9% of passengers would benefit from an investment cost of circa £180m, it is therefore difficult to see how this can be in the passenger's interest.

5.41 The figures in the table are based upon the high case, peak week schedule and do not reflect that PSL is calculated using a rolling twelve month average. Historic values have shown that a further 1% can be added to the peak week total by use of the twelve month rolling average. This would lead to baseline PSL in 2018 close to the 95% threshold currently used as the baseline for Q5.

5.42 It was also agreed, post internal analysis presented by GAL, that potential operational process improvements across all areas of the airport (such as CDM) could have an impact on PSL of up to 1% by 2018.

5.43 Taking all these points into consideration suggests that 95% pier service is achievable without the need for costly infrastructure that would certainly not be required in the early years of Q6 and would most likely not be needed at all. The ACC position is that Pier 6 is an unnecessary and expensive infrastructure project that would benefit only a small number of airports users. Therefore the ACC does not recommend this project going ahead in Q6. Should the CAA accept GAL's assertion that PSL will dip below 95% in Q6 then the airlines would propose a small adjustment to the PSL target in the North terminal at the end of the period rather than burden the majority of customers with an unnecessary expense?

5.44 Regarding A380 operations and stand availability, Emirates recognise that there is now a functional A380 stand capability at Gatwick on Pier 6. Nonetheless, Emirates would wish to see more A380 stands so that should an Emirates A380 arrive in Gatwick when this single stand is occupied there is capacity to pier serve an additional A380. Presently, Emirates reported that there is no specific plan to bring an A380 to Gatwick currently. Currently, a B777 service with an F&J fit of 50 seats adequately serves Emirates premium market here. An A380 configuration offers 90 F&J seats.

5.45 Additionally, Emirates is attracted to the design of GAL's Pier 6 south extension where there is a facility to board premium passengers from a lounge directly onto the aircraft.

NT IDL **£85m**

5.46 Further to the information provided under the NT Security project ACC airlines have not been able to find a common view on this project.

5.47 The majority of airlines support the NT IDL project, recognising that it brings commercial benefits to the airport, providing a positive NPV over the project lifetime and not increasing airport charges in Q6. The improved retail offering will also provide greater choice for passengers.

5.48 However, British Airways is unable to support the inclusion of the NT IDL project as it believes that GAL have failed to maximise the commercial revenue available from the current estate and the same level of passenger benefits could be achieved without the need for an extension to the current facility.

Upgrade Check-In & Bag drop (Ceilings & Floors)

5.49 The ACC has not found a common view on the ceiling and floor elements of the project as one carrier is supportive of the refurbishment of these areas within their check-in area of the North terminal, further details on individual airline views will be provided their submissions.

Early Bag Store £11.3m

5.50 GAL has proposed building two early bag stores facilities within the North Terminal to allow for an anticipated increase in the volume of bags in Q6. The ACC airlines have analysed the data provided by GAL and do not currently believe that this would be an efficient use of capital spend as the data is not conclusive. The data is predicated on the high case passenger volume in 2018 with an increase in long-haul carriers at the airport, there is also no allowance for reductions in baggage per passenger. The ACC believes that the current trend of baggage reducing on flights will continue as airlines seek to recover revenues to off-set the rising costs of fuel by charging for baggage. This will incentivise passengers to reduce baggage carriage leading to a total volume reduction; evidence of this is already being seen. The CAA, GAL and the ACC are already in agreement that Gatwick will remain a predominantly short-haul point to point airport and therefore the likelihood of long haul traffic significantly increasing within Q6 is low. The data provided by GAL included a contingency of 20% extra chutes for bags that are not processed in a standard way, the ACC believe this is too high and a lower number of baggage make up positions will be used for these bags. The ACC analysis shows that only if all of the GAL assumptions are materialised and the peaks of each handler are combined that there would be an issue, and then only at the end of the period. In the event that this happened there are operational solutions that can be employed and would not risk any detriments to the passengers.

Projects Not Supported

Table 5.4: Projects not support by the ACC

2011/12 Pricing		Reason For Not Supporting
Border Zones	£7.1	
Runway 2	£0.0	Should not be a capital project
NT Baggage Reclaim	£2.0	Not required
NT Arrivals Transformation	£5.7	Does not offer suitable passenger benefits
ST IDL Capacity	£27.4	Insufficient commercial returns to support an extension
Minor Projects	£9.4	Requirements already covered in Asset Stewardship
Liquid Explosive Detection	£1.6	Requirements already covered in Asset Stewardship
Hangar Facilities	£5.0	Insufficient commercial returns

Source: ACC analysis of GAL plan

Border Zones **£7.1m**

5.51 The ACC welcomes the CAA support that airlines should not pay for the introduction of automated gates within the immigration areas particularly in the absence of an SLA guaranteeing service levels. However the ACC rejection of this project is also based upon the following reasons.

- UKBF have advised previously that they will replace the current machines in 2015
- Gatwick already reaches the UKBF national targets
- The immigration hall already has suitable capacity
- The project offers little other than ambience enhancement
- The creation of a number of new manned desks is at odds with the assertion that UKBF will reduce staff

Runway 2 **£0m**

5.52 The ACC welcomes the approach taken by the CAA and agrees that safe guarding costs should not be treated as capital.

NT Baggage Reclaim **£2m**

5.53 Baggage reclaim capability has been extensively improved within Q5 with additional belts added including a 70m+ A380 capable belt. The ACC analysis has shown that no further enhancements are required and is therefore not supportive of this project. It notes that Davis Langdon has found that the project costs have also been double counted within the NT IDL project and therefore recommends that this is removed from both projects.

NT Arrivals Transformation **£5.7m**

5.54 The ACC has continued to work with GAL regarding this project and notes that Davis Langdon has been unable to justify the passenger benefits against the costs proposed by the airport. However the ACC believes that this is purely an "ambience" project and does not offer our passengers any real benefits. The ACC does not support ambience projects being included within the Q6 capital plan where there are no wider benefits for passengers.

ST IDL Capacity **£27.4m**

5.55 The ACC is pleased that GAL has been able to improve the business case from the submission put forward in January, however the business case still increases prices within the period and therefore does not meet the ACC criteria to be supported. The ACC consultants Javelin confirmed in their submissions that their benchmarking confirmed that Gatwick already offers greater levels of space per passenger than many comparator airports. The evidence that there is already sufficient capacity, GAL's inability to make a commercial project return within the period and the CAA evidence that only 2% of passengers found facilities in the South terminal to be poor compels the ACC not to support this project being taken forward in Q6.

Minor Projects **£9.4m**

5.56 GAL has described this project as a bucket of money for minor projects that may occur throughout the period. The ACC does not believe that there is a requirement for a separate project to cover these eventualities as they are already covered within the Asset Stewardship line and the change control process currently in Annex G. Gatwick's minor project processes provides ample flexibility to address this. Inclusion of these monies would simply increase the RAB value by £9.4m and not promote any efficiency from the airport operator, it should also be noted that there is no business case provided for this project.

Liquid Explosive Detection Systems **£1.55m**

5.57 This project is highly speculative and predicated on an assumption that the DfT will make changes to the screening process in Q6. Currently GAL has not supplied any information to support this assumption and the ACC is not aware of any proposed changes. Should this project go ahead in the period then it would be covered under the Asset Stewardship budget and therefore it should not be put into the capital plan as a line item. Should a suitable core and development mechanism be found then this would fulfil that criteria.

Hangar Facilities **£5m**

5.58 This project was initially brought into constructive engagement and then removed from the portfolio by GAL. It was then brought back onto the agenda at the very end of the capital consultation. The ACC sees merit in the provision of extra hangar facilities at the airport however GAL are unable to identify any airlines or maintenance operators who would like extra facilities at the airport and the business case increases prices for passengers within the period. It is the ACC's view; that due to the speculative requirement for this project if it were included in the capital plan it may never be built and the change control process would be used to put this money towards an alternative project, effectively allowing the airport to increase spend elsewhere.

5.59 The ACC would expect that projects of this nature would be justified on the commercial returns they make and would reduce prices for passengers within the period.

Other Projects

5.60 The ACC believe the following projects have merit but are not yet advanced enough in terms of their scope for the ACC to recommend that they are included in the capital plan and therefore the price cap.

Table 5.5: Other projects

2011/12 Pricing		Reason For Not Supporting
Business System Trans	£14.9	Business Cases are not sufficiently developed
Hold Baggage Screening	£151.0	Business Cases are not sufficiently developed
Stands 551 - 553	£8.8	Business Cases are not sufficiently developed

Source: ACC analysis of GAL plan

Business Systems Transformation £14.9m

5.61 The ACC accepts that Gatwick should invest in IT projects throughout Q6 to deliver services passengers and airlines value. It also recognises and that due to the fast changing nature of IT, it may not be possible to identify all future projects at this time. However it would be prudent to expect that there would be some operating costs benefits associated with this number of IT projects and none are currently shown within the business case.

5.62 Therefore the ACC does not support these projects going into the capital plan in their current form and suggests that these are included within the core and development approach being designed and where suitable scrutiny can be given to the individual projects when they are developed to a greater level of detail.

Hold Baggage Screening £151m

5.63 GAL advised the ACC in May that it mistakenly failed to develop a project to achieve Standard 3 Hold Baggage Screening capability within the capital plan and that due to DfT regulations this would be required at all UK airports by 2018, two years ahead of the requirements put forward by European legislation. A significant proportion of the project costs are to redesign the existing baggage areas to accommodate larger machines as the new technology is currently larger than the Standard 2 technology. Given that the implementation date may move back beyond Q6 and that it is realistic to expect technology improvements to lead to smaller machines, the inclusion of costs to enlarge and strengthen baggage facilities is likely to be unnecessary.

5.64 During the limited consultation on this project GAL advised the ACC that due to there being insufficient time to develop this project ahead of the Q6 submission that it would recommend to the CAA that this project be held outside of the price cap until a suitable level of information was available to the airport and the ACC airlines. The ACC supports GAL's recommendation that this project does not go into the price cap and further discussion is held on how this project will be treated after the June submissions.

Stands 551 & 552 **£8.8m**

5.65 The ACC airlines are supportive of a project to reconfigure stands 551-553 to ensure that they are usable by a wider range of aircraft and can serve the maximum amount of passengers. However there are a number of outstanding questions that require answering before the ACC could support the inclusion in the capital plan. As this project was not previously reviewed by the CAA and given the outstanding questions it would be prudent to do so for the reasons stated below.

