YOUR LONDON AIRPORT
Gatwick

Economic regulation at Gatwick from April 2014: CAA's initial proposals

RESPONSE FROM GATWICK AIRPORT LTD

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YOUR LONDON AIRPORT Gatwick

Executive summary

The CAA's proposals do not match the fundamental change in market structure

Gatwick is disappointed with the CAA's initial proposals for the regulation of Gatwick Airport. The CAA does not recognise the potential benefits of one of the most dramatic competition investigations ever undertaken by the Competition Commission. The fact that BAA's South East airport monopoly was broken up to, *inter alia*, introduces competition is almost entirely absent from the CAA's analysis. Instead, the CAA is proposing a relatively conventional price control settlement for Gatwick with little recognition that:

- There has been a radical change in ownership;
- Competition now exists where it did not previously;
- Stansted's incentives have changed radically and recently – it now has a strong incentive to make use of its 50% spare capacity with the recent easyJet announcement of growth plans demonstrating the impact of change of ownership; and
- The CAA's duties have been altered to protect the interests of users of airports, where appropriate, by promoting competition.

Indeed, in response to the change in ownership and the increase in competition between the South East airports, the CAA is proposing an extension of regulatory oversight into the areas of capital expenditure, service quality, operational resilience and financial resilience. Paradoxically, the CAA's reaction to the introduction of greater competition has been to propose an extension of regulation.

This approach to the regulatory framework stems from the CAA's related findings on Tests A and B with respect to its conclusions on substantial market power. We intend to respond to the market power findings in due course. Nevertheless, we do not see how the Competition Commission would have come to the conclusion to break up the BAA South East airports monopoly on basis of the geographic and product markets now being used by the CAA.

What is missing, as the CAA moves from a finding of substantial market power to a proposal for a more interventionist regulatory framework, is any consideration by the CAA as to how the competitive market should be facilitated, given the finding of substantial market power. The CAA's proposals are striking in that only a few sentences are devoted to an analysis of competition as opposed to the chapters devoted to the need for, and analysis of, a standard regulatory framework. We commissioned a report from Professor Stephen Littlechild, one of the most eminent experts in the area of regulation, to analyse the CAA's approach as well as Gatwick's proposals.

Professor Littlechild comments:

> *"This "nothing has really changed" stance suggests a substantial and worrying disconnect: the significant change in circumstances calls for a significant change in regulatory policy but the detailed working of the regulatory machine has responded only in form rather than in substance."*
>
> *"As a result, the CAA has overestimated the benefits of regulation and its impact on price in the short term, but failed to realise the adverse effects that its proposals will have on the development of competition, and hence on the benefits to users over the longer term."*

Contracts and Commitments

Although we are disappointed that CAA is currently favouring a standard regulatory framework for Gatwick Airport, we note that the CAA remains optimistic that our Commitments proposals could be an element of the regulatory regime. The CAA sets out its concerns with respect to the Commitments offered in the January 2013 submission to the CAA. We respond to the CAA's concerns later in this document and believe that we have satisfactorily addressed them. We have tabled a comprehensive, composite offer which is well within the parameters of any reasonable evidenced view of a regulatory counterfactual.

The rationale for Contracts and Commitments remains as set out in our January 2013 business plan submission. Our aim is to develop and manage the business more dynamically to build our competitive offering and make Gatwick Airport more attractive for our passengers and airline customers. We have therefore developed a Contracts and Commitments framework as an alternative to formal RAB-based price regulation. We believe that this framework will deliver several benefits:

- Greater flexibility to anticipate and react to the changing demands of a rapidly evolving aviation sector as both airlines and airports seek to differentiate their offerings through service innovations and price whilst improving efficiency and reducing costs;

- Better ability to serve the increasingly varied requirements of different airlines through more tailored agreements that address more precisely their specific needs;

- More certainty over an extended timeframe of 7 rather than 5 years for the airlines with Gatwick accepting more risk whilst having greater incentives to grow traffic, develop non-aeronautical revenues and drive efficiency improvements;

- Much better alignment of interests on capital expenditure with stronger incentives to manage it more efficiently while providing more flexibility to adjust to changing requirements compared with the current system which predetermines capital expenditure over too long a period in too much detail; and

- Reduced regulatory costs, less bureaucracy with better alignment of incentives for Gatwick and its airline customers to work together on a partnership basis to deliver better service and improved choice for customers.

Our key changes to the Commitments offered in January 2013 are as follows:

- **Price:** We are proposing that the Commitments price is moved from RPI+4% to **RPI+2.5%**, and that this is accompanied by a further commitment to the actual price paid by our airlines. Under this proposed arrangement, Gatwick would undertake to ensure that the overall blended price actually paid by airlines is at a lower level than the Commitments price. We believe that this will be achieved through the conclusion of contracts and / or other incentive arrangements with individual airlines. We propose that this outturn blended price would be **RPI+1.5%.** And, to the extent that Gatwick is unable to conclude contracts with airlines, then this blended price will effectively apply to the published tariff and therefore represents a tighter constraint than the Commitments price. We have retained 7 years as the duration of Contracts and Commitments.

  We consider that this price level should be sufficiently close to the CAA's regulatory price proposals (once the CAA has taken due account of our representations in this document) to be acceptable to the CAA. Certainly, our proposals cannot be seen as an excessive price;

- **Capital expenditure:** We are proposing a minimum level of capital expenditure to ensure that the bulk of the capital expenditure in our business plan is delivered. We propose that this is set at c.£100m p.a. on average, which equates to approximately 70% of the investment currently forecast. We believe that this should address the CAA's concerns in this area; and

- **Capital consultation:** We are proposing a comprehensive consultation protocol, based on today's Annex G consultation protocol, that will give airlines sufficient information on our capital programme while providing Gatwick with flexibility as to how we deliver, and change, that capital programme to respond to changes in market circumstances. We believe that this should address the CAA's concerns in this area.

Further detailed changes have been made with respect to enforceability, efficiency, service quality, transparency, operational resilience and financial resilience to address other CAA concerns. Taken as a whole, we believe that the Contracts and Commitments framework represents a significantly better outcome for airlines and passengers than the CAA's current regulatory proposals.

The regulated price counter-factual

The CAA uses its calculation of a "fair price" as one way in which the acceptability of the Commitments should be judged. We do not accept that the Act entitles the CAA to regulate to cap prices at a "fair" level, nor that the CAA's calculation is sound, nor that its use in this way is appropriate in the context of the market power test. Nevertheless, should the CAA decide to use its "fair price" as a regulated price counter-factual, then this submission makes the following points for consideration in any new calculation of this price.

- **Traffic forecasts:** The CAA concluded that there is potential for Gatwick to outperform its traffic forecasts.

  The CAA will have seen the encouraging traffic figures that are being reported in the first two months of 2013/14. These stem in part from our successful marketing efforts over the past year or so. However, this increase in traffic also reflects an increase in competition between our airlines. This is to be welcomed, particularly for its effect on prices paid by passengers. However, it is unclear at this stage how robust this increase in traffic is likely to be. The recent announcement of growth plans by easyJet at Stansted demonstrates the likelihood that strong competition will be a reality. Stansted's incentives have radically altered with its change of ownership and it plainly has the ability to give effect to those incentives. In addition, economic conditions remain uncertain, and competition between airlines might well lead to further airline exits from Gatwick. Nonetheless, we do feel that there is slightly more optimism in our traffic forecasts than in January 2013. We are therefore putting forward a traffic forecast that is closer to that used by the CAA in its initial proposals.

- **Operating costs and commercial revenues:** The CAA concluded that while Gatwick has improved operating efficiency, its future plans are insufficiently challenging. The CAA also concluded that Gatwick's commercial revenue forecasts are insufficiently challenging. We have provided detailed responses later in this document but our main concerns are as follows:

  - There are significant flaws in the consultancy reports upon which the CAA has relied;
  - The costs and risks of introducing the scale of change proposed by the CAA have not been addressed;
  - There is an inherent inconsistency in proposing significant cuts in operating costs while also seeking increases in service quality, without additional capex expenditure; and
  - The increases in commercial revenue proposed are unrealistic and rely on Gatwick introducing new charges upon passengers.

- **Pension commutation:** The CAA has not made allowances for the commutation payment in its price calculation. We believe that this is an unfair assessment and is at odds with the CAA's treatment of the inverse situation at Heathrow.

- **Capital expenditure:** The CAA concluded that most of Gatwick's proposed schemes have passenger benefits although costs need to be reduced.

  We believe that the capital programme put forward by Gatwick represents a compelling vision for the future of the airport. We note the step-change we can expect in the attractiveness of Heathrow once Terminal 2 – now less than one year away – opens. We must be able to compete with that. Hence, we have not reduced our capital expenditure forecast and we are pleased to report an increase in airline support for the investment included in our business plan. In addition, since the submission of the January 2013 business plan, it is clear that the DfT is pushing for significant additional security-related capital expenditure in 2018, and we have included in this submission an estimate of this expenditure.

- **Weighted average cost of capital:** The CAA proposes a pre-tax cost of capital of 5.65%. This can be compared to the equivalent figure of 6.5% used in Q5.

  We provide in this submission detailed evidence to challenge the CAA's analysis in this key area. First, the CAA has not recognised the risks facing Gatwick now it is separate ownership. It is not credible for the CAA to conclude that the risks facing Gatwick are the same as when we were under common ownership with the other South East airports. Second, the CAA cannot reasonably then go further to conclude that Gatwick's risk profile is almost equivalent to that of the National Grid. Third, the risks introduced by the CAA by proposing cuts in costs, increases in commercial revenue, cuts in capital expenditure, increases in the required service quality delivered against higher traffic forecasts, result in a risk profile incompatible with the cost of capital proposed by the CAA. Fourth, the CAA does not adequately account for Gatwick's efficiently incurred cost of debt.

In each of these areas, we provide new evidence that we believe should be taken into account by the CAA in developing its concept of a "fair price".

Other elements of the CAA's proposals

There are other elements of the CAA initial proposal that we comment upon in our response.

- **Minimum service standards:** While we are broadly content with the CAA's proposals for minimum service standards, there are elements of detail that in practice would cause Gatwick to fail a significant number of our current standards. We do not believe that airlines are calling for a significant increase in the minimum levels of airport service quality, and we do not believe that the CAA's detailed proposals are necessary. We are surprised that the CAA feels that our proposals to include minimum service standards for key aspects of the passenger experience are not welcome. Setting minimum service standards – if set appropriately – will not affect airline competition in the way suggested. We note that the CAA's proposals around operational resilience would in fact have the effect of the airport being asked to seek to influence airline performance. We have therefore retained our proposals in this area;

- **Operational resilience:** We note the CAA's proposals on operational resilience and we have made proposals in our Commitments in this regard;

- **Incentives to enhance capital efficiency:** We disagree strongly with the CAA's proposals in this area. The CAA's proposals, by effectively giving airlines a power of veto over our capital programme, risk reduction and delay in capital investment which are at odds with the need to improve the airport in the interests of passengers. We have therefore made proposals to improve the consultation framework in a RAB-based world although, as noted above, we have made proposals in a Commitments framework also; and

- **Licence drafting:** We note the CAA's proposals for an economic licence. We have provided, on a without prejudice basis, comments on the CAA's proposed drafting on a RAB-based licence framework. We now understand that the CAA is to consult on Commitments-based licence framework and we look forward to seeing that consultation shortly.

Conclusion

We believe that our Contracts and Commitments framework now adequately addresses the points of concern identified by the CAA in its initial proposals. While we remain concerned by the CAA's apparent preference for a regulatory framework, we believe that, for the reasons discussed in this paper and our submissions throughout the process, the CAA should – in its October final proposals – propose a Contracts and Commitments framework as its preferred outcome for the period beyond Q5.

We believe strongly that the CAA should seek to move away from a conventional regulatory framework in order to facilitate the competitive dynamic created by the break-up of the South East airports monopoly. To end with the conclusion of Professor Littlechild:

> *"With the most significant changes in airport sector and regulatory conditions for nearly three decades, a window of opportunity is open that will gradually close. If licensing and price regulation are not removed now, will they ever be?"*

1 Introduction

Gatwick notes that the CAA has considered a range of options for the future of the airport's regulation. In particular, we acknowledge the CAA's inclusion within the initial proposals of Gatwick's Contracts and Commitments framework as an option for the future. The CAA makes a number of practical comments about the way that the Commitments could work and this response document seeks to address these challenges. We encourage both the CAA and our airline community to consider carefully the significant advantages for passengers, airlines and the airport that could be secured from this new commercial future.

The CAA also makes a number of proposals about the calculation of a RAB based price in a traditional regulatory model. We believe that many of the cost and revenue projections in the CAA's initial proposals are not warranted, and are inappropriate for Gatwick. In this document, we provide further evidence and explanation to justify Gatwick's original January 2013 business plan.
Beyond these areas, this document also provides our response to each of the substantive points raised by the CAA.

1.1 Plan of Gatwick's response document

This response document draws out the key issues that arise from the CAA's initial proposals, in the first nine chapters:

Chapter 2: Contracts and Commitments;
Chapter 3: The CAA should promote competition where appropriate;
Chapter 4: Cost of capital;
Chapter 5: Capital expenditure and efficiency;
Chapter 6: Operating cost;
Chapter 7: Commercial revenue;
Chapter 8: Traffic forecast;
Chapter 9: Pension commutation; and
Chapter 10: Licensing.

These key issues represent areas in which we believe that there are significant items that the CAA still needs to consider before making its final proposals.

Chapter 11 contains our detailed comments on the remaining parts of the CAA's initial proposals; while further information, including our responses to the CAA's efficiency consultant reports, are provided in the appendices.

2 Contracts and Commitments

2.1 Introduction

In Gatwick's January submission, we proposed a new deal, a commercial approach for our airlines, comprising Contracts and Commitments.

As we explained in our January submission, we see a future in which airline-airport relationships at Gatwick are increasingly defined through bilateral contracts. We would expect such contracts to be tailored to the specific needs of different airlines and their passengers, and therefore to have bespoke service and price levels. These contracts would be negotiated on an individual airline basis.

Of course, we recognise that some airlines may choose not to enter into bilateral contracts, and will therefore continue to access the airport under the terms of Gatwick's Conditions of Use. To provide these airlines with long term certainty as to the future service/price offer available at the airport, Gatwick is proposing to put in place long-term Commitments.

The certainty provided by the over-arching framework of Commitments will also facilitate the development of contracts so that, in time, contracts become the norm.

We were broadly encouraged by the CAA's response to our Contracts and Commitments, welcoming as it did our innovative proposal, whilst recognising a tightly controlled regime necessary to curb the market power of Heathrow would not be appropriate for Gatwick and Stansted. This is, of course, in keeping with our view of the competitive dynamics now at play amongst the London airports. We differed from the CAA on some of the detail of the Commitments (where we have developed alternative proposals for this document) and on the need for a licence to reinforce the Commitments, but the course of this latter debate does not detract from the Commitments - they are designed to be free standing, contractually binding obligations whether or not the CAA, or potentially eventually the CAT, deems a licence necessary.

Gatwick has considered the feedback it received from the CAA, the ACC and individual airlines in relation to its initial Airport Commitment proposal, as set out in the Gatwick's January Business Plan. In light of these comments, Gatwick has revised the Commitments, as set out in Appendix 1.

A significant change relates to the structure and level of the price Commitment. In addition to a "*Core Yield"* price path that applies to charges under the published tariff (of RPI+2.5% p.a.), we have proposed the introduction of a **"Blended Yield" price path of RPI+1.5% p.a.** to apply to the combination (or blend) of charges under both the published tariff and bilateral contracts. This represents a further limit on the price per passenger that will be paid by airlines at Gatwick since it takes into account any contractual discounts. And, to the extent that Gatwick is unable to conclude contracts with airlines, then this Blended Yield price path will effectively apply to the published tariff and therefore represents a tighter constraint. This represents a significant concession by Gatwick - in addition to a lower "Core Yield" than in our January submission, we have proposed a further limit which gives credibility to Gatwick's intention on contracts and bears on what airlines will on average actually pay.

In summary, under the Commitments framework Gatwick will commit:

- For a period of 7 years (i.e. to March 2021);

- To limit increases in the average aeronautical yield from core airport services to RPI+1.5% p.a.;

- To maintain core service standards at the high levels already achieved in Q5, but with greater emphasis on passenger facing metrics than even the CAA have proposed for Q6;

- To undertake the capital investment required to meet its core service standards and its health safety and environmental obligations and, in doing so, invest at least £100m p.a. on average over the next seven years; and

- To adhere to a comprehensive programme of consultation in relation to its capital investment programme and fulsome disclosure of financial information to enable stakeholders to assess whether airport charges are reasonable.

The revised Commitments now represent a substantial improvement - from a passenger and airline perspective - relative to that put forward by GAL in January. This requires GAL to shoulder increased risk and to accept additional restrictions on the returns it can generate and retain through improved performance. Nevertheless, GAL believes that persisting with a RAB-based approach to regulation is not in the interests of passengers, airlines or Gatwick, given the need to impose costly, bureaucratic mechanisms for regulatory intervention to correct for the misalignment of incentives between the major providers of service to passengers (i.e. airlines and airport) caused by RAB-based regulation in the first place.

The good reasons for a move away from a RAB-based price control have already been made compellingly by the CAA. In its evidence to the Competition Commission supporting the break-up of BAA: "*The CAA accepted that continuation of RAB-based price control regulation might well serve to limit competition between airports as it would involve the regulator effectively determining the price, service quality and investment of airports, thus effectively crowding out the potential for competition*."

In summary, the Commitments provide airport users with certainty as to the range, availability, continuity, cost and quality of airport services. We are firmly of the view that the Commitments provide such through standalone contractual obligations which require no regulatory back up.
If the CAA concludes - incorrectly in our view - that Gatwick should be licensed, then such a licence with the Commitments in place would need to be very light touch.

2.2 Our Commitments to airlines and passengers

The detailed terms sheet for the Commitments is appended but, in summary these:

- Represent an enforceable contractual agreement between Gatwick and its airline customers, for the benefit of passengers and airlines, with a duration of 7 years. The Commitments will be enshrined within the airport's Conditions of Use which are, and will be, enforceable by airlines. Any variations to the substantive provisions of the Commitments within the Conditions of Use (e.g. initial term; contractual remedies and independent adjudication; price commitment; service commitment; investment & consultation commitment; information commitment; and operational & financial resilience commitments) will be subject to approval by a majority (as specified) of the airlines.

In addition to the normal contractual remedies available through the Courts, the airlines continue to have rights of redress through the CAA or the Courts in relation to the application of the Airports Charges Directive or general completion law. Moreover, we have proposed an independent dispute resolution process to ensure any dispute under the Conditions of Use can be resolved in an efficient and speedy manner.

- Commit Gatwick to defined price paths which, over the duration of the Commitments, would limit the average aeronautical yield (i.e. airport charges revenue per passenger) relating to core airport services.

  The principal price path which will bind Gatwick is the “blended yield”. This limits to RPI+1.5% p.a. the increase in aeronautical yield over the 7 year period of the commitments, taking into account, when calculating this, GAL’s actual revenues from airport charges for core airport services, whether such revenues arise under a bilateral contract (inclusive of discounts) or the airport tariff - i.e. it reflects a blend of both contract prices and tariff prices. This ensures the average price of the core service delivered to passengers is capped for the benefit of passengers, subject to airlines choosing to reflect this benefit to their customers. Furthermore, to the extent that Gatwick is unable to conclude contracts with airlines, then this blended yield price path will effectively apply just to the airport tariff.

  The second price path which will bind Gatwick is the “core yield”. This limits to RPI+2.5% p.a. the increase in aeronautical yield over the 7 year period of the commitments taking into account, when calculating this, the revenues GAL would earn from airport charges for core airport services if there were no bilateral contracts and all airlines were paying charges under the terms of the airport tariff. This provides those airlines that do not contract with assurance as to the level of prices (by reference to the average aeronautical yield) under the airport tariff. It also provides such airlines with additional safeguards to ensure bilateral contracts are not struck at the expense of those airlines remaining on the tariff. This acts to materially limit the flexibility that Gatwick has to enter into contracts; flexibility that would be the norm in other competitive markets.

  As both of the price paths relate to an average, the actual aeronautical yield for an individual airline may be higher or lower than the average depending on that airline’s use of core airport services and the applicable published tariff, or the terms of any bilateral contract.

  These proposals entail a modestly rising profile of prices over the next 7 years. Such an outcome is consistent not only with a market where demand is increasing and capacity expansion needs to be incentivised but also with the improvements that have been made and are planned for Gatwick. The investment planned will continue to improve the much enhanced quality of service and passenger experience that the airport already offers and its competitive positioning not only against Luton and Stansted but also against Heathrow’s much higher cost offering.

It is also clear that the regulated comparison price calculated by the CAA for its Initial Proposals was unrealistically low, derived in particular from cost of capital and operating cost assumptions that are at odds with the evidence, not least with comparators in both areas. The blended commitments price path which best reflects what airlines overall are likely to pay is significantly below what we believe is a realistic assessment of a regulatory price. To that extent it represents a gain, notably for airlines, compared with regulation. And passengers will benefit from the service proposition it represents. In relation to activities currently "specified", GAL has undertaken that they will continue to be set at a level which is fair, reasonable and non-discriminatory.

- Commit Gatwick to meet minimum Core Service Standards, based on the current SQR regime with the addition of measures associated with outbound baggage and security queues in excess of 30 minutes in any one day. These additions of scope consistent with the extensions proposed by the CAA in its initial proposals for a RAB-based regime, and we believe are a good reflection of passenger expectations.

  However, as airlines, passengers and the CAA have all expressed a belief that passengers are otherwise broadly satisfied with the minimum levels of service at the airport, Gatwick has proposed that the remaining service standards remain unchanged from the current SQR level. This differs from the CAA's Initial Proposal in which it chooses to increase explicitly the level of several SQR's (e.g. cleanliness, departure lounge seating availability and wayfinding) and to increase implicitly the level of all SQR's through a change in their underlying calculation (involving rounding).

  In relation to bonuses, GAL has also proposed that these targets remain unchanged from the current SQR levels. Conversely, the CAA's Initial Proposals suggest increases in the bonus standards, largely targeted at those that GAL is already meeting.

  GAL has proposed some changes to the weighting of the rebates, placing more emphasis on measures that are directly passenger facing (e.g. QSM measures) than the CAA. GAL has also proposed that the rebates would be payable for any number of months of failure in any year (not just the first six months of failure, as in Q5). Moreover, in relation to the subset of key passenger facing measures (i.e. QSM, Central Passenger Search (95/5 & 98/15), Passenger Sensitive Equipment (General & Priority), and Arrivals Reclaim) GAL is proposing that the monthly penalty associated with any single measure increases by a factor of 25% if there is a failure that extends beyond six consecutive months. This places more risk on GAL for failing to meet individual targets than either the current SQR regime or the CAA's proposal in relation to Q6, particularly should there be an extended failure to meet the SQR target.

- Commit Gatwick to undertake the capital investment required to meet its Core Service Standards and its health safety and environmental obligations.

  Gatwick is highly incentivised to deliver the capital investment programme that it has set out in its business plan, since this has been developed in the context of an over-arching need for

Gatwick to compete for passengers and airlines. Examining the programme at a more granular level, it is further evident that it comprises a range of projects and programmes that are:

- Closely aligned to the delivering the service levels as agreed under the service quality regime e.g. security queuing, pier service, airfield availability and asset availability; and/or
- Undertaken in partnership with airlines to deliver benefits to passengers and airlines alike, even though not directly part of the airport's service quality regime service (e.g. check-in transformation, which can only be progressed with airline buy-in); and/or
- Commercial revenue generating projects that deliver sound returns without the need for incremental airport charges; and/or
- Necessary to ensure that Gatwick continues to operate facilities that are compliant with all relevant environmental, health and safety standards.

As such, Gatwick does not believe it is appropriate to commit, in a more granular fashion, to specific projects e.g. using an example cited by the CAA in recent correspondence, whether the currently envisaged child friendly play zones will actually be developed. Nor should the Core Service Quality measures be extended to cover all such eventualities. Having the scope to manage the capital investment programme more flexibly is a key differentiator of the Commitments framework (and normal commercial practice), as distinct from RAB-based regulation. Nevertheless, Gatwick understands that this may give rise to a concern - albeit misplaced - that there could be a substantial reduction in the capital programme. To address this misapprehension, Gatwick has proposed in the revised Commitments to provide further surety to airlines and passengers as to the scale of development. To this end GAL has undertaken to invest, at least, c.£100m p.a. on average over the next seven years.

- Commit Gatwick to adhere to a comprehensive programme of consultation in relation to its capital investment programme. Gatwick's proposed approach to consultation extends beyond the basic requirements of the Airport Charges Regulations 2011 and has adopted the key principles of Annex G, whilst reflecting the experience of Q5/Q5+1.