5.66 Due to the position on the airfield the project will reduce the stands from three to two. The project includes an extension to the gate room area to ensure that there is suitable space for passengers. The ACC is unable to understand why this is required given the capacity reduction. The project scope includes two new air-bridges that also seem unnecessary as it would be more cost effective to re-use the current air-bridges and ensure that passengers are not charged for capital infrastructure unnecessarily.

6 Operating costs

6.1 Operating costs have a significant impact on Gatwick's price cap, and therefore the fares paid by passengers. Consequently, it is critical that these 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. The CAA has a statutory obligation to ensure that regulated airports operate efficiently and effectively.

6.2 Although the data provided in the CAA's initial Q6 proposal was helpful and a step in the right direction compared to that shared by GAL during CE, we are disappointed that it wasn't to the level that would allow the comprehensive analysis the ACC was aiming to provide. The lack of clarity around the final numbers and the efficiency levels captured in the proposal, by line item and year, has made it difficult to get a clear view of the proposal and for that we are frustrated. It is also important to note that the ACC did not commission its own piece of work regarding OPEX mainly due to the knowledge that the CAA was commissioning a large piece of work. As stated in our previous response to the GAL Q6 business plan the ACC was disappointed by the lack of information release by GAL for Constructive Engagement. The limited information available and the long delays in acquiring data meant that meaningful engagement was not possible. These two situations have lead to OPEX being a difficult building block to analyse and respond to over the Q6 consultation period.

6.3 The ACC is also disappointed that the work commissioned by the CAA on Central Service costs has not been included in the initial Q6 proposal. Central Service Costs make up a significant part of the overall OPEX forecast and based on the fact that the analysis has not been provided to the ACC, again does not allow the airlines to fully understand the position of the CAA.

6.4 Regarding the outcomes of the CAA's initial proposal The ACC is also concerned with many other areas of the OPEX forecast, in particular:

- The fact that the CAA has failed to take into account many of the arguments / pieces of data that the ACC provided in the response to GAL's Q6 Business Plan on:
  - Security costs including benchmarking and the inclusion of process efficiencies at AMD's (Archway metal detectors) to reduce headcount.
  - GAL's plan for [redacted] throughout Q6 which does not reflect trends seen in the aviation industry (or any other industry). This has been included in the CAA initial proposal
  - Efficiencies expected due to GAL's parent company acquiring additional airports

- The CAA's scale of potential efficiencies and the choice of point in range.

6.5 As stated previously the ACC is concerned that Gatwick is not planning to make any operating efficiency improvements in Q6, with no forecast improvement in operating unit costs. GAL is not forecasting any decline in operating costs per passenger, and instead expects these to marginally increase in real terms, despite forecast growth in traffic. This is an untenable position given both the improvements made in Q5 and the wider productivity gains in the sector, and is not how we would expect a business operating in a competitive environment to behave. [redacted]

6.6 Given the level of investment over Q5, much of which was timed to occur in the final years of Q5, we would have expected to see significant efficiency improvements, particularly given the underlying improvement in the condition of the airport's infrastructure. This has obviously not been included in GAL's updated business plan and the ACC is disappointed to note that appropriate levels of efficiency have not been included in the CAA initial proposal. After being part of the CE process it was made evident to all that within the limited information presented to the ACC and CAA by GAL there was no suggestion of areas where GAL is planning to achieve significant efficiency gains. GAL accepted in CE meetings that it is not planning to make efficiency gains. The ACC is disappointed with the level of ambition and believes that GAL could achieve significant savings if it focussed on becoming more efficient.

<u>ACC's Q6 Operational Expense Proposal:</u>

6.7 As a reminder of the basis of the ACC's Q6 OPEX proposal below is a summary of the main justifications for the original input from Jan 2013.

6.8 The ACC is expecting efficiencies in OPEX over the Q6 period and has built this into the ACC forecast. When looking at OPEX overall the ACC have kept costs almost flat over the Q6 period with small decrease towards the end of the period. The main justifications for this being:

- Trends in the wider aviation industry, regulation should ensure that the airports face the commercial reality of the industries they operate in or face misalignment with the passenger interest;
- The lack of efficiency planning in the GAL forecast leaving plenty of room for improvement in the business plan
  - This is evident in the fact that the unit OPEX costs are increasing over the period.
  - Due to substantial acquisitions by GAL's parent company i.e. LGW and EDI, to add to its existing portfolio that includes LCY. It would be expected that

group buying of shared type opex should create significant efficiencies across the group's airports, as the airlines do when increasing fleet numbers or property. An airlines insurance premium does not increase on a pro rata basis when it adds one more aircraft to its fleet.

- Large amounts of Capital Expenditure proposed by the ACC point towards efficiencies occurring in all OPEX lines
- There are a number of areas where there is evidence that GAL is not operating in the most efficient way.

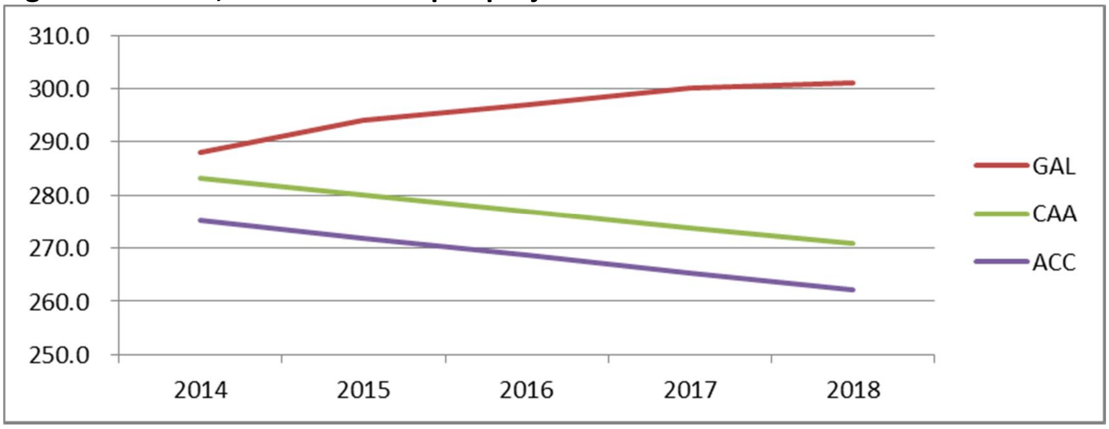
6.9 In the table below are the proposed Q6 forecasts for GAL, the CAA and the ACC. (in 2011/12 prices as reported by the CAA in the initial Q6 proposal)

Table 6.1 ACC, GAL and CAA opex projections for Q6

2011/12 Prices	2014	2015	2016	2017	2018	Total Q6
GAL	288.0	294.0	297.0	300.0	301.0	1,480.0
CAA	283.1	280.0	276.9	273.8	270.8	1,384.6
ACC	275.3	271.9	268.6	265.4	262.2	1,343.3

Source: GAL RBP, CAA initial proposals and ACC January submission

Figure 6.1 – ACC, GAL and CAA opex projections.



Source: GAL RBP, CAA initial proposals and ACC January submission

Central Service Costs / [redacted] salary costs:

6.10 As stated above, the ACC is disappointed that the work commissioned by the CAA on Central Service costs has not been included in the initial Q6 proposal. Central Service Costs make up a significant part of the overall OPEX forecast and based on the fact that the analysis has not been provided to the ACC, again does not allow the group to fully understand the position of the CAA. Considering the point raised above that GAL plans [redacted] in staff pay throughout Q6 [redacted].

ACC evidence / data not recognised in the CAA initial paper:

6.11 The ACC feels it is necessary to include the below analysis and benchmarking data that made up part of our initial submission on Q6 as it was not taken into account in the initial submission from the CAA. The information covers vital areas of the OPEX forecast that can have a large impact on the final outcome.

Security Costs

6.12 Security costs make up a large portion of the forecast and therefore are very important in the overall analysis of the OPEX line.

Å **SECURITY UNIT COST BENCHMARK:**
The following table compares, on a like for like basis of man year equivalents, the significant increase above the industry norm that GAL incurs/charges for security officer unit costs at LGW. The unit costs below are also like for like ie. they include all costs to employ. This illustrates over the Q6 period that if GAL had controlled its unit costs for security officers to be equal to market rates (or outsourced the service), the security cost of the Q6 period would be £[REDACTED]m lower than allowed for in the business plan. As a proportion of all Staff Costs, this one change would represent a reduction of 7%.

REDACTED

- **SECURITY MAN YEAR BENCHMARK:**

REDACTED

Summary

6.13 In summary, while we recognise the efforts made by the CAA to look at GAL's cost base in greater detail we remain disappointed with the conclusions that the CAA has reached.

6.14 In particular, the CAA does not appear to have recognised many of the arguments made by the ACC in its initial submission on these issues. Furthermore, the top down benchmarking evidence gathered by the CAA from the likes of ATRS and

Leigh Fisher would tend to re-enforce our view that costs at Gatwick are above benchmark levels which would indicate that there is clearly scope for significant savings in Q6. The CAA's analysis of opex per passenger on a time series basis further underlines this point.

6.15 The ACC considers that of most relevance to this assessment is the CAA's analysis of airport costs compared to airline costs. While we recognise that these comparisons may be imperfect, airlines cannot accept a situation in which they are forced to reduce their own costs by 18% in real terms while airports are able to enjoy unit cost increases of 34% over the same period. We strongly agree with the CAA's conclusion that this evidence would tend to suggest that GAL could achieve a greater level of efficiency.

6.16 We consider that the CAA has been far too conservative in its assessment of the results of various consultancy studies that were commissioned. For example with respect to the SDG study into maintenance and renewal costs we note that the CAA has assumed a stretch savings of £4m per annum over Q6. However, we also note that this was based on an assumption that GAL would only be required to catch-up to 50% of the benchmark level on SDG's preferred measure of maintenance costs per square meter. In our view, it is not unreasonable for the CAA to assume that GAL will be in line with benchmarks by the end of Q6.

6.17 Likewise, with respect to frontier shift we note that the CAA's consultants suggested that GAL should be required to improve its efficiency by 1% per annum. We do not understand why the CAA has assumed only 0.5% per annum on this issue. As we note above, GAL's plan does not identify specific efficiencies nor does it assume a reduction in unit costs.