  The proposed approach makes allowance for information provision, at an appropriate level of detail, to enable airlines to understand and provide properly informed views:

  - At a strategic level, the overall development plans for the airport and the associated financial outcomes;
  - At a tactical level, the outputs being delivered from major projects and the delivery of these projects to time, scope and budget; and
  - At an operational level, the day-to-day impact of projects on airline activities at the airport.

  A key element of the consultation will be the publication annually of a 5 year rolling forecast for the capital investment programme, incorporating an explanation as to any material differences between the latest forecast and: (i) the prior year forecast; and (ii) the forecast arising from the current CAA review. We believe that the publication of data relative to the current capital investment programme will assist the CAA and airlines in determining whether there has been a material or unjustified departure from the programme as currently envisaged.

- Commit Gatwick to the ongoing provision of financial information, in a level of detail equivalent to that currently published, which enables stakeholders to assess whether airport charges are reasonable;

- Commit Gatwick to develop and maintain an operational resilience plan which will set how GAL intends to operate an efficient and reliable airport to the levels required by the Commitments or otherwise agreed with users and, in particular, how it will secure the availability and continuity of airport operation services, particularly in times of disruption. GAL will consult annually on the resilience plan with all interested parties including the CAA.

  This plan encompasses the coordination of activities across a variety of service providers at the airport (including airlines and ground handlers), in particular during periods of disruption.

- Commit GAL, in the context of maintaining its financial resilience, to provide an annual confirmation of the adequacy of its financial resources to operate the airport, notify the CAA of changes to GAL's current financing arrangements (which contain significant safeguards in regarding the conduct of business and financial arrangements), and to maintain a continuity of service plan.

2.3 Addressing reservations concerning Gatwick's initial Commitments proposal

Gatwick has considered the feedback it has received from the CAA, the ACC and individual airlines in relation to its initial Airport Commitment proposal, as set out in the Gatwick's January Business Plan submission. In light of these comments, Gatwick has revised the Commitments and these are set out at Appendix 1.

Summarised in the table below are the principal observations made by the CAA in relation to Commitments, as set out in the CAA's Initial Proposal. Set alongside the CAA's comments are Gatwick's responses, highlighting how the revised Commitments address the CAA's concerns. In addition, where the ACC and airlines have made observations that are over-and-above those made by the CAA, Gatwick has incorporated a response into the narrative.

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Table: Detailed Gatwick responses to the CAA's initial proposals on Commitments

CAA comment	Comment
Price: The CAA would want the Commitments to offer a price that is fair. The CAA's views of a fair price are set out in Part B.	Naturally, Gatwick wishes to ensure the price is reasonable and it prepared its January Business Plan submission with this in mind. In its Initial Proposals, the CAA indicated that a 5 year RAB-based price control could be set in the region of RPI+1%. And that the CAA's assessment of a "fair price" in relation to a 7 year price control could be in the region of RPI+0%. We have set out elsewhere in this document the significant issues that GAL has with the CAA's analysis in concluding these views on price. Gatwick believes that the CAA does not have power to regulate to specify a "fair price". GAL believes that RAB-based prices substantially in excess of the level indicated by the CAA are warranted. Nevertheless, as in our January proposal, GAL is prepared to extend an offer for Commitments below what we estimate to be a realistic assessment RAB-based price control. This reflects Gatwick's confidence that the flexibility afforded by the Commitments Framework will enable us, and our airline partners, to focus on increasing the overall value of activity at the airport. There is a need to break with existing mindsets, engendered through RAB-based regulation, that focus on the "zero-sum game" of arguing over dividing up the existing value of the business, rather than seeking to grow it to the mutual benefit of the airport, airlines and passengers. The price paths offered by GAL (and described in more detail above) are: • the "indicative blended yield", limiting increases in the average aeronautical yield from core airport services to RPI+1.5% p.a. over the 7 year period of the commitments, calculated using actual revenues arising under bilateral contracts and the airport tariff; and • the "indicative gross yield", limiting increases in the average aeronautical yield from core airport services to RPI+2.5% p.a. over the 7 year period of the commitments, calculated using pro forma revenues assuming all airlines operate under the airport tariff.
	While not referenced in the CAA Initial Proposals, the ACC and certain airlines have asked whether there should be further limitations placed around the operation of the price path and whether certain specified activities could be brought within the ambit of the price path. Gatwick has proposed a series of amendments that are designed to address these concerns. • *Price path limitations* In theory, Gatwick could choose to price above the indicative price path in the early years and then price well below the price path in later years, notwithstanding that the asymmetric interest charges we have proposed would discourage this. Recognising these concerns, Gatwick has proposed additional protections, by way of a set of boundary conditions applied to the "Cumulative Gross Revenue Difference". These limit the potential for a materially positive Cumulative Gross Revenue Difference and reduces year-on-year volatility in charges for those airlines on the Commitment price. It is our wish and intention that contracts should become the determinant of what airlines actually pay. • *Inclusion of certain specified charges under price path* The ACC and certain airlines have indicated a preference for specified activities to be incorporated under the price cap as these are part of the airlines costs associated with operating at the airport. Gatwick has proposed that some operational charges (e.g. ID passes, FEGP (excluding the commodity element) and airside licences) are incorporated within the overall price commitment. This does not, however, include operational charges subject to separate legislation (e.g. PRM and check-in and baggage) nor quasi-commercial charges (e.g. staff car-parking).
Enforceability of the Commitments:	
Gatwick is apparently able to make unilateral variations or contract out of the terms,	The Commitments will be reflected in the Conditions of Use and are therefore contractually enforceable by the airlines operating at Gatwick. Gatwick is not able to make unilateral variations to the key aspects such as in relation to Price Commitment and Service Standards. This was clear in the drafting of the January Commitments draft, but Gatwick has provided further drafting in the latest Commitments to emphasise this point. If the drafting remains unclear, then this can be refined, as it has always been Gatwick's clear intention that this is the principle which should apply and there is no legal impediment to making this happen. Gatwick has committed to make available the Commitments to all airlines operating at the airport now or at

	any time during the 7 year term. Airlines operating at Gatwick currently will be able to secure the benefits of the Commitments from the outset and there can be no doubt whatsoever that Gatwick will be entering into a contractually enforceable agreement with them at that point. GAL has no intent of withdrawing the offer contained in the Commitments during their term and would be fully aware of the regulatory and legal consequences of an attempt to do so.
The Commitments are enforced by airlines rather than passengers, where their interests may not always align.	Gatwick acknowledges that the Commitments are not enforceable by passengers. There is an alignment of carrier/passenger interest in the vast majority of cases (and it only takes one airline to enforce: there is no need for every single one to do so). As with a regulatory model, the obligations are formulated with passenger interest in mind but practically their enforcement is by airlines through their contractual rights in the case of Commitments or through regulatory complaint in the case of regulation. The new competitive environment will be far more effective in protecting the interests of passengers than any direct contractual enforcement right.
The CAA has no direct route of enforcing the Commitments or sanctioning their breach.	Breaches or disagreements will be subject to the independent adjudication process and ultimate review by the courts. Gatwick has proposed that the adjudication provision include a requirement for the adjudicator to consider any representations from the CAA. More serious, flagrant breaches of the commitments would also be subject to the courts which can move very quickly to make interim orders and have the ability to award damages. But, in addition, if the commitments regime was not working, this would clearly constitute a material change of circumstances entitling the CAA to revisit its market power assessment.
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.	Gatwick is not proposing an automatic pass-through of costs. However, it has proposed permitted adjustments to the indicative price path in certain very limited circumstance reflecting the fact that the Commitments extend over a 7 year. The provisions relating to taxation changes have been removed. The redrafting of the provisions in relation to security costs and the second runway investment now very tightly circumscribes the circumstances under which the indicative price path might be varied: • *Security requirements* Gatwick drafting from the illustrative Conditions of Use shared with the CAA in March (now reflected in revised Commitments) proposes a mechanism similar to (but simpler than) the Q5 approach to security costs. GAL has included an adjustment of 90% to these increased costs, to incentivise efficiency. A substantive addition made by GAL in the latest draft relates to the costs of implementing new hold baggage screening requirements. As discussed with the CAA and airlines, it is now clear this is likely to be a significant investment within the five year period from 2013/14, but this project is at too early a stage of refinement to have been included in the Q6 capital investment programme. The project is of sufficient scale that it will be treated as a Major Development Project in its own right, and thus be subject to detailed scrutiny in accordance with the consultation process in the Commitments. The mechanism for adjusting prices to reflect this expenditure flows from this. • *Second runway costs* Gatwick has provided that any adjustment would only be permitted “if, following the Airports Commission, the Government supports the development of a second runway at Gatwick Airport”. Not to allow for such an adjustment might frustrate the implementation of the Government’s national infrastructure plan at a time when there may be capacity constraints in the London system and airlines holding slots at these airports would reap further benefit yet from scarcity rents. Furthermore, we have: o Stipulated that the second runway adjustment would apply to “reasonable costs” of applying for planning permission and the subsequent development, so airlines can challenge efficiency of expenditure under the dispute resolution provisions; o Provided that these costs would be consulted on as a “Major Development Project” (as described in more detail under “Consultation”); and o Assumed for charging purposes that the costs of early stage development work (in particular the costs of the runway planning application) would be recovered over a 10 year period rather than within the year of expenditure.

Service quality: The level of rebates and bonuses in the service quality scheme should prevent service quality from being reduced and provide bonuses only where there is significant outperformance of existing levels of service quality.	Gatwick has used the Q5 service standards as the basis for the Commitments service proposal, and we note that the CAA has adopted a similar approach in its draft licence. Consequently, in relation to service rebates, there are only modest differences between the two proposals, the notable points being: • The CAA has tightened certain of the QSM measures relative to Q5, either directly (e.g. moving the targets for cleanliness from 4.0 to 4.1 and departure lounge seating availability from 3.8 to 4.0) or effectively by changing the rounding of the data. This could result in Gatwick failing various measures immediately. We do not believe this is the CAA's intent and, given that passengers, airlines and airport appear to concur that standards are sound, we do not propose further changes; • The CAA envisage a maximum annual rebate being paid on each measure after 6 months of failure, with no further penalty until the subsequent year, if the issue persists. Gatwick proposes that a rebate be payable in any month in which there is failure and, moreover, that in relation to certain key passenger facing measures the monthly penalty associated with any single measure increases by a factor of 25% if there is a failure that extends beyond six consecutive months. This increases the incentive on GAL to remedy the service failing. • The CAA and Gatwick propose slightly different weighting of measures. Gatwick's reweighting of measures in the revised Commitments, places greater emphasis across all the passenger facing measures (i.e. passenger satisfaction measures, passenger security search, passenger operational measures, and pier service) than proposed by the CAA – we believe this is the right outcome for passengers; and • The CAA has proposed a new service rebate metric related to Central Security Queues extending beyond 30 minutes on a single day. Gatwick has adopted this in the revised Commitments. While Gatwick accepts this measure in principle, the practicalities of implementing this will need to be worked through. It may be that rather than add a further measure, the rebate weighting attached to this new measure (0.20%) could be instead apportioned to other passenger focussed measures. On bonuses, Gatwick's original proposal was for bonuses that were symmetrical with the rebates, and therefore the theoretical maximum bonus would be 7.0% of airport charges. The CAA has proposed that the bonus potential be curtailed relative to Q5, from 2.2% to just 1.4%., and with more stringent targets set. In Gatwick's latest proposal, we have reduced the measures to which bonus measures apply, with emphasis retained on direct passenger facing measures, subject to a theoretical maximum of 3.5%. Pier Service and Outbound Baggage would be two airline operational measures that alternatively might be considered for inclusion. With a much reduced suite of bonuses, Gatwick has maintained consistency with Q5 and the CAA's initial proposals, such that they result in an adjustment to the indicative price path rather than just be an offset to rebates.
The Commitments should also include protection against repeated failures to meet service quality targets.	Gatwick proposes that, in the event of defined persistent failure, Gatwick would be required to draw up and then implement an improvement plan in consultation with the ACC. We propose that this would include a requirement for the parties to consider any representations from the CAA made in the passengers' interest.
Airline service quality targets should also not distort competition between airlines.	Gatwick has retained the two proposed airline service standards - relating to check-in queuing times and arrivals bags waiting times - given the importance that passengers clearly place on these two critical processes. Set at the levels envisaged, these do not have the potential to distort competition between airlines within relevant markets. For example, in the short-haul market, long check-in queues and poor last baggage performance do not represent intended business outcomes (at the levels of performance proposed) for either full service carriers or even low costs carriers (given, for the latter, the vigorous management of hold baggage allowances and focus on turn-around performance) - they represent poor operational performance. Nevertheless, GAL does accept that some refinement might be required to differentiate between long-haul and short-haul operators given the differences in terms of aircraft payload. In any event, as structured, there is no requirement on the part of an airline failing these standards to pay additional monies to Gatwick, but there is the potential to forgo rebates that Gatwick would otherwise be liable to pay to that airline. We believe such a proposal to be firmly in the passengers' interests.
Transparency The Commitments should provide sufficient information to airlines to allow them to understand whether charges are reasonable. *As a minimum, the*	Gatwick publishes detailed statutory accounts. These provide greater disclosure than the current regulatory accounts and contain sufficient, meaningful data in relation to the operating cost and revenue components of EBITDA, and in relation to the capital expenditure and depreciation components of Gatwick's asset base, to enable airlines, the CAA, and other users of Gatwick's accounts to undertake an analytical review of Gatwick's on-going business performance, capital investment, and financial returns, (including relative to the CAA's financial projections prepared as part of the Q6 review) and to assess whether charges are reasonable.

Commitments should include • *the same public provision of audited data as currently provided in the regulatory accounts,* • *[…]*	It should also be noted that Gatwick is a single purpose entity and is not part of a wider operating group. As such, there are none of the complications of determining how to allocate, say, head office costs shared between multiple airports or set transfer prices for products between related wholesale and retail businesses. This further emphasises the sufficiency of the statutory accounts. Gatwick commits that the scope of disclosure in its statutory accounts is maintained to be consistent with that of its most recent accounts (i.e. Gatwick's Report & Financial Statements for the year ended 31 March 2012) in so far as it relates to the operating costs, revenues, fixed asset base, depreciation and capital expenditure. In addition, GAL will publish annually a statement of GAL's assessment of the value of its asset base. This will set out the underlying assumptions and calculations. This will enable stakeholders to verify the calculation and inform their own analysis..
As a minimum, the Commitments should include • *[…]* • together with transparency over the costs of activities currently covered by the public interest condition (with the exception of activities covered by the Airports (Groundhandling) Regulations 1997 (AGR)).	In relation to currently Specified Activities (save those separately provided for under the Groundhandling Regulations or PRM legislation), Gatwick has undertaken: • To ensure that those charges relating to Specified Activities are set at a level which is fair, reasonable and non-discriminatory; • Prior to making any amendments to those charges, to provide relevant information (including cost information, where relevant, or other information if charges for the specified facilities are not established in relation to cost) and assumptions adequate to verify the basis upon which the charges have been calculated; and • To provide an annual statement of actual costs and revenues in respect of each of the specified activities.
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.	Gatwick is highly incentivised to deliver the capital investment programme that it has set out in its business plan, since this has been developed in the context of an over-arching need for Gatwick to compete for passengers and airlines. Examining the programme at a more granular level, it is further evident that it comprises a range of projects and programmes that are: • closely aligned to the delivering the service levels as agreed under the service quality regime e.g. security queuing, pier service, airfield availability and asset availability; and/or • undertaken only in partnership with airlines to deliver benefits to passengers and airlines alike, even though not directly part of the airport's service quality regime service e.g. check-in transformation, which can only be progressed with airline buy-in; and/or • Commercial revenue generating projects that deliver sound returns without the need for incremental airport charges; and/or • Necessary to ensure that Gatwick continues to operate facilities that are compliant with all relevant environmental, health and safety standards. As such, there are clear incentives for Gatwick to execute its capital investment programme. Nevertheless, Gatwick believes it can offer further assurances through the Commitments framework as to the execution of the capital programme and the provision of information to enable the CAA, airlines and passenger groups to track the progress of the capital programme, as set out in the business plan. These assurances are reflected in the revised Commitments, but summarised below: • Gatwick commits to maintaining the airport to comply with all applicable safety and environmental requirements. This undertaking was included in Gatwick's January Business Plan. However, the CAA appears to have given this little weight. We believe that this is important, in an industry in which safety and security is paramount and where growth can only be realised by focussing on safety and environmental concerns; • Gatwick commits to maintaining the airport to maintain and develop the infrastructure of the airport to enable the airport-wide service standards to be achieved; and • Gatwick will publish annually a 5 year rolling forecast for the capital investment programme and

	provide an explanation as to any material differences between the latest forecast and (i) the prior year forecast; and (ii) the forecast arising from the current CAA review. We believe that the publication of data relative to the current capital investment programme will assist the CAA and airlines in determining whether there has been a material or unjustified departure from the programme as currently envisaged.
Consultation: The Commitments should include consultation requirements beyond those required by the ACD and address the significant information asymmetry between Gatwick and the airlines; allow airlines to provide properly informed views on the capital programme, the changes made to the programme and their implications; and provide clarity over how the airport operator has made decisions in contentious areas.	Gatwick has always been clear that consultation in relation to the capital investment programme is a normal commercial activity that it would expect to undertake and that the key elements of this are set out in the Airport Charges Regulations 2011. Nothing has changed, in principle. However, it is now clear that it would assist the CAA and airlines for Gatwick to provide further guidance on - in fact, commitment to - what this will entail in practice. Accordingly, Gatwick has set out in the revised Commitments its proposed approach to consultation, which extends beyond the basic requirements of the Airport Charges Regulations 2011. Gatwick has adopted the key principles of Annex G and reflected the experience of Q5/Q5+1. But, Gatwick has also ensured that what is proposed delivers a genuinely different outcome that properly reflects the progressive commercial rationale of Contracts & Commitments rather than the overly engineered and bureaucratic approach of RAB-based regulation. In summary, the revised Commitments: • Set out a process for airline consultation, not airline approval or veto or delay; • Make allowance for information provision, at an appropriate level of detail, to enable airlines to understand and provide properly informed views: o At a strategic level, the overall development plans for the airport and the associated financial outcomes; o At a tactical level, the outputs being delivered from major projects and the delivery of these projects to time, scope and budget; and o At an operational level, the day-to-day impact of projects on airline activities at the airport. • Provide a process for consultation, seeking informed views from airlines in their capacity as users of the facilities (either directly or indirectly by their customers).
Operational resilience The Commitments do not provide clarity on what Gatwick will do and how it will interact with other service providers at Gatwick to ensure the availability and continuity of airport operation services to further the interests of passengers, particularly during disruption.	Gatwick has proposed a series of undertakings that are comparable to those highlighted by the CAA in its draft licence.
Financial resilience The Commitments do not provide clarity on what Gatwick will do to ensure its financial resilience and continuity of service.	In assessing the credit worthiness of any airport as a contractual counterparty, we would expect an airline to consider the recent financial performance and the financing structure of the airport. Gatwick's published accounts (which will continue to be provided, as noted above) provide detail on the financial performance. Gatwick also has established a long-term financing structure, the details of which are in the public domain and incorporate a range of safeguards for creditors which are aligned to the potential interests of airlines e.g. limitations on the ability of Gatwick to increase financial leverage; limitations on activities carried on by the airport. We consider that these safeguards and information provision provide adequate reassurance to airlines and passengers on the financial strength of the airport. In addition, GAL has proposed the development of a continuity of service plan. It is envisaged that this would be relatively light, reflecting that Gatwick is a single-purpose company, based on a single site, with no operational interdependencies with other group companies, and with a clear cash flow imperative of maintaining passenger activity. More involved continuity of service plans might be appropriate for large scale multinational businesses (e.g. a bank) or nationwide network utilities (e.g. rail).

3 The CAA should promote competition where appropriate

3.1 Introduction

Gatwick is concerned about the combined effect of the CAA's initial proposals for the three currently regulated airports. The effect of the CAA's proposals results in the regulator determining the key outcomes for passengers in the South East airports market, rather than allowing the market and competitive dynamics to reveal and determine market outcomes, thereby furthering the interests of users.

Contrary to the CAA's general duty to promote competition where appropriate, the proposals risk undermining the competition that already exists and reducing the competitive interaction between airports in the future. It is particularly appropriate to allow competition to determine outcomes when the interests of users vary and may be inconsistent across the five parameters mentioned in section 1(1) of the Civil Aviation Act (range, availability, continuity, cost and quality). This is because the process of competition is likely to result in more differentiated offerings, which allow airlines to choose the offering that best suits them (and passengers can choose between airlines); whereas a regulated outcome is likely to be more homogenous and involves the CAA, rather than passengers, making a judgement about the trade-offs between the five parameters. Ultimately, we believe that the CAA's proposals will be detrimental to the interests of passengers. Parliament clearly expressed a preference for competition over regulation in such circumstances[1].

The CAA has not explained how it will determine when the promotion of competition is appropriate to further the interests of users; or how it has approached the question of balancing the interests of different users when they may not be aligned (for example, some users may benefit from an onerous price control, whereas others would be better off with improved range and choice of services, funded by slightly higher prices).

Even if the CAA concludes that Gatwick has sufficient market power to required regulation, we believe that it is important for the CAA to be transparent about the factors it considers necessary to develop a more competitive market. A finding against Gatwick in the market power assessment, in our view, does not negate the need for the CAA to address its general duty. In this light, we refer to the paper by Professor Stephen Littlechild from May 2013, which among other things, described the importance of the CAA promoting competition and his view that the CAA's initial proposals fail to do this.

A number of key elements characterise a competitive airport market. These include short term elements that facilitate passenger and airline switching, and longer term elements, such as those that deliver additional capacity, improved service and innovation in terms of product offerings and service delivery. These key elements include:

- Pricing flexibility to incentivise different behaviours and use of facilities, and to meet the different requirements of different customer types;

1 See sections 1(1), (2) and (4) and (104) of the Act.

- Flexibility to adjust investment programmes and delivery timescales in response to changing circumstances;
- Incentives for innovation in all areas of the operation and service delivery; and
- Incentives to target and attract new customers.

Chapter plan
In this chapter, we summarise the CAA's proposals for regulation at the three currently designated London airports. Then we discuss each of these elements in turn. In particular, we highlight the CAA's proposals, where we consider that they fail to promote competition. We also promote a more appropriate suite of regulatory proposals. Finally, we describe how the CAA's proposals could introduce significant distortions to competition, rather than promoting it.

3.2 The CAA's proposals for regulation

At a summary level for Heathrow and Gatwick, the CAA proposes tight 5 year binding RAB based price controls (or arrangements that approximate to that outcome), with real falling prices at Heathrow, and modest real price increases at Gatwick. These are combined with tightly specified service quality targets. For Stansted, the CAA proposes an open-ended price monitoring regime, with the expectation of at least modest falls in price and encouragement for the airport to agree a set of service standards with airlines. Accordingly, the outcomes for passengers and airlines across the three principal airports serving the south east of England will largely be determined by the CAA through its regulatory proposals, and not by market dynamics.

The CAA's proposals for Gatwick increase the regulatory burden and oversight, particularly for capital investment, compared to the current price control arrangements which were set when the three airports were under common ownership. This is a perverse result given that the underlying rationale for the break-up of BAA was to increase competition in the South East airports market, which logically should tend towards lighter regulation.

However, since the sale of Gatwick, there is substantial evidence that competition has increased between airports and is continuing to do so (see the recent Stansted/easyJet announcement[2]). Although Gatwick and the CAA disagree about the extent of that competition, we understand the CAA agrees that there has been such an increase. It is also our expectation, as it was the expectation of the Competition Commission ("CC"), that the recent sale of Stansted will increase yet further the competitive dynamic in the market[3]. We find it difficult, therefore, to understand why the promotion of competition has not played a significant role in the CAA's thinking, not least given its status as part of the CAA's general duty and both the existing market evidence and the potential for competition further intensifying.

2 http://www.stanstedairport.com/about-us/media-centre/press-releases/easyjet-sign-long_term-deal-to-double-traffic-at-stansted
3 BAA had no incentive to cut prices at Stansted to fill its unutilised capacity because doing so would cannibalise earnings from Heathrow (and, until it was sold, Gatwick); it is only now that Stansted is in independent ownership that this incentive has ceased to exist.

3.3 Pricing flexibility in a competitive market

For Heathrow and Gatwick, the CAA has proposed price caps in a similar vein to those applied in Q5, which are binding and as such, greatly constrain the scope for product and price differentiation and the emergence of bilateral contracts tailored to individual customers' characteristics and requirements. This point was recognised by the CC in its market investigation, where it recognised that under the Q5 price control, there was modest scope for price competition between the three South East BAA airports. In its initial proposals, the CAA makes it clear that it considers its RAB based price cap proposals represent what it calls a "fair price". This is because the CAA considers this price will provide the airport operators, in each period, with returns on their historic cost base commensurate with the CAA's estimate of the operator's weighted average cost of capital ("WACC").