6.18 Against that background, we have sought to use the CAA's framework for assessing opex to develop a revised ACC position which reflects the views set out above as well as our interpretation of the consultancy studies published by the CAA.

6.19 In developing an updated ACC projection, we would make the following observations:

- The CAA has a statutory obligation to ensure that regulated airports operate efficiently and effectively which means that the failure of the CAA to set GAL a target to meet this requirement would, in our view, constitute a failure to meet the statutory obligations.
- The ACC does not understand why the CAA has chosen a point estimate of around 25% of the possible total savings developed in the work produced by its consultants. At a minimum the ACC believes this should move to the 50% point to reflect the concern that GAL needs to work towards greater levels of efficiency (in fact we think the CAA's range is too narrow as we explain further below).

- One of the factors that the CAA appears to have considered when selecting a low point in the efficiency range is the fact that there will be traffic growth during the period. The ACC's view is that it is important to separate the concepts of traffic growth and efficiency savings and to show these separately in any analysis.
- We do not accept the CAA argument that because GAL has outperformed the Q5 settlement that further savings will be harder to find. We think the opposite is true and that GAL's track record of reducing costs in recent years is evidence that this trend should continue in to Q6.
- Moreover, the ACC considers that it is not appropriate to use GAL's projection of costs in 2013/14 as the start point for applying efficiency. Regulatory precedent (for both airports and other sectors) is generally to use the most recent full year for which actual data is available as the base year, which in this is case is 2012/13. Otherwise, the outperformance that GAL enjoyed during Q5 will not be shared with users. This would be inconsistent with the fundamental principle of RPI-X regulation.
- The ACC considers that the way the CAA has analysed the results of the consultancy studies is somewhat unusual in that one normally might expect consultants and benchmarking evidence to provide evidence on how inefficient the company is today or compared to the base year rather than how much it can reduce its own plan by the end of the period (because the plan is likely to be padded anyway).
- With that in mind, we consider the assumption that the identified savings should be achieved by 18/19 to be generous on the basis that regulators usually require companies to implement revealed efficiencies over a much shorter time period e.g. in its review of Dublin Airport the Commission for Aviation Regulation (CAR) in Ireland required efficiency targets to be met within 3 years.

6.20 Nonetheless, to enable comparability with the CAA the ACC has set out below its own interpretation of the studies as well as other areas where we consider savings are possible.

6.21 Given that we are still waiting on the results of the Helios study, the ACC considers this analysis to be illustrative and it would welcome the opportunity to provide further evidence and views after the results of that work have become available.

Table 6.2 ACC assessment of scope for efficiency in Q6

Opex in 2018/19

£m 2011/12 prices	CAA Low Stretch	CAA High Stretch	ACC view	ACC comment
RBP	301	301	301	As per GAL business plan
Security costs	n/a	n/a	REDACTED	REDACTED
Wage efficiency	-13	-19	-19	We consider the CAA's range to be conservative as it reflects only the total 'cash' reward rather than total 'overall' reward and does not include savings available from reduced absence rates.
Frontier shift	-7	-14	-10	As noted above, we do not consider there is justification for reducing the frontier shift target identified by the CAA's consultants. Nonetheless, given that we have used the CAA methodology which assumes some unidentified savings in GAL's plan, we have opted for a conservative mid-point (roughly equivalent to frontier shift of 0.75%)
Other opex	-3	-4	-4	We note the range is very narrow but consider the top end is achievable.
Pension efficiency	-4	-5	-4	We have used the low end of the CAA range to reflect the fact that we have selected the high target on wage efficiency. Again we consider this to be conservative.
M and A	-1	-4	-4	We have selected the top end of the CAA range but consider this to be very conservative as it reflects the consultant's views that GAL would only need to narrow the gap to 50% of the benchmarked costs.
Central services	NA	NA	0	We look forward to reviewing this study when it becomes available.
Total Efficiency	-25	-41	REDACTED	
Costs in 18/19	277	260	REDACTED	
Cost reduction factor (Approx)	0.80%	2.00%	**2.50%**	

Source: ACC assessment, numbers subject to rounding

6.22 Under the ACC's assessment of the consultancy studies as well as our own analysis of opex we consider that a higher efficiency factor should be used than the 1.1% assumed by the CAA in its initial proposals. As noted above, we consider that 12/13 should be used as a base year and that costs associated with traffic growth should be accounted for separately. In light of this, we have developed a revised ACC projection of opex as set out in the table below.

Table 6.3 ACC assessment of challenging but achievable opex projection in Q6

11/12 prices	**12/13**	**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		275	268	262	255	249	243	1,276
Costs of traffic growth[7]		1	6	7	9	11	13	47
ACC forecast		**276**	**274**	**269**	**264**	**260**	**256**	1,323
CAA projection			283	280	277	274	271	1,385
Variance			(9)	(11)	(13)	(14)	(15)	(62)

Source: ACC analysis

6.23 We consider this to be a challenging but achievable projection of opex in Q6, noting in particular that we have taken fairly conservative views on a number of issues. More importantly we consider this to be a holding position and would welcome the opportunity to develop this analysis further pending the publication of the Helios study looking at central costs.

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

7 Commercial revenues

7.1 The CAA's initial price proposals are based on the projections made by its consultants, SDG adjusted to reflect changes in traffic forecasts.

Retail, advertising and car parking

7.2 SDG's conclusions took account of the earlier assessment made by Javelin and ACTM for the Gatwick ACC on retail, advertising and car parking. The ACC considers that some of SDG's reasons for discounting Javelin and ACTM's estimates are questionable. The ACC notes that Javelin is a leading specialist in airport retail and that their assessments, which were intended to be fair and balanced, are based on a close understanding of the market.

7.3 The ACC found it difficult to review the CAA's retail and car parking revenue projections because they were based on a report by SDG, where some key details were redacted from the published version. It was therefore difficult to see which areas had been changed most by SDG. We proposed to the CAA and GAL that the full unredacted report should be passed to Javelin who would be retained by the ACC to review the report. Javelin was already subject to a non-disclosure agreement with GAL from the time of their earlier report. Our request was quite unreasonably refused by GAL despite there being no remaining confidentiality issue and the CAA was unwilling to proceed without GAL's consent, offering a meeting with SDG instead.

7.4 The ACC decided nevertheless to appoint Javelin, who had to use the redacted version of the SDG report. GAL did, however, provide Javelin with the relevant section of the Revised Business Plan and the recently revised business case for the North Terminal extension. Javelin and ACTM have addressed SDG's comments on their previous report, including some apparent misunderstandings, and also considered more recent data that has become available since their earlier report.

7.5 A full copy of their report is attached to this response[8]. All the numbers have been rebased to 2011/12, consistent with the SDG report and the CAA recommendations, to make comparisons easier.

7.6 Javelin were able to confirm that there was a strong basis for confirming their previous projections for retail revenues per passenger. They did concede that car park income per passenger could be lower than previously forecast, but would not fall as low as SDG had forecast. The results of their assessments are shown below.

[8] The report contains confidential GAL information (for example on the NT IDL project) which would need to be redacted if the CAA intends to publish on its website.

Table 7.1 Commercial revenue yields

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

Source: Javelin report

7.7 However, the ACC considers that there is plenty of upside potential if these forecasts were to be adopted. Car park yield is likely to rise given the strong potential for passenger growth. We also agree with SDG that there is potential for the airport to generate new revenues from drop off charges, (though we do not advocate this and have not built it into the forecasts). Javelin's retail forecasts are also conservative.

7.8 Finally, we would like to point out that significant investments have recently been made in improving the retail offer. During the time of the works, space has been removed. The CAA should expect a noticeable increase this year and at the start of Q6. It would be unduly conservative to base the assessment on recent tends and we would ask that this is considered carefully when examining changes from the baseline.

Property

7.9 Some Gatwick airlines provided input to SDG before they provided their report to the CAA. The ACC broadly supports the CAA's property projections and offers no further comment here.

Non-regulated revenues

7.10 The ACC, like the CAA, continues to use GAL's forecast non-regulated revenues. There was a meeting between GAL and the airlines in June to discuss the basis of these forecasts. The ACC consider that there may be opportunities to reduce the costs, and therefore the revenues, in some areas, but we note that this is likely to have no net impact on Q6 price projects (as both costs and revenues would reduce by the same amount). We discuss in in the next chapter that the protections provided in the Q5 decision 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).

7.11 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 and other revenues.

Table 7.2 ACC and CAA projection of non-aero revenues.

£ '000	**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

8 Other charges and revenues

8.1 As noted in the previous chapter, we have used GAL's projection of non-regulated charges in the ACC price cap modelling. We also have a number of observations on the projections of these charges and the arrangements for how they should be regulated in Q6.

8.2 The specified charges which encompass: check-in, baggage, utilities, staff car parks, staff IDs and PRM total together over £60m by the end of Q6. The numbers provided by GAL show an increase in real terms over Q6. The three main activities: check-in and baggage, PRM and utilities which account for 80% all show material real increases during Q6. Check in and baggage has increased, by 76% from £13.6m to £23.9m, since the beginning of Q5 through to the end of Q6. This is an example of poor management of costs. In the ACC's view, the CAA must enforce upon GAL effective management of the cost base and not allow GAL to pass on poor cost management onto the passengers.

8.3 In that regard, the ACC would expect any future projections of these charges and revenues to be transparent and cost-based with full consultation between GAL and its airline customers.

8.4 Additionally, the ACC would expect the CAA to continue with the measures that were used Q5 to protect users within the single till from any exploitative increases in such charges during the course of Q6. Thus, the ACC would welcome the following measures:

- The CAA to set out in its final proposals each of the charges that have been assumed in developing Q6 forecasts for specified activities and other services which are remunerated through non- regulated charges. These data, along with the supporting material on underlying costs and volumes provided by GAL to airlines should provide a transparent benchmark against which airlines would be able to measure any subsequent changes in actual charges during Q6, and against which GAL would need to explain any such variances arising from changes in input costs and/or assumed volumes.
- The CAA to confirm that airlines will continue to benefit from the transparency conditions imposed following the 1990 public interest finding by the then Monopolies and Mergers Commission (we consider this issue further in Chapter 16).
- The CAA to confirm the policy set out in Q5 that it would not expect to see any material upward shift in these charges during Q6 resulting from any change by GAL in accounting or cost-recovery policy, beyond those already embedded in the revenue forecasts for Q6. Any such charge increase to be carefully scrutinised by the CAA and could be considered by the CAA in setting price caps for the relevant airport for the next price control period.