The CAA appears to set great store by the concept of a "fair price" as it devotes a significant proportion of its initial proposals to discussing and calculating this, even though there is no reference to such a concept in its statutory duties. This can be contrasted with the CAA's discussion of the promotion of competition, which only has fleeting reference in the initial proposals document, despite this being a key part of the CAA's general duty. Moreover, price is only one of five parameters mentioned in section 1(1) of the Act and, we believe, the CAA has wrongly given it predominant weight, whereas the CAA could have avoided making a value judgment, trading off the interests of users one against another, by instead promoting competition.

Concerns with the CAA's concept of a "fair price"

Despite the apparent importance of the concept, it is not clear from the CAA's documents to whom the CAA's calculation of a "fair price" is fair. While incumbent airlines will be protected from the returns of the airport increasing above the CAA's calculation of the weighted average cost of capital (WACC), the CAA has not presented any analysis as to how this translates to a "fair price" to passengers to whom its general duty is directed, or what such a fair price would mean for an airport market with the characteristics of the south east. In particular, it is well understood that airlines do not price on a cost-plus basis, but price according to the underlying passenger demand. Indeed, this fact underlies some of the analysis in the CAA's May 2013 SMP document. In such circumstances it is necessary for the CAA with its duty to passengers (rather than to airlines and passengers under the Airports Act) to show how any restriction in airport charges will be transferred by incumbent airlines to passengers in their airfares. If this cannot be demonstrated, it seems clear that the restriction on airport charges is largely/ wholly for the benefit or airlines.

This issue is more pertinent at airports with capacity constraints, which, the CAA argues, applies to Gatwick. At uncongested airports one might expect airline entry to undermine any effort by an incumbent airline to preserve the benefits of price regulation for itself and not pass it on to passengers. However, at congested airports, such airline entry is much less of a threat to incumbent airlines and can have associated high costs, for example due to the requirement to purchase slots. The CAA has itself, in the debate over future capacity, identified rising air fares as a consequence of capacity shortage, but has not related that to its concept of a regulated "fair price". Indeed, the logic of the CAA's stance on airport capacity is that incumbent airlines will retain most, or all of any difference between a "fair price" and a market price, as is evidenced by the slots market at Heathrow and (increasingly) at Gatwick.

Our other concern in this area is that the CAA has not presented any analysis as to how its proposals represent a fair price to the passengers of potential future airlines operating from an airport, or airlines seeking to grow at an airport. It is clear that the CAA's proposals could be inherently unfair to these future airlines. This is because the CAA proposes to keep prices at Gatwick below market clearing levels. This means that incumbent airlines, which by definition already have a foothold in the market due to their slot holdings, have an inherent advantage over potential new entrant airlines as these latter airlines will have to either not operate potentially more profitable routes, use sub-optimal slots or pay an upfront cost to acquire their required slots. Thus the CAA's initial proposals will entrench the market position of incumbent airlines, making it more difficult for new airlines, which could be more efficient users of the scarce runway capacity (e.g. by offering services for which passengers have a higher willingness to pay, to provide services to passengers in the South East). It is not clear how this is in the interests of passengers.

Competitive markets are characterised by more flexible approaches to pricing

The outcome designed by the CAA in its proposals, including its calculation of a "fair price", is not the outcome that would be delivered in a competitive market. Indeed, in such markets, periods of relatively high and relatively low returns can be observed as firms innovate, invest in new facilities and capacity, tailor their service delivery to their customers' requirements, design prices that reflect the differential value that different customer groups bring to the value chain, and seek to attract new customers and grow the market. A tariff regime that restricts price to a RAB-based calculation of cost does not deliver this.

This point is in fact acknowledged by the CAA in its consideration of Test B of the market power test in its assessment of market power at Stansted when its states:

> *"high prices can be part of the mechanism of a well functioning market where they encourage entry by equally (or more) efficient competitors and are eventually competed away. A core question is whether it is likely that, given the particular market dynamics, the high prices are likely to drive entry. Therefore an assessment of price over an appropriate time period rather than a simple consideration of the spot price is important. Further, prices play a role in rewarding investment and innovation, either of which can be damaged if the dominant firm considers it cannot gain the appropriate compensation. The market setting therefore plays an important and variable role in the assessment of excessive pricing. This can mean looking beyond whether a price represents a covering of costs plus a reasonable rate of return to taking proper account of the wider market context."*[4]

Despite the recognition which the CAA (rightly) gives to this concept, the CAA has not taken this approach in designing its approach to regulation, in particular to rewarding innovation, investment and service, which will likely be all the more important to passengers as capacity tightens.

This omission is further highlighted by observing the practices of regulators and competition authorities which have responsibility for the oversight of other sectors. This shows clearly that the CAA's proposals are an outlier in regulatory design. For example, in many markets which have

[4] Paragraph 8.46.

previously been subject to regulation and which have subsequently been opened to competition, regulators have removed ex ante price controls in their entirety (e.g. retail energy and, more recently, retail telecoms and some wholesale telecoms markets) and relied on competition law to address any potential abuse of market power. In other instances, regulators have continued to impose price regulation, but such regulation has not been based on historic cost RAB-based calculations. Alternatives include calculations based on forward looking costs (such as long run incremental costs in telecoms) or relatively loose safeguard caps (e.g. for retail telecoms and postal services).

Competition authorities have also been reluctant to introduce ex ante price controls as remedies to a finding an abuse of a dominant position on firms not already subject to economic regulation due to the risk of creating artificial distortions in markets. The CAA has itself recognised this point in its 'minded to' view on Stansted's market power, but has not carried this through to its proposals for regulatory design.

These approaches by regulators and competition authorities in other sectors have been justified on a number of bases. These include a recognition that a static interpretation of competitive outcomes of price equal to cost is not appropriate in a market with competition, and of the risks to nascent competition (such as in the South East airports market) arising from the regulator setting inappropriate price/service outcomes.

3.4 Flexibility in capital investment delivery

Competitive markets are also characterised by a much more flexible approach to capital investment delivery than allowed for by the CAA's initial proposals. The CAA could seek to argue that its proposed approach to the treatment of capital investment goes some way to providing a more flexible environment, more akin to that experienced in a competitive market. This is because the CAA is proposing to have two distinct groups of capital expenditure, one for "core" projects, that are agreed with airlines and well specified, and the other of "development" projects, those being less well developed and specified and yet to be agreed with airlines.

However, even this "regulatory innovation" is very different from what would happen in a competitive market. In particular, it is envisaged that the decisions about what projects are accepted as core or development would be significantly influenced by the views of incumbent airlines with no, or very little, opportunity for potential new airlines to feed into the process. This contrasts with a competitive market where firms would be seeking opportunities to identify and attract new customers and would give their needs and requirements a significant degree of weight in the development of their commercial strategies.

The creation of the category of development capex also creates a potential distortion to how a competitive market would operate. In particular, the CAA's proposals mean that these projects will only progress if there is agreement from incumbent airlines or if the CAA determines that they should. At the very least this will introduce potentially significant increases in regulatory delay to projects, undermining the airport's ability to respond to market developments. Moreover, this "regulatory innovation" increases the involvement of the CAA in the running of the airports as compared to previous regulatory periods. Again, this is counterintuitive as the market is certainly more competitive than previously, suggesting that a reduction in regulatory oversight would be appropriate, rather than the increase proposed by the CAA.

3.5 Scope for innovation

Innovation is a key characteristic that marks out markets with competition from those without competition. Rivalry between competing firms sets in train a process of dynamic discovery whereby firms interact with customers understand their needs and requirements and strive to better their rivals. It is innovation in terms of service delivery, operations management, product development etc. that provides opportunities for firms to secure the rewards of their efforts and gain an advantage over competitors. The CAA's proposals, if implemented, will significantly reduce both the motivation towards and the rewards from innovation and competitive rivalry and thus undermine the incentives on the airport operators to undertake such innovation.

The CAA's proposals are contrary to the view of the CC and previous views of the CAA, which identified the benefits from competitive rivalry between separately owned Heathrow, Gatwick and Stansted airports (even within existing runway capacity constraints), driving incentives to innovate, improving service delivery, increasing capacity and the efficiency of operations. The proposals are also inconsistent with the CAA's previously expressed views about the undesirable characteristics of RAB-based regulation, where it submitted to the CC that:

> *"continuation of RAB-based price control regulation might well serve to limit competition between airports as it would involve the regulator effectively determining the price, service quality and investment of airports, thus effectively crowding out the potential for competition."*

This supports the view that improved incentives to innovate, improve service delivery, increase capacity and the efficiency of operations would be delivered by a more flexible approach to pricing and investment project delivery. However, we are in addition concerned that the CAA's proposals for the setting of its service metrics undermine the potential rewards for innovation.

In particular, the service quality proposals for Gatwick and Heathrow are broadly similar to and as such are broadly acceptable. However, the CAA proposes to reset the standards based on December 2012 performance at each airport to secure historic actual service performance for future users, and to adjust the way the measure is calculated. What this means is that, for Gatwick, the required service standards will be higher and indeed, based on the calculation change alone we would be failing some of our measure today. This is tantamount to the CAA penalising Gatwick for its past successful delivery of increased standards, even where these are beyond regulatory standards and have been delivered in response to increased competition. The approach this encapsulates undermines incentives on airport operators to continually strive to increase the levels of service in the future.

3.6 Incentives to attract and retain new customers

As noted in the discussion above, there are a number of aspects of the CAA's proposals that reduce the ability of, and incentive on, the airport to attract and retain new airlines. These include in particular:

- The process by which future capital development projects will be incorporated into the regulatory settlement, which is dominated by incumbent airlines;

- The fact that the CAA is proposing to restrain airport charges to a measure of accounting cost, below market clearing levels and which do not reflect the full economic value of the airport, delivering an inherent advantage to incumbent airlines over potential entrant airlines; and

- The reduced incentives to innovate, including on improving service, which could be particularly valued by new airlines and by passenger groups which Gatwick would wish to grow, such as attracting business passengers away from Heathrow.

Given that the CAA has a duty to promote the interests of passengers, including future passengers, we consider the CAA's proposals should be amended to better reflect the needs of these users.

3.7 Distortions arising from differential regulatory models

Not only are we concerned that the CAA's proposals do not promote competition and do not represent a shift in regulatory intervention consistent with the increase in competition, we are also concerned that the different proposals from the CAA for the three airports could introduce significant distortions to competition.

For example, the combination of the CAA's proposals on price levels, which require real price falls at Heathrow, and to a lesser extent at Stansted, will make it more difficult for Gatwick to retain and attract airlines in preference to the others. This point was explicitly recognised by the Competition Commission where it considered that there was modest scope for price competition while airports were subject to price regulation. This issue is particularly acute in a market which the CAA argues has capacity constraints, which would thus be expected to see charges rising and not falling. Indeed, the CAA explicitly recognises that Heathrow's regulated charges are currently below market clearing levels. The CAA's proposal to reduce these prices further will exacerbate this problem of excess demand and make it even harder for other airports to attract airlines in preference to Heathrow.

The CAA's proposals on the structure of price caps are also problematic. These are similar for Gatwick and Heathrow, both being binding RAB-based controls. However, the structure of control at Stansted can conceivably give it much greater flexibility in its charges. For example, while the CAA has set out a clear expectation that prices should fall RPI-0.5.RPI on a net yield basis, this is not an absolute cap. This means that Stansted will be able to justify (to the extent that it is supported by the facts) that it is appropriate for it to increase charges above this level, so as to be able to offer incentives within commercial contracts for airlines to grow.

In addition, there is no time limit to the Stansted price monitoring regime. This could allow Stansted to make longer term deals with airlines without the risk of an automatic reset in 2018/19. This will result in a lower risk from agreeing longer term contracts than would be the case in a 5 year RAB-based binding cap environment.

These problems on price levels and structures are exacerbated by the CAA's proposals for service regulation, which we have discussed above. Moreover, Stansted is afforded a further degree of flexibility in its service proposition than either Heathrow or Gatwick. This will provide it with greater ability to tailor its offers and compete for airlines and passengers than is afforded to Gatwick or Heathrow.

Overall, Stansted is afforded significantly greater flexibility than Gatwick and Heathrow. These differential approaches to regulation, where the CAA is determining outcomes for passengers, further limits the ability of competitive dynamics to deliver market signals in the passenger interest.