- The CAA to confirm that it would take action to remedy a situation such as an increase in non-regulated charges in Q6 that had not been adequately justified with reference to stated principles of cost recovery and consultation with airlines.

8.5 Under the new legislative framework, the ACC considers that it should be possible to capture these measures under the new GAL licence.

9 Regulatory Asset Base

9.1 The ACC was unable to support a small proportion of the Q5 investment and we consider the CAA should remove or reduce this from the opening RAB. A reduction would reflect the fact that some of the investment was inefficient and therefore the airport should not earn its full return. If the CAA includes all investment, the airport will treat future consultation as a mere formality. We would therefore ask the CAA to consider carefully the following projects:

- The NT baggage system costs increased without good reason and without proper consultation; this was evidenced in the URS report issued on behalf of the CAA. GAL made a number of scope changes to the project without consulting through the normal channels and then required the ACC to sign of a number of change controls totalling approximately £7m two years after the changes were made, as highlighted within the URS report.

- The ST immigration project proceeded without airline support for the same reasons airlines have not supported the proposed Q6 NT project. The cost of machines, at least, should be removed. We note that the CAA have removed the costs of e-gate pass machines from the NT immigration project put forward by GAL for Q6. This is a clear indication that GAL were incorrect to proceed without airline support and should have these costs disqualified from the RAB.

- The cost of new snow ploughs and other snow clearing equipment was not signed off because the airport was unable to provide reassurance to airlines about the expected performance improvements, despite promising to the House of Commons Select Committee that this would be done.

- The A380 stand on Pier 6 south was created without any evidence that this would be used. While we did accept that there may, in time, be demand for A380 services at Gatwick, this was highly speculative and no commitments or financial payments were made by the airlines in order to have this as an option.

- The ACC recommended that the ST Crew Reporting Project be assessed by URS as part of the Q5 review process. At that time the project was in its relative infancy. The project will be completed within 2013 and therefore within the Q5 period. The ACC airlines do not believe that this project has been consulted in line with Annex G and that as the project costs have almost doubled to £22m it is unlikely that best practice project management has been followed. Therefore for these reasons the ACC request that the CAA review this project further before allowing any costs to be entered into the RAB.

9.2 Pending the CAA's assessment of these projects we have not made any adjustments to the opening RAB to reflect these concerns in our price cap modelling.

10 Cost of capital

Introduction

10.1 The ACC has considered the evidence set out by the CAA, in particular the analysis by pwc, as well as evidence provided by CEPA for British Airways.

10.2 The ACC agrees with the CAA that there are strong arguments that Gatwick's cost of capital has reduced over the last five years. This recognises the fall in returns seen in global markets; the significant falls in interest rates; and the reduction in corporate tax rates.

10.3 The ACC notes that GAL's debt is currently trading at prices that deliver a two per cent real return on GAL's bonds. A cost of capital which is too high would lead GAL to make significant windfall gains.

The ACC's proposed cost of capital

10.4 The ACC proposes a cost of capital for Gatwick of 4.9%.

10.5 This proposal has been developed from the CAA's analysis, and only differs from the CAA's initial proposal in the treatment of three significant policy choices (i) the gearing ratio (ii) the use of point estimates and (iii) the treatment of the cost of debt.

10.6 The ACC has not considered the case for any changes from pwc's underlying assessment of market data.

The gearing ratio

10.7 The ACC does not support the decision to lower the gearing ratio to 55%. The ACC agrees with the CAA that airlines and passengers should not be exposed to the risk of service failures at Gatwick as a result of a too highly leveraged financing structure. However, there is no evidence that a 60% gearing ratio is excessive. Infrastructure assets traditionally have high levels of gearing and a move to a 55% gearing ratio is excessively conservative. GAL has itself made the case to its investors for gearing to rise to 65% and the financing agreements set a limit of 70%[9].

10.8 The ACC believes that the CAA should retain a 60% gearing ratio.

The development of point estimates from within a range

10.9 The final cost of capital for Gatwick is built up from a series of estimates of the individual elements of the cost of capital calculation. The CAA has used pwc's estimates of the potential numerical ranges of each of these elements to determine a point estimate for each element, which are then used to determine the final cost of capital.

10.10 The CAA has used point estimates from the top quartile of pwc's recommended ranges, on the basis that it mitigates the risk that Gatwick will underinvest or reduce service quality. However, the ACC believes that the CAA's approach will not mitigate these risks, and instead will simply create windfall profits for GAL. Further, the CAA has not considered the adverse and long term consequences on passengers from over-incentivisation, which is one of the recognised weaknesses of RAB based regulation.

10.11 The link between GAL earning higher returns on its asset base and a reduction in the risk that it will under invest or lower service quality is unclear. While GAL's ability to finance investment may depend on its overall (future) profitability and (future) cash flow, its willingness to invest in a specific project will depend on the returns from that individual project. This return is determined more by actual borrowing costs and the particular returns of a project, than on GAL's overall returns on its asset base.

10.12 The ACC notes that the CAA has not set out an example of how this risk could occur and how its proposal mitigates this risk. Increasing GAL's overall returns as a way to mitigate the risk that individual projects become undesirable to GAL after they are put into the price cap, is a very imprecise approach. The main effect of which must be that GAL earns a windfall on much of its asset base, and that at best passengers receive the benefit of an investment that would otherwise not have incurred. The more likely outcome would seem to be that GAL earns a windfall profit and that there is no impact on incentives except a perverse incentive to over-invest in order to increase the value of the RAB.

10.13 A similar analysis applies to any incentive on GAL to spend money on service quality. Where this expenditure is an operating cost there is no link between GAL's return on capital and operating cost choices. So choosing a higher percentile of the elements of the cost of capital can not have any effect on GAL's choices.

10.14 The cost to passengers of the CAA using the 75th percentile from within the pwc ranges is about £12m a year, which ends up as excess profit for GAL. This is an almost 10% increase in the profit on the 'true' cost of capital indicated by pwc's estimates.

10.15 The ACC believes that the CAA should use the mid-point of the ranges, a fair approach to balancing the interests of the airport owner and passengers. There is no suggestion that the pwc ranges are asymmetrical, therefore either end of the pwc ranges are as likely as the other. The mid-point is therefore the 'best' estimate of the individual elements and contains sufficient headroom to allow for uncertainty.

10.16 The ACC notes that the midpoint of the equity beta range is 1.03, very close to CEPA's assessment of the equity beta as 1. To be conservative, the ACC has used

1.03 for modelling purposes. We consider that CEPAs assessment provides strong corroborating evidence for selecting the midpoint of the equity beta range.

10.17 We also note that Gatwick Airport made a case to its own investment community in 2011 that it is relatively resilient to shocks and downturns because of its diverse airline base and routes, providing good protection against airline changes; the high propensity to spend among passengers using Gatwick; and GAL's strong position in a major capacity constrained air transport market. (This argument also rested on a stable regulatory regime and effective management.)

The approach to the cost of debt

10.18 The ACC has looked carefully at this issue, considering evidence from CEPA alongside pwc. On balance the ACC supports the use of a floating cost of debt, indexed on market data. This better reflects the true cost of debt in the market and ensures that passengers are not required to over-reward GAL over time due to the need for the CAA to take a conservative approach to the cost of debt if it is required to fix it for a five year period.

10.19 Using a floating cost of debt helps address the risk of windfall gains for GAL. The ACC notes that currently GAL debt is trading below the range of cost of debt set out by pwc.

10.20 The ACC recommends that the CAA use a cost of debt of 2.5% as the initial estimate, as set out by CEPA in its assessment of the current cost of debt under the indexation methodology. The ACC notes that this is within the range set out by pwc.

Conclusions

10.21 The ACC believes that the CAA should use a cost of capital of 4.9%. It notes that this is based on the evidence set out by pwc and used by the CAA. The variation from the CAA's initial proposal is due to the positions taken by the ACC on policy decisions, not arguments around 'true' market rates.

10.22 The ACC notes that the recommended 4.9% is supported by CEPA's work, which recommends a cost of capital of 4.8%.

11 A fair price

11.1 As noted in chapter 5, ACC airlines have different views on the appropriate capital plan for Q6 which would, in turn, lead to different price paths. For modelling purposes, this chapter examines the price path that would arise from including only the capital projects that all airlines support in the price cap. Thus, the ACC sets out in this chapter a path to a price cap of RPI-9%.

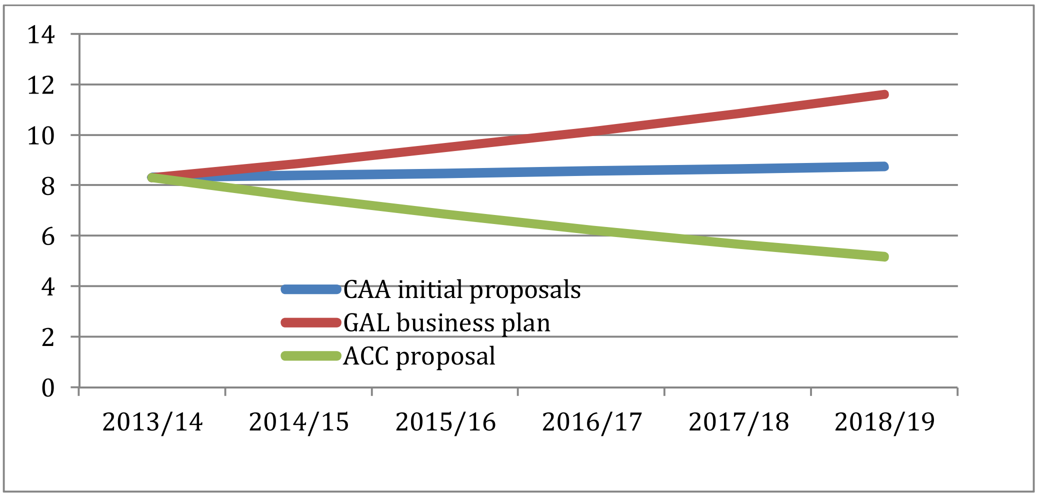
11.2 Table 11.1 below brings together the ACC's view of the RAB-based 'building block' components, which have been discussed in the previous chapters, and sets out the ACC's assessment on what would be a fair price in terms of the maximum level of airport charges for GAL for the five year Q6 period.

Table 11.1 – ACC assessment of a RAB based price cap for Q6

£m 11/12 prices	14/15	15/16	16/17	17/18	18/19	Q6
Opex	£274	£269	£264	£260	£256	1,323
Depreciation	£142	£143	£137	£123	£127	£671
Cost of capital	£116	£114	£111	£108	£106	£555
Gross revenue requirement	£532	£526	£512	£491	£489	£2,549
Other revenues	£260	£261	£265	£278	£288	1,352
Net revenue requirement	£272	£265	£247	£213	£201	£1,197
Passengers (m)	36.8	37.3	38.1	38.8	39.6	190.6
Unprofiled yield per pax	£7.39	£7.10	£6.48	£5.49	£5.08	

Source: ACC calculations

Figure 11.1 – Comparison of CAA, GAL and ACC price caps



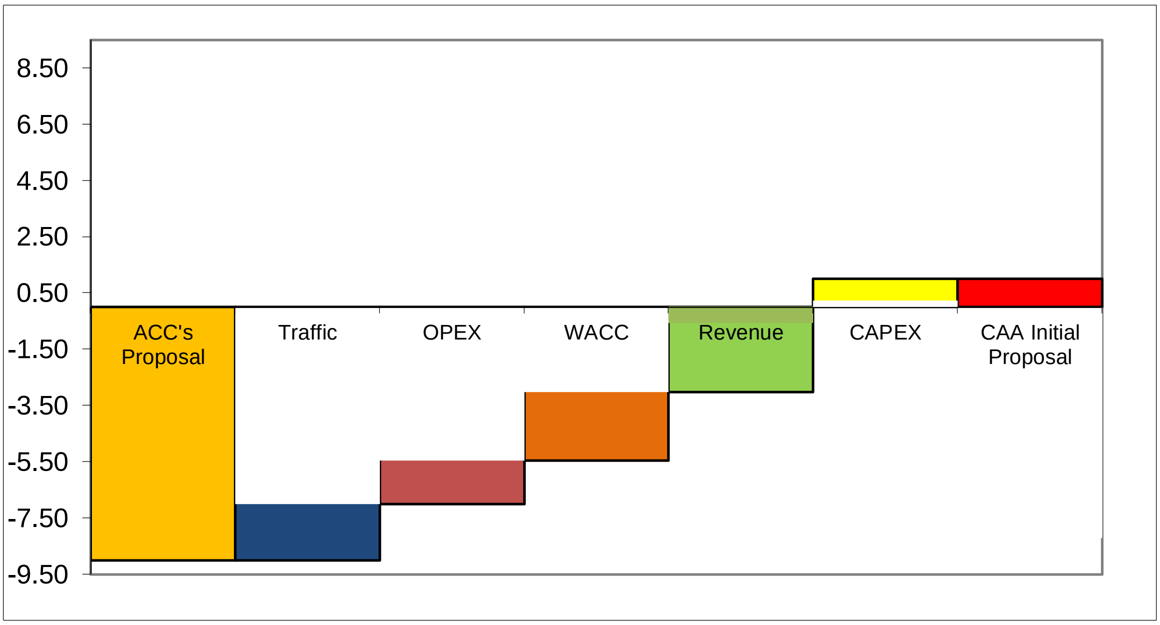
Source: ACC calculations and CAA initial proposals document

11.3 The chart above shows how the ACC's projection of a fair price compares to GAL and the CAA's view of a RAB based price cap by comparing the simple average of the yield over the Q6 period. This shows that the main differences in the resulting price profiles arise from different assumptions from the CAA on:

- Traffic - the ACC forecast is around 5% higher than the CAA to reflect more up to date information notably easyJet's acquisition of Flybe slots.
- Opex - the ACC projection is 4% lower than the CAA reflecting our view that greater efficiency savings are available.
- Other revenues - the ACC projection is 8% higher reflecting the higher traffic forecasts and the views of our expert consultants on commercial revenues/passenger in Q6
- Our view that the weighted average cost of capital should be 4.9% compared to the CAA's assessment of 5.65%.
- Our projection of depreciation is 7% lower than the CAA's reflecting the smaller capital plan.

11.4 The waterfall diagram below shows the relative impact of each change.

Figure 11.2 waterfall comparing CAA proposals to ACC position



Source: ACC calculations

11.5 We do not currently see the case for any profiling of the cap beyond price smoothing and would not support a Po adjustment.

11.6 In relation to financeability, we do not have access to GAL's detailed model to enable an assessment of ratios and other financial indicators. In light of the evidence from figure 11.6 of the CAA's price cap proposals that GAL would enjoy significant headroom over the benchmark calculations and the CAA's assessment that 'its conclusions are not sensitive to changes in the underlying assumptions noted above' we consider that our projection would also be consistent with a solid investment grade credit rating.

11.7 The ACC notes that the price cap proposed is an outcome of evidenced assessment of the building blocks that would be used in a RAB model. While the ACC has in some cases derived the building block estimates from proposing that GAL deliver efficiency gains (in particular on operating costs), the vast majority of the building block estimates are either an outcome of the ACC's views on how Gatwick should develop to best meet the demands of airline passengers (in particular for capital projects) or are derived from independent consultants (for example commercial revenue forecasts). In other circumstances the ACC has used the approach the CAA took in Q5, but has updated this given current publically available data (e.g. in deriving the proposed WACC). Much of the difference is derived from our higher traffic forecasts, reflecting the fact that Gatwick is poised for growth, boosted by Easyjet's purchase of Flybe slots. Gatwick Airport has also recognised the potential for growth by making a strong case to the Davies Commission for a second runway.

12 The form of regulation

Introduction

12.1 Whilst this response focuses on the initial price proposals put forward by the CAA, the market power assessment published by the CAA is important context and the ACC will respond to this in due course.

12.2 The ACC continues to believe that GAL holds significant market power. Despite this, we have been open to considering the concepts being explored around alternative forms of regulation and in particular contracts and commitments at the airport. However, as initially defined by GAL we did not see these as a remedy to GAL's substantial market power. Given this, a formal RAB based regulatory approach seems to be the most appropriate way to safeguard the interests of airlines and our passengers.

12.3 As such the ACC, and a number of its individual member airlines, provided detailed responses to the initial commitments proposal put forward by GAL. We welcome the extent to which some of these comments have been addressed by the CAA in its initial proposals. In particular that any commitments would need to be based on a lower price (although the ACC believes it should be lower than proposed by the CAA) and that a regulatory back-stop, in the form of a licence, is needed.

12.4 Since the publication of the CAA's initial proposals, GAL has published an updated version of its commitments. This section provides some initial comments on these however, the proposal has come too late in the consultation process for a detailed response so the ACC will follow up with further comments once it has had time to take advice.

12.5 This section sets out our views on the forms of regulation discussed by the CAA in its initial proposals document.

Alternative forms of regulation

12.6 The CAA focuses on two main types of regulation (RAB and price commitments), however, comment is provided on further alternative forms of regulation. The ACC broadly agrees with the conclusions that CAA has come to on RAB based alternatives;

- **Long run average incremental cost**: The ACC shares the CAA's concerns that the implementation of a LRIC based control at Gatwick could undermine its primary duty to protect consumers. The ACC agrees that the practical difficulties in its calculation, the specifics of airport capacity in the south east of the UK that may render it inappropriate, the significant sensitivity of the calculation to regulatory judgement, and the data intensive nature of the calculation make this option unsuitable for regulating GAL's airport charges in Q6 given the risk it could undermine, rather than support, protection for users and the promotion of competition.

- **Price monitoring:** The ACC agrees with the CAA's assessment that it would not be appropriate to set precise price caps based on comparator benchmarks. However, the ACC also agree that benchmarks can provide a useful indication of the possible ranges for a competitive price.

Price Commitments

12.7 The CAA's initial proposals express a preference for a 'commitments' based regulatory model for GAL in Q6, with some suggested modifications from the proposal put forward by GAL in its business plan in February. If these modifications cannot be agreed the back stop regulation will be a traditional RAB based mechanism.

12.8 The ACC welcomes the assessment from the CAA that there were a number of serious issues with GAL's proposal. In particular the CAA highlights that the enforceability and the terms of the commitments are such that they do not offer sufficient protection to be in the passenger interest.

12.9 The ACC agrees that the commitments proposal previously put forward was not workable. The ACC provided evidence on this in its previous submission which centred around 6 main issues:

- The legal status of the commitments is inadequate – exposing airlines and passengers to significant risk;
- The proposed price in the Commitments is too high and does not represent value for money for passengers;
- There is too much uncertainty around future charges; for example, from potential runway 2 costs and service bonuses;
- The commitments do not encompass all the charges paid at the airport – exposing passengers to significant risk from residual charges;
- The service proposals do not address the concerns set out by the ACC with GAL's original proposals; and,
- The proposed Commitments do not remedy Gatwick's significant market power

12.10 The ACC notes that there has been a relatively limited discussion with GAL since the publication of its business plan on commitments and conversations had somewhat stalled ahead of the publication of the CAA's initial proposals.

12.11 The CAA suggests a number of changes that would need to be made to the commitments proposals to make them a workable solution to protecting passengers from GAL's market power in Q6.

12.12 The first set of changes are new licence conditions that would need to be introduced to ensure the regulatory back-stop provides enough protection. The CAA's initial views are that a licence should include:

- A condition enabling the CAA to enforce the commitments. This would provide a direct response to concerns about enforceability and would allow enforcement in the interests of end users, rather than simply airlines.
- A condition preventing GAL from altering the commitments without good reason and from withdrawing the commitments. This would address the concerns that the conditions of use could allow the airport to unilaterally vary or withdraw the commitments.
- 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 power would operate within quite narrowly defined circumstances.
- A condition allowing the CAA to introduce a freeze on charges if it is undertaking an investigation. This would prevent detriment during the time it takes to remedy the failure of the regime, for example while new licence conditions are introduced, or the MPT is being reassessed.

12.13 The ACC agrees with the CAA's assessment that any commitments framework would need to be backed up by a regulatory licence and broadly agrees with the licence conditions the CAA would seek to introduce (although the statements above are too broad so the ACC would need to work with the CAA to understand the detail). However, there is some confusion as to whether the commitments would sit inside, or just be backed up by, a licence. If they were only backed up by a licence that simply contained the four points above, some airlines have identified significant problems with this approach, for example the removal of an ability to appeal the terms to the Competition Commission, and consider that the whole approach of having the Commitments simply backed by a licence is questionable as a matter of law. The ACC would need to be re-assured on this point and as any such licence is developed the ACC would seek to work closely with the CAA on the detail of this.