3.8 Potential implications of the CAA's initial proposals

Gatwick is concerned that the CAA's initial proposals, if implemented in their current form, will lead to unintended consequences, which would fail to promote competition or be in the interests of passengers. In particular:

- As the proposed caps are binding at Gatwick, it will (inevitably, and in common with all regulated entities) have an incentive to seek to maximise within the regulatory settlement, whereas users would benefit if Gatwick was incentivised to engage with energy, focus and resources in competing vigorously with other airports;

- RAB-based regulation will crowd-out and dilute incentives on the airports to reach commercial agreements with airlines (e.g. to increase growth). Why would the airport and the individual airlines invest the effort in such agreements if the benefits can only be kept for a short time and will then ultimately be shared among all airlines? This risk is demonstrated by the historic evidence of the lack of bilateral contracts at the regulated airports in the UK; and

- Gatwick will be held back in its delivery of its vision for airlines and passengers due to the lack of future flexibility in the regulatory proposals. This is aggravated by the proposed reduction in the capital investment programme in the CAA's initial proposals, unlike the case at Heathrow and Stansted. These factors will undermine our ability to compete successfully and provide the services and facilities required by passengers and airlines.

We are also concerned that a set of market outcomes which is dictated and directed by the CAA, rather than revealed by commercial and competitive interactions will not best serve the interests of passengers. These interests will be best served by the promotion of competition in line with the CAA's general duty.

In contrast, we consider that our proposal for a regime of Contracts and Commitments will deliver much better against the CAA's statutory duties. While the CAA has accepted the principle of such Commitments, it has done so in ways which significantly reduce the freedoms and flexibilities that our proposals encapsulate and increase regulatory intervention. These risk undermining the benefits that will materialise from our Commitments. Our revised Commitments provide sufficient protection to passengers in terms of range, availability, continuity, cost and quality of airport operation services, while at the same time delivering the key characteristics of a competitive market set out above.

Given the serious concerns of Gatwick with the CAA's proposals, in particular around the lack of consistency with the CAA's general duty to protect the interests of passengers, where appropriate by promoting airport competition, we urge the CAA to revisit its approach and to put more clearly front and centre, as intended by Parliament and envisaged by both the CC and the CAT, the promotion of competition.

4 Cost of capital

4.1 Introduction

The CAA has proposed a calculation of a regulated price for Gatwick Airport that assumes a real, pre-tax weighted average cost of capital ("WACC") of 5.65%[5]. Since publication of the initial proposals, government bond yields have increased by over 80 basis points ("bp"), with a significant negative impact on the values of a broad range of asset classes. The estimate of WACC in the initial proposals does not reflect the level of uncertainty in current capital markets. In this context, the CAA and its advisers not only assume a risk-free rate which is inconsistent with the uncertainty that current low rates will persist, but dismiss inappropriately the evidence that the fundamental risk of Gatwick is higher than assumed in Q5.

A full response is included in Appendix 2.

4.2 Our concerns with the CAA's approach and outcome

We engaged Oxera to advise on cost of capital issues. Oxera remains of the judgement that the most appropriate estimate of the real pre-tax WACC for Gatwick is 7.1%. This note focuses on the initial proposals and presents the combined impact of making the adjustments to address the fundamental concerns about the analysis in the initial proposals as they relate to Gatwick's risk and cost of debt. The cumulative impact of these adjustments alone is a real pre-tax WACC that is 100bp higher than that put forward in the initial proposals[6].

There are two over-riding concerns with the CAA's analysis and initial proposals:

- First, the complete disregard for the WACC impact of the increase in risk over the period since February 2006, the cut-off data for analysis of the BAA Q5 beta, which underpinned the WACC assumptions for Q5; and

- Second, the conclusion that Gatwick and Heathrow have the same cost of debt despite the former having a lower credit rating and higher bond yields reflecting the higher risk of Gatwick relative to Heathrow. The evidence provided by the CAA's advisers does not support an assumption of the same cost of debt for the two airports. In any event, the cost of debt applied to Gatwick is too low.

Dealing first with the risk point, Oxera and Gatwick undertook a forward-looking analysis of a range of credible but low-probability scenarios faced by the three designated airports over the period 2014–19, to understand the range of potential outcomes for profitability. This analysis suggested an increase in systematic risk for Gatwick Airport of 15–25% relative to the period preceding Q5. The recent announcement of a long-term framework deal for growth between Stansted Airport and easyJet suggests that one of the scenarios anticipated in this analysis is more likely now than when

[5] CAA (2013), 'Economic regulation at Gatwick from April 2014: initial proposals', paragraph 10.158.
[6] The calculated estimate of 6.59% has been rounded to 6.60%.

the analysis was undertaken last year[7]. The conclusion of the CAA and its advisers that market developments since February 2006 have had zero impact on systematic risk and the WACC is not a credible interpretation of the evidence.

Turning to the cost of debt, it is clear that Heathrow and Gatwick should not have the same cost of debt and that, in any event, the CAA analysis results in an inappropriate outcome for the Gatwick rate. In particular, we would highlight the following:

- Gatwick has less debt than Heathrow relative to RAB but nevertheless has a lower credit rating on senior debt (BBB+ compared with A–). No recognition is given to the rating differential despite the CAA's advisers acknowledging that it exists;

- The spreads on Gatwick debt in the market are 30bp wider than equivalent Heathrow debt based on calculations by the CAA's advisers;

- Gatwick has a smaller and less regular issuance programme, which significantly increases the costs of issuance compared with Heathrow;

- The balance between embedded and new debt is incorrect given Gatwick's Q6 investment aspirations, with more weight needing to be given to embedded debt; and

- The cost of the embedded debt is incorrectly calculated with no allowance being made for hedging costs, despite these being a requirement of the banking market to arrange debt finance at the time of issuance.

In addition to the concerns about the risk analysis and debt, the calculation of the pre-tax WACC by the CAA and its advisers assumes that tax is paid on real rather than nominal profits. If this difference in tax is not accounted for in other components of the allowed revenue calculation, there will be an inconsistency in the calculation of the regulated price. This in turn means that the forecast post-tax return for Gatwick will be significantly lower than the post-tax WACC in the initial proposals.

Our conclusion that the WACC proposed by the CAA for Gatwick is inappropriate is reinforced through some simple cross-checks. In particular:

- The WACC for Gatwick has been reduced relative to that for Heathrow since Q5. This does not reflect the increase in risk for Gatwick following the break-up of BAA;

- The initial proposals imply that Gatwick is significantly less risky than BT Openreach, without any evidence to support this risk differential;

- The proximity of the WACC proposed for Gatwick to that assumed by Ofgem for electricity transmission networks does not reflect the relatively higher risk of Gatwick; and

[7] Oxera (2013), 'What is the cost of capital for Gatwick Airport beyond Q5?', methodology and estimation, prepared for Gatwick Airport, January 31st.

- The transaction value of Gatwick for the sale in Q5 at 0.88 of the RAB supports the analysis of fundamental risk drivers that suggests that forward-looking risk at Gatwick has increased. The analysis by the CAA's advisers that suggests transaction values of around 100% of RAB is incorrect.

Although government bond yields currently indicate a risk-free rate that is low by historical standards, the highly unusual capital market conditions mean that yields are unlikely to remain at this level during the period up to 2019. The combination of the CAA's low assumption for the risk-free rate and all the factors summarised above gives an unjustifiably low estimate of the WACC, which should be increased at a minimum by 100bp.

5 Capital expenditure and efficiency

5.1 Introduction

This chapter seeks to address the key areas within the capital expenditure and efficiency chapters of the CAA initial proposals. The key areas are listed below and later explained in more detail individually:

- Ongoing consultation;
- Consolidation of easyJet into one terminal;
- Major projects – fundamental messages:
  - Delivery of 95% pier service in North Terminal;
  - Early bag store – North Terminal;
  - Upgrade of check-in and bag drop – both Terminals; and
  - Border zone – North Terminal.
- Appropriate tollgate for including a project within the core budget;
- Appropriate tollgate to trigger a project;
- Capital expenditure budget;
- Q5 capital efficiency;
- Future capital consultation; and
- Capital efficiency beyond Q5.

Finally, we offer detailed comments on the two chapters related to capital investment in the CAA's initial proposals.

5.2 Key areas of comment

Ongoing consultation

An updated position of the ACC's support for the capital programme is documented below. In some areas a decision is still awaited from the ACC.

Table: Capital investment core projects ongoing consultation

Project / Programme	Cost (£m)*	ACC Position	Comment
Delivery of 95% pier service in North Terminal	£175.45	Support expenditure to date (£8.269m)	The ACC does not have a common view on whether there is support for this project moving beyond Tollgate 3
NT security reconfiguration	£25.17	Support	Some budget brought forward to Q5
Early bag store (NT)	£24.00	Do not have common view	Further working sessions held
Upgrade check-in and bag drop (including ceilings and floors) NT	£24.00	Partial support	Outputs from first trials shared. The ACC does not have a common view as to whether to support the replacement of floors and ceilings. It supports the bag drop equipment and installation, but it does not support removal of mezzanines
Upgrade check-in and bag drop ST	£17.60	Partial support	
Border zone NT	£13.22	Not supported	
NT IDL reconfiguration and expansion	£87.77	Support	Some budget brought forward to Q5
Runway 2	£10.00	Unknown	Ongoing monthly consultation
Business Systems transformation	£15.79	Support	The ACC sees this as a development project
Stand reconfigurations	£10.00	Support	
Product development – car parking	£5.00	Support	
Digital media	£5.30	Support	
CIP departures	£2.30	Support	
NT baggage reclaim	£2.80	Not supported	
NT arrivals transformation	£11.86	Not Supported	Reduced scope and budget
ST IDL capacity	£30.00	Not Supported	Now £34m budgeted for next period
CIP arrivals	£2.14	Support	
Additional NT coaching bays	£2.41	Support	Amended scope and budget
ST public transport & DDA access	£9.20	Support	
Consolidated car rental & MT facility	£8.00	Support	
New projects consulted post-RBP			
Stands 551, 552, 553	£9.35	Decision awaited	
Hangar facilities	£5.35	Decision awaited	
Minor projects	£10.00	Decision awaited	Fund for minor projects not yet known or scoped

* Gatwick's figures in 2013/14 prices.

Table: Capital investment development projects– changes to the RBP

Project / Programme	Cost (£m)*	ACC Position	Comment
HBS replacement by 2018	£158.21	Support	Gatwick/ACC agreed on joint approach to the DfT regarding date of requirement. Gatwick and the ACC agree this should be a development project as it is prior to TG2
Liquid explosives detection	£1.65	Decision awaited	The ACC indicated likely support, as a development project

* Gatwick's figures in 2013/14 prices.

Table: Capital investment asset stewardship projects – changes only to the RBP

Project / Programme	Cost (£m)*	ACC position	Comment
Stand replacement	£19.55	Support	Following review of Pavement Condition Index (PCI) replacement of 100% (50%) of stands predicted to be poor condition by 2018
ST ceiling replacement	£24.11	Support	Some budget brought forward to Q5
Commercial minor projects (incl. KFC drive through, ST retail enhancements)	£9.13	Support	ST IDL reconfiguration project removed & retail enhancements via 'churn' incorporated instead to asset line
The ACC made it clear that while it supports all of the asset stewardship projects, this support is based upon the overall budget incorporating the maximum level of potential savings identified by the ACC's consultants			

*Gatwick's figures in 2013/14 prices.

Table: Capital investment carry over projects – including changes since the RBP

Project / Programme	Cost (£m)*	ACC Position	Comment
ST baggage & pier 1	£88.60	Support	No change since the RBP
Pier 5	£2.89	Support	
Gatwick stream flood attenuation	£0.39	Support	
Consolidated security gate	£0.96	Support	Project currently at tollgate 3
FEGP replacement	£0.05	Support	
River Mole	£0.31	Support	Capital contribution to EA

* Gatwick's figures in 2013/14 prices.

In summary, Gatwick's capital programme is:

Table: Gatwick's capital investment programme for the period beyond Q5

	5 year period Cost (£m)*	7 year period Cost (£m)*
Total asset stewardship	£367.26	£555.46
Total carry-over projects	£93.20	£93.20
Total core projects	£506.71	£726.51
Sub-total	**£967.17**	**£1,375.17**
Development projects	£159.86	£159.86
Sub-total	**£1,127.03**	**£1,535.03**

* Gatwick's figures in 2013/14 prices.

Consolidation of easyJet into one terminal

Gatwick supports the consolidation of an individual airline's operations into one terminal, as this improves the passenger experience. Currently, easyJet's operation is split between North and South Terminals. When the RPB was published, a satisfactory solution had not yet been identified that would enable easyJet consolidation, given the airline's growing traffic at Gatwick. This was because a consolidated easyJet operation in the South Terminal would cap the airline's overnight stopping traffic at 53 based aircraft. Any growth in aircraft numbers beyond that point would require the overflow of operations from the South to the North Terminal. We considered the possibility of overflow to be unsatisfactory, given the original cost and upheaval of consolidating easyJet's operation in the South Terminal and the loss of benefits to passenger experience.

We note that during Summer 2013, easyJet has based 54 aircraft at Gatwick; with 51-54 aircraft stopping overnight.

Analysis of the options has continued. The latest discussions with the airline have focused on consolidation into the North Terminal, which could accommodate growth beyond 53 overnight based aircraft. This proposal also has a lesser impact on the airfield than South Terminal consolidation, thereby helping to maintain a resilient airfield operation.

However, such analysis is ongoing, particularly given easyJet's recent announcement that it has purchased all of Flybe's slots at Gatwick, and will be incorporating them into its programme during Winter 2013/14 and Summer 2014. easyJet has not yet informed us of the impact on its schedule. However, in our analysis of easyJet consolidating into North Terminal we had assumed that the Flybe slots would also be located in the North Terminal.

Major projects – fundamental messages

- **Delivery of 95% pier service in the North Terminal:** This project delivers 6% additional pier service and is essential to ensure that 95% pier service is still delivered in the North Terminal, as traffic continues to grow towards 45mppa. The project delivers flexible stands with the ability to serve both short and long haul aircraft. In comparison with previous pier service projects at Gatwick, the capex to pier service benefit ratio has improved, as illustrated in the table below.

Table: Comparison of capital expenditure vs pier service ("PSL") benefit – Gatwick projects

Pier project	Cost (£m)*	PSL Benefit	Cost / % PSL Benefit (£m)*
Pier 1 (Pier element not incl. baggage costs)	£92m	-1.2%	N/A
Pier 2 Reconfiguration	£38m	0.8%	£48m
Pier 5 Reconfiguration	£75m	2%	£38m
Pier 7	£400m	6%	£67m
Pier 6 Southern extension	£180m	6%	£30m
Pier 6 Southern extension – Pier service element (minus remote stands @ £20m, minus asset replacement scope @ £29.5m)	£130m	6%	£22m

* Gatwick's figures in 2013/14 prices.

If this project is not included in the CAA investment plan, the implications for service quality also need to be recognised by the CAA. Effectively, Gatwick will be unable to commit to the delivery of 95% pier service, as whether or not this can be achieved will no longer be within our control. The ACC have worked with us to agree and understand the modelling and assumptions for this project. The results of the modelling are being delivered during June 2013 and a conclusion with the ACC is expected shortly. It is worth noting that at least one ACC airline has written to the CAA confirming its support for this project;

- **Early bag store – North Terminal:** Further discussion has taken place on the requirement for the early bag store, with an ACC decision expected in end of June, as to whether it supports the project. ACC members now better understand the business case. Additionally, the data that we shared with Davis Langdon ("DL") was misinterpreted, with consequences for the CAA's own analysis. Improved understanding of the evidence is likely to change the conclusion that DL reached. It should also be noted, that for the purposes of this analysis, we did not use IATA benchmarks, but the actual bag ratio data for each individual airline and market.

  The key point is that without an early bag store in North Terminal, all airlines will need to restrict their check-in opening hours, as there will be insufficient make-up capacity for airlines to continue to operate as today. For example:

  - easyJet will be restricted to opening check-in/bag drop 1.5 hours prior to departure by 2018. Currently, it is officially opened 2 hours prior to departure; however, the airline routinely allows passengers to check-in several hours earlier;
  - At the moment, BA operates anytime check-in. By 2018 during peak hours, this will be restricted to 1.5 hours prior to departure for short haul aircraft and 3 hours prior to departure for long haul aircraft. The restrictions will need to be enforced from 2015 progressively, while tightening to the times shown above by 2018; and
  - Currently, Thomson offer day-before check-in for its morning flights. This facility will be lost and it will also be restricted in peak hours to opening only 1.5 hours prior to departure on its short haul flights and 3 hours for its long haul flights;

- **Upgrade of check-in and bag drop – both Terminals:** Through the results of the first trials, the savings to airlines in terms of operating costs have become clearer. We have built a model, that we have shared with individual airlines, which allows them to input their own data, to calculate expected savings. The upgrade reduces queuing for passengers and enhances the environment in the North Terminal (old area), bringing it into line with the North Terminal extension and the South Terminal (once the ceilings have been replaced). The new layout proposal also retains staffed desks for those passengers requiring this service and retains the current orientation of the desks. The ACC has indicated support for the transformation of check-in/bag drop. However, the ACC has no common view with regard to the uplift of the environment within the old North Terminal area; and

- **Border zone – North Terminal:** We have shown the ACC the revised business case for this project, which has a lower cost following further development and understanding of the technology required to create the capacity. We have explained the reduced manning ratio available to the UK Border Force ("UKBF") by the installation of e-gates. While the cost for fitting 'old' technology is cheaper (fitting manual desks is only £1.36m cheaper than using e-gates), the manual desk approach would not lead to improved queuing for passengers. Currently, UKBF is using volunteer staff to try and cover some of the manning shortfall during this summer, but even with these extra staff, not all current manual desks will be used. Therefore, the cost of the installation of further manual desks would be nugatory, as their installation would not benefit the passenger by reducing queues as intended. We note the CAA's comment regarding an SLA from the UKBF and would welcome this commitment. However, we believe that it is unlikely to be forthcoming. Gatwick does not wish the passengers to continue to suffer a degraded service, when there are things within our control which can improve this. The ACC does not support this project.

Appropriate tollgate for including a project within the core budget

We believe that all of the projects in the RBP should be designated as 'core', because they have all had tollgate 2 level of scrutiny, both by Gatwick and the ACC. We do not believe that tollgate 3 is the appropriate milestone for projects to qualify for inclusion within the core capex budget, as by that stage a project is well into development. Within our process a project becomes live and capital is allocated once it has been approved at tollgate 2. For example, the only project within our core list to have reached tollgate 3, delivery of 95% pier service, has involved many years of work and Gatwick spending circa 14% of the total cost of the project - £8.3m, which has been supported by the ACC and a change control sheet signed. Cancellation of this project at this stage would result in an unwarranted amount of waste. We could not envisage spending this amount without allowance in the core budget.

History has shown that agreement from the airlines is not always possible and that reaching agreement can often be an extended process. This increases the risk to the airport that money spent prior to inclusion within the core programme would be wasted. This would dis-incentivise investment, as well as delay or stop the delivery of benefits to airlines and passengers. If this requirement for airline agreement had existed in Q5, then the world-leading ST security central search area would not have been built. This is because ACC verbal support was available during design, however, ACC formal agreement was not granted until many months after construction had commenced.

Gatwick's proposal is that all projects passing Tollgate 2 are core, because by that stage, a business case would have been accepted and the capital would have been committed to develop the project.

However, this means that the CAA's current distinction between core and development capital is not workable. This is because it is not consistent with the tollgate process or the degree of certainty at each stage of that process, and it assumes that airline agreement can be achieved without delay or cost increase to the project(s). As stated in our RBP, we see some merit in the sort of core/development framework the CAA has in mind, it is essential that the details of any final proposition enable us to invest in improving the airport for both passengers and airlines. Therefore, we suggest a meeting with the CAA prior to finalising its proposals, so that there is full appreciation of the capex planning and implementation system.

Appropriate tollgate to trigger a project

For Q5+1, the ACC and Gatwick agreed that it was appropriate to use tollgate 2 as the stage for deciding whether a project should be subject to a trigger mechanism. This was because this is the point at which a business case is accepted and capital monies committed. Although the budget for each project was likely to change, within the project risk accounting, the ACC and Gatwick identified the practical benefit of agreeing the overall (Q5+1) sum for trigger liability, together with the principles of apportioning that to the identified individual projects at tollgate 2. This gives early certainty to the airlines about Gatwick's overall liability in relation to the agreed trigger projects. We also agreed that the project trigger definition would not be written until after tollgate 4, which is when there is more certainty on scope, cost and programme. This agreement was approved by the CAA and is working well.

The CAA are now suggesting to change that staging point to tollgate 3, rather than tollgate 4, for both a decision on whether to apply the trigger mechanism and to agree the trigger definition. This would not work within our system of capital planning, because tollgate 3 is beyond the point at which capital monies are committed. In addition, we note that the ACC is keen to attach a trigger at the point of commitment to the core budget, if the project is strategically important. At the same time, tollgate 3 is prior to of the required level of certainty on cost, scope and programme, which occurs at tollgate 4. Therefore, tollgate 3 is too early a stage to agree a trigger definition, rather, tollgate 4 should remain the appropriate point at which this should be done. We request the CAA to review this proposal.

Capital expenditure budget

We have responded in detail to the SDG report with regard to asset renewals and do not agree with its conclusions for reducing on-cost and risk allowances. These represent the actual costs of working at Gatwick compared to other, more usual environments.

Gatwick is a 24/7 live environment, within which we need to work while allowing the airport operation to continue. For some projects, this means dynamically changing the interface with the operation throughout the day. This often leads to short working windows and entails extensive coordination and consultation. Examples of this in Q5 have included: i) the check-in and arrivals area flooring in South Terminal; ii) the IDL projects in ST; iii) the project to transform the UK Borders area in South Terminal; and iv) the NT Interchange project. In addition, parts of our campus have older buildings with incomplete plans/services data. This means that in constructing changes, we are faced with the complexities of landside/airside operations, at the same time we have many stakeholders to consult with before and during any construction project. Such consultees do not just include the ACC and wider airline community, but also control authorities and our tenants, such as retailers/handling agents. Our detailed response to this report is contained in Appendix 10.

We have also responded in detail to the DL report about the core projects and do not concur with its conclusions regarding the unit costs or on-costs. The key points of this response are in Appendix 4.

At this early stage of project development, we are surprised that the CAA is proposing that a cost reduction is applied at Gatwick. Due to the majority of projects being at an early stage of development, it may be possible for costs to be incurred below estimate, it is equally possible for them to be above estimate. Best practice shows that the cost certainty of the estimates for the majority of the projects at this early stage is +/-30%.

We continue to develop the capital programme and our current budget for core, asset stewardship and carry-over projects is £967.17m for a 5 year period and £1,375.17m for a 7 year period, both in 2013/14 prices.

Q5 capital efficiency

The CAA suggests that up to £11m of capital expenditure in Q5 could be excluded from the RAB. The evidence does not warrant such exclusion.

It is also suggested that the North Terminal extension expenditure of up to £4m did not follow best practice capital management. However, this amendment has since been fully supported by the ACC, with a change control sheet being signed at the March JSG meeting.

URS suggested that expenditure of up to £7m in crew reporting project was not effectively consulted upon, and as such was not carried out in accordance with Annex G. We responded to URS' report, providing evidence that the critical period it referred to (where cost consultation did not occur) was the period when we were designing with our consultants, the proposed changes, as well as evaluating the costs. The evidence provided to URS showed that this activity was ongoing and that we did not have the cost change information until the meetings we held with the ACC representatives. We are happy to share this information directly with the CAA in order to confirm that consultation was consistent with Annex G.

Future capital consultation

In spite of URS not identifying any systemic issues with current consultation, the CAA's initial proposals would result in consultation becoming more time and cost intensive. Gatwick welcomes the CAA's comment that it is open to suggestion on the topic. Therefore, we have included a proposal in Appendix 3. For clarity, Gatwick sees the key issues arising from the CAA's initial thoughts in chapter 15 as:

- **Keeping Annex G largely intact**: Annex G was originally designed for Heathrow and Gatwick when owned by the monopoly of BAA and is therefore no longer appropriate for a competing Gatwick. Appendix 3 contains Gatwick's proposal for streamlining consultation requirements and making them not only more efficient, but also more effective, with benefits to all parties and for the timely execution of the capital programme;

- **Requirement for airline agreement (or CAA) prior to moving a project from development to core:** We have already pointed out that had this requirement been in place in Q5, the ST security project would not have been built. That is perhaps the most notable example. There were numerous other projects which were added to or otherwise significantly changed during Q5, in consultation with the airlines, all of which would be unlikely to have taken place under the regime suggested, as the requirement to produce the in-depth evidence needed to satisfy airlines prior to incorporating a project into core capex would have been too costly and time consuming to undertake. Therefore, CAA's proposed approach risks constraining future investment in the airport, with adverse consequences for service standards and passenger experience;

- **Potential requirement for all projects to be included within the trigger mechanism once they reach tollgate 3:** We believe that cost, scope and programme certainty is not known/fixed enough for a trigger to be applied at this stage of the process. At tollgate 3, the project cost estimate and programme is typically at +/-15% for the scope agreed at that point. Beyond tollgate 3, the design is carried out and the scope may change, as better ways are found of implementing the project. This is best practice in the field of project management. It is not until tollgate 4 that the cost, programme and scope are fixed to a level that would give sufficient confidence to agree a trigger definition, and even after this stage, some changes could occur. Therefore, any trigger mechanism at tollgate 4 would still need to retain flexibility as was the case in Q5, to allow that change to occur, following consultation with the airlines and then approval from the CAA.