12.14 Other than the regulatory licence, the CAA's initial proposals also raise a number of other issues with GAL's proposals. These are around:

- **Price**: The CAA would want the commitments to offer a price that is fair and the ACC supports this. GAL's proposed price is excessive and very far from efficient. We have seen no indication that the airport will be willing to offer an efficient price or to pass on to consumers any of the reduced costs they would expect from a reduced regulation.
- **Efficiency**: The amendment of the full pass through of the costs of changes to security requirements to something similar to the Q5 arrangements, the removal of the pass through of taxation changes, and the removal of the pass through of development costs of a second runway.

- **Service quality**: The level of rebates in the service quality scheme should prevent service quality from being reduced, but 7% is insufficient to do this, especially in a Commitments environment where all RAB incentives are removed. Airlines are not willing to pay bonuses for outperformance (except under freely negotiated bilateral contracts where there are mutual benefits). The commitments should also include protection against repeated failures to meet service quality targets. Airline service quality targets would also distort competition between airlines.
- **Capex**: A commitment to deliver any outputs resulting from the capex plan that are over and above the outputs that would be reflected in the service quality regime.
- **Consultation**: The commitments should include consultation requirements beyond those required by the ACD and address the significant information asymmetry between GAL and the airlines;
- **Transparency**: The commitments should provide sufficient information to airlines to allow them to understand whether charges are reasonable.
- **Operational resilience**: The commitments should provide clarity on what GAL will do and how it will interact with other operators at Gatwick to ensure the availability and continuity of airport operation services to further the interests of passengers, particularly during disruption.
- **Financial resilience:** The commitments should provide clarity on what GAL will do to ensure the financial resilience and continuity of service.

12.15 A greater level of detail on the content of any revised commitments, from what has been provided in the CAA's initial proposals, would be needed for the ACC to make a full assessment.

12.16 There is considerable detail that would need to be understood with the mechanism which has not yet been clarified. Until some of these details can be filled in, it is difficult to provide meaningful comment on whether this proposal is workable, assuming of course that basic issues with the licence framework and price can be resolved.

12.17 The ACC has therefore sought to engage with GAL during the CAA's consultation period to understand their reaction to the CAA's initial proposals and whether they would be provided an updated proposal on commitments.

12.18 GAL shared an updated version of its commitments on the 7th June. As this came relatively late in the consultation period, the ACC has not been able to provide full comments on this updated proposal. However, the ACC makes some initial points about the updated proposal from GAL:

- GAL maintains that a regulatory, licence back-stop is not needed and as such this is not included in their updated commitments. The ACC continues to believe that only a licence backstop can provide sufficient protection for passengers;

- GAL has not included an updated price in its proposals – this makes it impossible to assess the commercial viability of any licence proposal;
- There remains uncertainty around future charges; for example, from potential runway 2 costs and service bonuses; and,
- There remains service standards on airlines which the ACC does not believe are appropriate.

12.19 We, therefore, currently do not view the creation of such commitments as an effective remedy for the substantial market power that Gatwick continues to hold. However, the ACC will follow up with detailed comments on the revised proposal put forward by GAL ahead of its session with the CAA board on the 17th July. Although there remains a question of whether enough further changes can be made to overcome these problems in a way that would provide benefits over a RAB based approach.

13 Service quality

13.1 easyJet has made its own case to the CAA for a different SLA regime that is focused on fewer, event-based measures, incorporating much higher penalties. They would like to make it clear that they have not changed their position. Nevertheless, if the CAA were to adopt a more evolutionary approach, as set out in the initial proposals, easyJet would like to see improvements and has therefore worked with the ACC to try and establish a common position on key points. Therefore any reference in this document to the ACC is without prejudice to easyJet's position.

The passenger interest

13.2 The ACC supports the CAA's view that passenger priorities for Q6 are:

- to maintain consistent delivery of current performance levels in critical areas, rather than driving up performance; and
- improvements should be made only where the passenger benefits demonstrably outweigh the costs.

13.3 This interpretation is consistent with the previously stated ACC objectives of:

- providing a greater focus on key measures;
- removing bonuses;
- increasing the total potential rebate; and
- introducing event-based rebates including a replacement for the ACT.

13.4 We therefore support strongly the three proposed new event-based measures which are designed to ensure greater consistency of performance:

- outbound baggage;
- 30 minute maximum queue at central search; and
- a simple airfield availability measure to replace the aerodrome congestion term

13.5 As discussed below, the ACC is broadly supportive of much of the CAA's proposed SQR regime, which is likely to further the passenger interest. However, bonus payments appear to be inconsistent with the passenger interest, and the CAA's own view of passenger priorities, as discussed below.

The proportion of airport charges at risk

13.6 The CAA proposes not to increase the amount at risk under the SQR from 7% on the basis that the current system has incentivised service improvements and therefore 7% is adequate. This reasoning ignores other important factors. The new owners of Gatwick identified poor service performance as one area where they could demonstrate superior performance compared with BAA. If the airport is sold, as seems likely, the new owners might just as easily decide not to prioritise service and performance could slip, especially if the failure costs are less than compliance costs.

13.7 The CAA appears also to have overlooked the CC's rationale for rebates in their public interest findings, which was that in a normal market, prices to customers would vary according to performance. This implies that rebates are not intended merely to incentivise the airport, but also to provide a measure of redress to customers. An increase would therefore have two benefits. It would strengthen the incentives for the airport to avoid failures, by directing management attention, opex and capex where necessary and would provide a more proportionate remedy if things do go wrong. Therefore, if the CAA wishes to align regulation more with what would happen in a competitive market, there is a strong case to double the maximum rebates to 14% of airport charges and to focus the scheme to align better with passenger interests. It seems clear that 14% would not only provide stronger incentives to maintain current standards, but would also move the airport more towards a more normal commercial arrangement, thus reducing the distortions of regulation.

13.8 Putting 14% of airport charges at risk would not increase the airport's risk compared with Q5. This is because the likelihood of failure was much higher when the Q5 regime was set. Risk exposure = Probability of failure X the cost of failure

13.9 In the first year of Q5, 2.3% of airport charges was paid in rebates. This means that there was a 33% failure rate against the measures (despite the fact that passengers were 2m below forecast which would have eased pressures in areas such as central search). In fact, the failures and rebates had been rising steadily over Q4, so there was a strong expectation of failure when the Q5 decision was taken.

13.10 In Q6, the failure rate is likely to be close to zero, given GAL's track record of meeting the standards consistently, thanks to improved management and investment across the airport. If we assume, nevertheless, a 10% failure rate and 14% of airport charges are at risk, the rebate would be only 1.4% of airport charges - considerably less than the Q5 risk, despite the increase in the total exposure.

Relative weighting of rebates

13.11 The ACC supports the CAA's approach of adjusting weightings in a way that simplifies the scheme and places more weight on important measures. The ACC agrees with the concept but proposes to put greater weight on security queue measures and other operational measures where failure would cause the greatest disruption to the passenger, including flight departure or arrival delay.

13.12 As the airfield measure is new, we do not propose to give it the weight it deserves, recognising that a new measure can take time to bed in. In any case, this will still represent a meaningful strengthening of incentives, given the limited value of the previous airfield measure Gatwick.

13.13 The ACC approach reduces the relative emphasis on passenger satisfaction measures, on the basis that they cover very few areas of importance to passengers, important though they are. The ACC considers that the passenger is likely to be more satisfied overall if their entire airport experience, including their flight, is efficient and free from disruption.

13.14 In a few cases (stand availability, FEGP and PSE (general)), the ACC proposes to reduce the rebate to a token amount (0.1%). These token elements remain in the scheme but will not be the main focus of attention in Q6, given the current level of provision at the airport. Keeping them in the scheme recognises their importance; includes them in the measurement reports and allows them to be given increased weight in future if necessary. This follows the approach taken at STN for Q5.[10]

13.15 The ACC believe this approach to reweighting is consistent with the CAA's objectives and with research on passenger priorities. In summary, the table below compares the ACC and CAA proposals on the relative importance of each category.

Table 13.1 Relative importance of SQ categories

Category	CAA relative importance		ACC relative importance	
	NT	ST	NT	ST
Passenger satisfaction	20	21	11	12
Security	30	32	36	39
Passenger operation	19	15	21	16
Airline operation	17	18	22	24
Airfield	14	15	10	10
	100	100	100	100

Source: ACC analysis

[10] The ACC also considered reducing transfer search to zero in ST, but did not wish to prejudice the interests of airlines not represented on the ACC Working Group. We therefore invite the CAA to decide how best to weight this measure in ST.

13.16 In the table below, we provide the suggested rebates for each element which also takes account of the proposed maximum rebate of 14% of airport charges.

Table 13.2 ACC proposed SQ weightings

	Element	Standard	NT (CAA)	ST (CAA)	NT (ACC)	ST (ACC)
1	Dep Lounge seating avail	4.0	0.36%	0.36%	0.4%	0.4%
2	Cleanliness	4.1	0.36%	0.36%	0.4%	0.4%
3	Wayfinding	4.1	0.36%	0.36%	0.4%	0.4%
4	Flight info	4.2	0.36%	0.36%	0.4%	0.4%
	Subtotal pax satisfaction		1.44%	1.44%	1.6%	1.6%
6	Central search average * Central search max	95% < 5’ 98% < 15’ < 30’	0.85% 0.45%	0.85% 0.45%	2% 1.4%	2% 1.4%
7	Transfer search *	95% < 10’	0.2%	0.2%	0.4%	0.4%
8	Staff search +	95% < 5	0.33%	0.33%	0.7%	0.7%
9	Control posts *	95% < 15’	0.33%	0.33%	0.7%	0.7%
	Subtotal security		2.16%	2.16%	5.2%	5.2%
10	PSE general	99%	0.35%	0.35%	0.1%	0.1%
11	PSE priority	99%	0.35%	0.35%	1%	1%
12	ITTS 1 car ITTS 2 cars	99% 97%	0.3%	0%	1%	0%
13	Arrivals reclaim	99%	0.35%	0.35%	1%	1%
	Subtotal pax operation		1.35%	1.05%	3.1%	2.1%
14	Outbound baggage	?	0.2%	0.2%	1.4%	1.4%

15	Stands	99%	0.25%	0.25%	0.1%	0.1%
16	Jetties	99%	0.3%	0.3%	0.6%	0.6%
17	Pier service	95%	0.3%	0.3%	1%	1%
18	FEGP	99%	0.15%	0.15%	0.1%	0.1%
	Subtotal airline operation		1.2%	1.2%	3.2%	3.2%
19	Airfield availability	?	1%	1%	1.4%	1.4%
	Totals		7.15%	6.85%	14.5%	13.5%

Source: ACC

* subject to new definition for automatic measurement (the CAA is coordinating).

+ following investment in Q5, this should be a flat 5% In all areas

Calculation of rebates

13.17 The ACC supports the continuation of the monthly rebate being one sixth of the annual limit, as proposed by the CAA.

13.18 It will also be important to set rebate amounts for the three new event based measures, given that only an annual maximum is proposed. [We propose that a single event failure should pay a sliding scale according to the severity of the failure:

1. Failure (paying $1/x^{th}$ of the annual maximum);
2. Serious failure (paying $1/Y^{th}$ of the annual maximum); and
3. Severe failure (paying $1/z^{th}$ of the annual maximum)

13.19 For example if serious failures were set at 1/10th this would allow 10 serious failures per year before the incentive is lost. The definitions of serious and severe would need to be established when the standard is established.

Bonuses

13.20 As mentioned above, we do not believe there is a good case for bonuses and this also appears to be contrary to the CAA's interpretation of passenger interests. The purpose would be to incentivise improvements in areas where there is no evidence that the very small benefits would outweigh costs of up to £4m/year, or around £20m over a 5 year period (assuming the CAA element weightings). The CAA's own research has found that the overwhelming majority of passengers already rate their overall experience in the airport terminal as good or excellent and that these areas of passenger experience are unlikely to have an effect on a passenger's choice of airport11. This aspect of the proposal also creates the risk that GAL will prioritise investment in these areas at the expense of more worthwhile projects, in the hope of achieving additional revenues. This is contrary to the CAA's intention expressed in 13.71 for not increasing the standards themselves. It is also unclear how bonuses would incentivise terminal equivalence.

13.21 We are also strongly opposed to the use of a potential bonus pot of 1.2% of airport charges that could be used to incentivise enhancement in GAL's performance during the Q. This exposes airlines and passengers to a price risk and regulatory intervention given that the airport is bound to make the case for receiving additional revenues. This is likely to lead to regulatory gaming and inefficiency, with the airport seeking bonus payments for improvements that should be provided as part of particular projects. Airlines are also opposed to providing bonuses for operational resilience. Passengers, airlines and the CAA should be entitled to expect the airport to have in place an effective integrated business resilience programme and this should be a licence requirement. The ACC proposed weightings discussed above, would also address the CAA's concern to improve operational resilience, by placing a strong incentive to maintain agreed service levels especially in areas that cause disruption.

13.22 The airlines consider that the benefits of outperformance against measures is very much smaller than the costs of underperformance, especially where this results in disruption, distress or discomfort. In competitive markets, where parties contract freely, it would be a matter for both parties to agree on the appropriate service levels and any bonuses payable. It is difficult to see whey the regulator should remove that choice from airlines, who operate in a competitive market.

13.23 The ACC does consider that the airport should be entitled to contract freely with individual airlines to provide higher service levels in return for additional payments, if both parties are willing. It would then be a simple matter of removing the data for the airline in question before reporting performance for the other airlines against the published SQR. This would allow bonus type payments where there was a value to the airline making the payment.

Publication of results

13.24 The ACC supports the CAA's proposals

Content of the SQR

[11] Figures 3.1 and 3.2 of the CAA Q6 initial proposals April 2013

13.25 The ACC supports the CAA proposals, including wifi availability as part of the definition of the Flight Information measure. We intend to work with GAL on definitions of the new elements:

1) outbound baggage availability
2) maximum security queue time
3) Airfield availability measure
4) Redefined flight information measure

13.26 A more detailed proposal will follow this submission to give time for further discussion with GAL. We would also welcome further involvement by the CAA in these discussions and advice on the process. The CAA's previous involvement was very helpful.

Higher QSM standards

13.27 The ACC supports the CAA proposal of increasing standards to reflect current performance and the standards suggested are appropriate.

Measurement issues

13.28 The ACC supports the consistent use of two decimal places for the reasons given and we intend to do further work on measurement issues in discussion with GAL.

Automated queue measurement and the implications for establishing equivalent standards

13.29 The ACC intends to continue to contribute to this CAA led work. We hope that a decision can be taken by the time of the next CAA Q6 price proposals and we understand this is the intention. We recognise that the first year of Q6 may need to proceed with the old metrics, but a definite transition date and formula should be agreed in the decision.

Financial incentives on airlines and handlers

13.30 Airlines remain opposed to these measures, which are intended by GAL to homogenise performance rather than set a baseline to avoid operational problems. GAL's proposal would undermine competition between airlines, differentiation and passenger choice. We remain willing to discuss with GAL any problems that might exist in particular areas, to understand the need for improvement

13.31 The ACC is also aware of a new CAA consultation on the use of its new information powers. We will therefore consider the case for a wider information regime for consumers.

Publication of UKBF performance and airport ASQ rankings

13.32 The ACC supports the CAA's proposals as a means of providing transparency for passengers for services provided on a monopoly basis.

13.33 We note the CAA is considering using its own powers to publish performance information on a wider range of stakeholders. The CAA should ensure this initiative first identifies a market failure and then ensures that its approach targets the specific issue in a proportionate and meaningful way. We look forward to discussing this further in due course.

Changes to the SQR regime

13.34 The ACC supports the CAA suggestion that changes to the SQR should be permitted within the Q6 period, subject to proper consultation and agreement by the CAA. This was the situation in the past and we see no reason to change it.

14 Operational resilience

14.1 In principle the ACC is supportive of new measures to develop a more collaborative and better planned approach to dealing with disruption and looking after the interests of passengers and cargo owners at such times.

14.2 We agree with the CAA that collaboration is essential to coordinate the response to disruption, for both resolving the causes and looking after passengers. We also agree that GAL is best placed to perform this role through resilience plans and good day to day collaborative working.

14.3 Nonetheless, operational resilience was not discussed in any detail through CE and we would welcome the opportunity to engage further with the CAA, GAL and other stakeholders on this important issue. In particular, the proposals document and the draft licence envisage roles for third parties and the potential for GAL to develop 'rules of conduct' that would be required of airlines and other parties. Airlines do not support imposition of such rules and would be very concerned to ensure that any arrangements of this type were tenable and that they did not cut across existing regulations. We do, however, recognise the airport's important coordinating role.

14.4 Airlines are subject to binding obligations regarding passenger welfare and compensation in the event of cancellation under EU denied boarding regulations. Airlines would be strongly opposed to any further measures which increase liabilities or impose any new obligations.

14.5 For those reasons, it will be important to consider the detail of these new arrangements to ensure that they do not impose a disproportionate burden on airlines and problems for passengers.

15 Capital efficiency

15.1 The ACC remains committed to its earlier position that the regulation and remuneration of capex should be improved in Q6 and that some model of splitting capex into core and development projects is likely to best enable this.

15.2 We agree with the CAA that artificially forcing all capital projects to be agreed at the time of the price review for the next five or six years does not reflect the dynamic nature of the industry and the need for flexibility in the capital investment plan (CIP).

15.3 We also agree that GAL and airlines would benefit from greater flexibility around capex, while GAL should have strong incentives to deliver projects efficiently and on time.

15.4 Under the current rules, the RAB is rolled forward for actual rather than projected capex (subject to the tests of adequate consultation and best practice project management). This means that the airport has a high degree of certainty that investment will be funded in the future but it also means that there are few, in any, incentives to outperform and to spend capital more efficiently.

15.5 Therefore, there is a balance between incentivising the investment required by airlines and their passengers and the promotion of efficiency in terms of producing capacity and service quality at the most efficient cost. The discussions around core and development capex provide a good opportunity to review how this balance should change in Q6.

15.6 In considering these issues further we have first of all reviewed the evidence on GAL's historical approach to undertaking investment during Q5 before going on to consider the options for improving capital efficiency in Q6.

Review of Q5 capital efficiency

15.7 The ACC commissioned ATKINS to undertake an independent review of the efficiency of GAL's Q5 Capital Investment Programme. The ACC asked ATKINS to review a number of specific projects as well as the overall Q5 project envelope.

15.8 From this review we have been able to make a number of observations:

- The **capital investment plan (CIP)[12] process** - throughout Q5, the annual CIPs only gave an overview of overall progress of the plan and lacked any level of project cost detail making it impossible to identify how a project had performed against the original budget.

[12] The CIP is available on the GAL website.

- **Accuracy of GAL's Cost forecasts -** Only basic cost advisory sheets (CAS) were included in the CIP 2008 and none were included in any of the other subsequent CIPs. In the absence of any subsequent revisions or amendments to the original CAS sheets produced in 2008, ATKINS could not be confident as to whether the original project budgets were appropriate and were unable to verify all of the costs e.g the treatment of on-costs and the allocation of expenditure between opex and capex.

- **Track-ability of the plan over Q5 -** Evidence from the investment trackers in the CIPs shows that the original plan from 2008 which underpinned the Q5 settlement was fundamentally amended year on year. The total value of the 2008 plan had declined substantially by 2010, with numerous projects being completely redesigned, amalgamated with other projects, or cancelled. A substantial proportion of the overall Q5 costs, circa £350m, were recirculated by GAL to be reallocated on projects that the airlines had not committed to directly ahead of Q5.

- **Cash Flow Forecast -** ATKINS established that the Q5 CAPEX forecast was substantially overestimated, running consistently ahead of the actual expenditure until the final year of Q5. Arguably GAL benefitted from delivering projects late in Q5 and enjoyed the benefits of a resultant positive cash flow.

- **Change Control** - Prior to October 2011, ATKINS struggled to find any change control records. From October 2011 onwards CCRS's were included within the documentation provided at Capital Investment Board meetings. However, there was very little cost information provided in support of these and they typically only provide a single sentence description of the change.

- **Risk Management** - Throughout Q5, there has been a concern around the lack of visibility of cost information provided to the ACC in support of R2 drawdown. Within the CIP Performance Pack there is a Risk and Budget Contingency Analysis which includes a Budget Contingency Drawdown Graphic. The drawdown graphic appears to be based upon the assumption that the R2 Risk budget will be fully expended. The actual drawdown is erratic relative to the smoothed forecast expenditure, which is understandable. However, the peaks in the actual drawdown suggest that as project risks pass or are mitigated money is released back to the risk budget. If this is the case the ACC doesn't appear to be in possession of sufficient detailed information to make informed decisions on the efficiency of these projects, or whether they should go ahead, in order to make best use of these returned risk funds. It is unclear as to the level of input the airlines are permitted in the reallocation of risk monies.

15.9 In light of this evidence and the findings of URS, the ACC considers that:

- The level of detail provided by GAL on individual capital projects needs to improve.
- The process for tracking the plan over time and agreeing changes needs to improve.
- The current incentive for the airport to over-state the scale and timing of the plan ex ante needs to be reviewed.
- The treatment of risk and contingency budgets both before the cap has been set and after the period has started needs to be reviewed.

15.10 In the ACC's view, these experiences from Q5 would tend to re-enforce our position that new arrangements for the regulation of capex are required for Q6. We have set out below our emerging thinking on how this might function.

Capital Efficiency during Q6

15.11 Due to the volume of work that has been required in other areas of the Q6 process the ACC has not as yet been able to undertake any meaningful work with GAL on developing capital efficiency processes for Q6. However the ACC understands that this is an important area and the work needs to be undertaken as soon as possible. As we note in the section above we are concerned that the current arrangements lead to examples of GAL "gaming, "thrifting" and at times "gold plating" capital projects all achieving the same result, a sub optimal output for our passengers.

15.12 In our view is vital that care is taken and enough time provided for all parties to fully understand the implications of alternative approaches to the regulation of capex to ensure that the arrangements do not incentivise the wrong behaviours from either sides as this is likely to lead to poor outcomes for passengers. As detailed work has not been undertaken the ACC is unable at this time to provide any finalised position. Nonetheless, to assist the CAA in understanding the ACC position and help to take the process forward the ACC has supplied its "without prejudice" early thinking on the CAA proposals.

15.13 The ACC would see the development of these discussions as a priority for the summer months ahead of the CAA's final proposals later in the year.

Core and Development

15.14 As we note above, the ACC remains supportive of a core and development approach to capital projects for Q6. The ACC continues to believe that under the current system Tollgate 4 (TG4) is the correct milestone to achieve for a project to move from development to core. In that regard, the CAA suggestion of using TG3 in GAL's internal process is ambiguous and unclear. For the process to have transparency the ACC would require that projects only move after the ACC has signed off TG3 and not a GAL internal TG3 whereby airlines may not agree that the project is suitably developed, however the ACC understands that GAL may wish to progress projects that may not be supported by the airline community such as the A380 stand project in Q5. In these cases GAL would be able to progress projects using their current “at risk” process. Should they be able to demonstrate to the CAA that they had met the requirements of Annex G then these projects would be allowed into the RAB or disqualified as appropriate. However, depending upon the emerging arrangements for core and development, changes to Annex G may be required in order to gain assurance that the appropriate requirements had been met.

Core Capital

15.15 Further work would be required to understand the impacts of allowing projects into the capital plan based upon P50 and P80 estimates and therefore the ACC will make no further comment at this time.

15.16 The ACC agrees with the CAA that triggers for core capex need to be well defined, and that the three month lag should be removed as it is would no longer be relevant in the context of core and development. It also welcomes the proposal that incentives would be removed for GAL to game projects and make GAL inter-temporally indifferent through the creation of a mechanism to recover lost cash flow. However the ACC is unclear on how this would work alongside conventional trigger payments and that there should not automatically be symmetry should GAL accelerate projects. It would be more logical to only allow the airport to pull forward projects where airlines are in agreement as otherwise there will be an incentive to spend money as early as possible if airlines are to be charged for this.

15.17 The CAA proposal to look at projected versus actual spends at an aggregate portfolio level may have merit however we believe it could be open to gaming and the ACC would need to understand more about how this may work.

Development Capex

15.18 Allowing development capital to go into the budget at P80 levels as opposed to P50 may over inflate the development capital pot leading to a position where excess monies are then effectively available for use on other projects. One way to ensure that this does not happen would be to use the same mechanism for correcting late delivery of projects. In the event of a project moving to core at a value significantly less than the P80 budgeted level, the “over budget” could then be put into a separate pot. Should GAL wish to use this money for additional projects it would be able to do so provided it gets approval, alternatively if there are any monies within this pot at the end of the period they would be returned to the airlines using the cash-flow correction.

15.19 The ACC supports the CAA’s proposals that airlines should have the ability to propose projects for inclusion in development. We also believe that GAL should be required to seek the formal approval of the airline community to include new or remove existing projects. It also welcomes the CAA’s statement that when a project passes from development to core capex, that the cost allowance will be fixed at that stage and that GAL will bear all risk of under and over-spending.

Capital investment Expertise

15.20 The ACC supports the proposal to increase the level of capital investment expertise in Q6. However further work is required to ensure that the ACC airlines are assured that the expertise is neutral and not at the behest of the airport.

16 Other issues

16.1 In this chapter we set out our views on the CAA's proposed approach to transparency, safeguarded assets, the security cost pass through mechanism, opex incentive mechanisms, and inflation indices.

Transparency

16.2 Under the current regulatory arrangements, GAL is compelled to provide to the CAA and service providers information on the detailed costs and other factors it takes into account when setting charges for activities covered by the 1991 public interest finding.

16.3 We support the CAA's view that the current transparency condition has worked well, reassuring interested parties that these charges are based on appropriate criteria, and it has not imposed an unreasonable burden on GAL.

16.4 We also support the CAA's proposal to include the transparency condition in the licence. We would welcome further clarification from the CAA on how it proposes to manage this requirement over Q6 in light of the proposal that only those Specified Activities not covered by the AGR would be included in the licence.

16.5 We do not support the CAA'S proposal to remove the requirement to explain variations from the profit centre reports. We consider that this requirement provides an important safeguard and given that the systems are already in place to produce this information we do not agree that this creates an unnecessary additional burden.

Safeguarded Assets

16.6 We do not support the current approach to dealing with safeguarded assets as it effectively means that users bear the risk of stranded assets.

16.7 We would prefer an approach under which GAL should invest in safeguarded assets at its own risk. If the assets ever came into use then they could be transferred into the RAB.

16.8 We understand this is not a big issue at Gatwick as little or no assets qualify for this treatment, nonetheless we consider that each case could be handled on its own merits such that if airlines agreed with safeguarding a particular asset then the current approach could apply.

Security cost claim mechanism (the s-factor)

16.9 We agree with the CAA that the risks arising from security requirements changing in the future should not be dealt with by making conservative (i.e. high) estimates of future security costs in the base case for setting the price cap.

16.10 We consider that it remains appropriate to include a pass through mechanism within the control period for dealing with variances in security costs. Our main concern is that while the current mechanism was designed to by symmetrical such that the price cap would vary for both increases and reductions in security standards, in practice our understanding is that hitherto it has only functioned in an upward direction i.e. all claims made under the S-factor have led to increases in charges. This is likely to be a function of the fact that the airport has no incentive to inform the CAA when security requirements may be relaxed and costs decrease whereas it has a very strong incentive to make a claim under the S factor when the opposite happens. Other interested parties such as airlines are unlikely to be privy to the detail of changing requirements and not in any position to make a claim or to notify the CAA when circumstances change.

16.11 We consider that it would be desirable for the CAA to consider this anomaly further and to review the functioning of the mechanism in the future. One approach for Q6 may include the CAA undertaking a review of the position with the DfT on each occasion when the standards change.

16.12 As a minimum, we would expect the CAA to recognise that the S factor provides some protection for GAL in the event of the security environment changing and for that reason there is no need to build additional contingency into any security cost projections or to otherwise rely on conservative modelling of these costs.

Opex efficiency incentive mechanisms

16.13 We agree with the CAA's view that there are currently no grounds for introducing enhanced incentives on opex efficiency.

Traffic risk sharing

16.14 Similarly, in light of the lack of support for introducing traffic risk sharing arrangements we agree with the CAA that this should not be pursued for Q6.

Within period traffic mix forecast correction (K) factor

16.15 We support the CAA's proposal to retain the Q5 approach to correcting for in-period traffic variances

Inflation

16.16 The ACC notes the work being carried out by the UK Statistics Authority and the ONS on RPI, in particular the decision to be made this summer on, whether RPI merits continued designation as a National Statistic. If the RPI is no longer deemed fit for purpose because it overestimates inflation then there are obviously questions about value for passengers from its on-going use. The ACC therefore believes this needs to be considered before the final decision is taken.

Non-passenger flights

16.17 We support the CAA's proposed approach to dealing with non-passenger flights.

17 Licencing issues

17.1 We welcome sight of the draft airport licence proposed for GAL and the discussion of the conditions that should be included therein. We also welcome the CAA's proposals to discuss the draft licence in more detail with stakeholders over the summer.

17.2 Our main interest with respect to the new licence relates to the price control and service quality conditions. With that in mind, we are somewhat disappointed that the CAA has provided only around 3 weeks for affected parties to comment on these critical areas.

17.3 The ACC recommends that the CAA should provide further opportunity for airlines to make representations on these important issues prior to the CAA making its final decision later in the year.

17.4 With respect to the ring-fencing conditions – while these have an important role to play we are concerned that as currently formulated they may be so watered down that it is not entirely clear how much protection they will provide.

17.5 We currently do not foresee the need for any specific price control reopener conditions.

17.6 We support a mechanism to adjust the SQR subject to appropriate safeguards and governance.

17.7 The requirement or otherwise for a consultation protocol akin to the present annex G is likely to be informed by the development of new arrangements for capital efficiency and capital governance.

17.8 We support the inclusion of a complaints handling condition.

17.9 We support the inclusion of non-discrimination conditions.

17.10 Airlines strongly urge the CAA to remove GAL's unilaterally imposed condition (with in GAL's CoUs) relating to liability and replace this with a condition which would be present in any normal commercial relationship between a customer and supplier. The revised condition should set out GAL's obligation to indemnify airlines for any direct costs relating to GAL's negligent actions. This should be a condition of the license and enforced within the CoUs.

Annex – Study from Javelin on commercial revenues

Attached as a separate document.