  The CAA also proposed that the trigger mechanism should be used more widely than in Q5, but the regulator hoped that this could be done without increasing complexity or regulatory burden. In order to minimise project complexity and regulatory risk, we suggest that the CAA should only apply the mechanism to all major projects (over £10m), which the ACC/airport deem operationally important;

- **The use of P50 and P80 allowances (an allowance derived from risk modelling) and applying that to cost estimates:** We are confused by the wording in paragraph 15.26, as it appears to imply that P50 and P80 risk allowances should be applied to cost estimates, which is not the correct use of the risk model. Gatwick uses a standard class estimate system, where Class 5 is a conceptual estimate, generally used for projects prior to tollgate 2, up to a Class 1 estimate, which is the contractor's tender and used at tollgate 4. Even at tollgate 4, the project accuracy is +/-5%-10%, depending upon the level of detailed design that has been possible.

  For development capex, any estimates that we have for projects would be at Class 5, which has an accuracy of +/-30% and a risk allowance of at least 20% dependent on the project.

Therefore, following project management best practice, it would be appropriate to base any development capex on a Class 5 estimate, not to use the method described for Heathrow; and

- **Uncertainty about retaining the two tests of capital efficiency: i) best practice capital management; and ii) effective consultation in line with agreed protocol:** The CAA does not state whether these tests are to be retained, but Gatwick supports their retention. Core capex consultation in recent years has shown that attempts to obtain firm support from the ACC on some issues is both time consuming and sometimes impossible.

  A recent example of this is the project to attenuate potential flooding of the airport from the Gatwick Stream. The ACC supported the project at tollgate 4 in March JSG meeting, for the sum of £8.2m, in the knowledge that planning permission had just been awarded and conditions had been attached. Once Gatwick had assessed the planning conditions, we realised that extra funding was required and presented an R2 (Portfolio Risk & Contingency Fund) drawdown in April. Initial comment from the ACC representative was that this would be supported. However, consultants advised an ACC member that Gatwick should have known about these conditions and hence, should bear the cost. In response to questioning, we provided an explanation of which conditions had been anticipated (and the allowances made in the risk plan), and which conditions had not been anticipated and why. The ACC is still considering its position. Meanwhile, the project is continuing to progress as otherwise the cost of delay would increase from the £700k R2 drawdown figure.

  An earlier example where consensus support from the ACC has proved impossible to obtain to date, has been the A380 stand (one member – Emirates, are supportive and have written to the CAA to confirm this). This stand was successfully used for a scheduled Emirates flight in March 2013 and a chartered Lufthansa flight in May 2013. It has also enabled the airport to engage in meaningful discussions with potential new long haul carriers, one of which had made it clear that one of the necessary elements for them to consider operating at Gatwick was the ability to operate A380 aircraft.

  Therefore, it would be a retrograde step for the efficiency of process and costs if the current requirement to *consult* was enhanced to a requirement to *agree*. Experience shows that this would result in delay, additional cost and ultimately a potential suffocation of investment.

Capital efficiency beyond Q5

We have a number of concerns about the CAA's proposals concerning capital efficiency beyond Q5:

- **The CAA's proposals to make Gatwick indifferent to the timing with which it carries out core capex:** Gatwick does not support the introduction of yet more complexity into the regulatory management of its capex fulfilment. The consequence of an adjustment mechanism would be increased incentives on parties at the airport to game the governance arrangements, to disallow already part-completed projects, thereby achieving an unfair discount. Such a mechanism would be added to the costly review of capex fulfilment at the end of a regulatory period, which has previously considered additions/subtractions from the RAB value. If the CAA were to continue with this policy, then we see no additional need for an adjustment mechanism.

- **Options for bringing in capital investment expertise to airlines:** The CAA has proposed the introduction of an Independent Fund Surveyor panel, following proposals for such a body at Heathrow.

  At Gatwick, we believe that engagement with our airline customers should develop in an alternative direction. We recognise the need and potential for valuable input from our airline customers, particularly on key operational matters. We want to strengthen the links between the operational experts at the airport and the airlines, to grow the day-to-day understanding of our customer needs.

  We believe that an appointed panel of independent representatives is likely to introduce more unwarranted and expensive red tape into the commercial relationship between airport and airline customers. Further, the presence of additional panel members is likely to put a barrier between the operational staff of the airport and airline customers – to the detriment of all. This would have the effect of reducing the input of airlines into the development of the airport.

  We could envisage the continuation of the current arrangement at Gatwick, in which the ACC employ consultants, as required, to help them with their decision making, the cost for which we recover via airport charges.

- **The design of governance arrangements around approvals for projects funded as development capex before work takes place and to improve the working of existing arrangements:** Appendix 3 provides our proposal for both core and development capex and is intended as a replacement for Annex G.

5.3 Other comments on the CAA's initial proposals

CAA's chapter 5 – Capital expenditure:
This section covers specific comments which are not picked up elsewhere in this chapter.

5.3: **Inputs for modelling and demand for facilities:**
We have been able to address the ACC's concerns regarding individual capital projects, for example, for 95% pier service in North Terminal. The ACC expressed concern around the inputs to the modelling and the demand for facilities. We put in place a working group, which has held regular meetings since July 2012. In these meetings, the inputs (including traffic numbers) have been agreed prior to modelling. The results of that modelling are due to be finished at the time of writing. However, the immediate outcome of the focus on this particular project is that the ACC was able to support the £8.3m spend committed to date on exploring this issue and on carrying out the optioneering and modelling requested by the ACC.

5.17: **NT baggage reclaim:**
A typing error meant that this line was shown in the IDL business case (the actual cost was not double counted). This solution was safeguarded as part of the NT extension project during Q5 and the scope of safeguarding this area was discussed and agreed with the ACC. As such, it is not the solution which is in dispute, but the timing of the demand.

5.17: **NT arrivals transformation:**
We have put forward to the ACC a reduced scope and reduced cost option. The ACC do not support this project.

5.17: **NT coaching bays:**
This project is price neutral to the airline community. As such, the ACC has changed its stance and is now supportive of the project.

5.19: **Constructive Engagement:**
The very nature of the constructive engagement process imposed on an airport such as Gatwick, with the variety of operators and their business models, leads inevitably to the inconclusive outcome that occurred. As each airline focuses on potential impacts to price, rather than which service or capacity outcomes are required for a successful airport to meet the needs of both airlines and passengers.

5.20: **Passenger and airline interest alignment:**
We agree with the CAA's assessment that the airlines do not always represent passengers' interests. We believe that their interests can be aligned, but that is by no means always the case, due to the need for airlines to prioritise their own business interests and profitability.

An example of this is the 'Gatwick Connect' project. We are piloting the potential for passengers who *self-connect* through Gatwick to be assisted through the process, to make it easier and more efficient for them[8]. We have invested in infrastructure and re-deployed staff to ensure that we can test the potential of this initiative properly. While there is direct support from airlines taking part in the trial, there is no ACC consensus on this project and the official ACC view was to delay and not go live with the pilot this summer. This is a clear example of how the airlines do not necessarily act in the best interests of the passenger.

5.21: **ACC representation:**
While Aurigny and Thomas Cook were engaged at the JSG level, they did not participate in Constructive Engagement or the capital consultation groups that have followed. While Thomson has been more involved, the three airlines represented at such meetings were easyJet, BA and Virgin Atlantic. The ACC has also assured Gatwick that its decisions are discussed with their full membership prior to being communicated to the airport.

8 Self-connecting passengers are connecting passengers who arrange connecting flights themselves. This category of passenger is growing due to the ever increasing ability for passengers to research and book the best fares/routes online. This practice has become more common where some airlines, including easyJet, do not have interline agreements. Self-connecting passengers arrive on one flight, collect their bags, proceed through customs to landside, before processing back through check-in and security for their next flight. This is inefficient and frustrating for such passengers. Gatwick Connect improves this passenger experience by receiving bags in the baggage hall and checking them in before customs, after which the passenger just needs to go through security and into the IDL to wait for their next flight. We believe there is a significant demand for this product.

5.22: **CAA Consumer Panel visibility:**
It would be helpful if the CAA can share the findings of the CAA Consumer Panel, passenger research and complaints referred to in the CAA's document. We note that a CAA document on passenger research was released in June and on early reading we are unsurprised that most passengers were satisfied with their queuing experience as the survey was carried out in the quietest months at Gatwick (with the exception of October half term). During the busier months, our data shows that queuing at check-in/immigration and waiting at baggage reclaim are frequent passenger complaints. This is why we are seeking to address the issues in these areas via process improvement and/or capital investment. We would add this and the other data to our own research sources to continue to improve our service offer.

5.26: **ST IDL reconfiguration:**
There has been further development and consultation on this project and a more cost effective way has been proposed to increase commercial revenues which, due to the nature of the work, is now incorporated within the commercial asset stewardship and minor works business case. The ACC has supported this revised proposal.

5.30: **Additional runways:**
We note the CAA's discussion of the costs associated with work relevant for the Airports Commission. We believe that the development of runway capacity is in the interests of passengers. However, until Gatwick announces that it intends to pursue a planning application, these costs are treated as opex. See reference to the re-opener that we would pursue in this scenario in our response to the CAA's opex projections.

5.32: **Business systems transformation:**
Further detail has been discussed with the ACC and it is now supportive of this business case.

5.35: **Additional NT coaching bays:**
We have confirmed that coach operators are requiring this extra capacity and the charges will be amended accordingly to recover the capital cost over the asset life.

5.36: **ST public transport and DDA access:**
The ACC is now supportive of this project.

CAA's chapter 15 – Capital Efficiency:

15.12 & 15.26: **Cost estimation:**
We do not use the same system for cost estimating that the CAA outlined is used at Heathrow. We have explained our system both to the ACC and the CAA's consultants.

15.16: **Achievement of project milestones:**
With one exception – North West Zone (which was settled in Gatwick's favour) – it has been possible at Gatwick to establish objectively whether project milestones have been achieved, as the ACC and Gatwick have agreed in advance a trigger checklist for each trigger project.

15.27: **Minor works:**
We welcome the CAA's statement that it would look favourably on proposals to make provision now for investments that have not yet been identified, and have included a line for minor works in our updated capital programme to partly address this.

15.30: **Adjustment to the price cap:**
This point refers to annual adjustment to the price cap for development capex. Can the CAA confirm that the annual adjustment would not apply to asset renewals or core capex, as seems to be implied.

15.33: **Real-time award of cost allowances:**
We do not have the same opinion as the CAA. We believe that more risk is imposed on us as a result of this proposal. As pointed out above, in order to have cost and programme certainty at tollgate 3, Gatwick will need to spend a considerable proportion of the project costs which, under these proposals, would be at risk of not being included in the RAB.

15.35: **Capex triggers:**
The CAA implies that it can only introduce new triggers if there has been agreement between Gatwick and the airlines. We believe that this contradicts paragraph 15.29, which states that new projects can be introduced with either airline or CAA approval to a proposal from Gatwick.

15.39: **ACC expertise:**
We are open to a proposal from the ACC to introduce capital investment expertise via consultants. We facilitated this for the ACC during last year's Constructive Engagement process and are continuing to facilitate new requests using the same methodology. The ACC has not put forward a proposal to manage this differently.

6 Operating costs

6.1 Introduction

The CAA's initial proposals conclude that Gatwick's operating costs ("opex") projection is inefficient, based on a top down benchmarking and a series of consultant reviews. The proposals then reduce opex in the RAB based price by 6.5% compared to the 2013/14 projected level.

We have serious concerns about the robustness of both the benchmarking work and the consultant reports from which the CAA derives its conclusion of inefficiency. In a regulatory context, Gatwick recognises that such consultants' reports provide a degree of challenge. That is to be expected. But such a challenge needs to be based upon sound analysis and factual accuracy. That is not the case with the reports supporting many of the CAA's judgements. There appear to be systematic shortcomings in terms of factual accuracy and the evidence provided. In many cases conclusions have been based on assertion, rather than evidence. This chapter highlights flaws in the consultants' analysis, on which the CAA is depending, as well as providing new evidence from a detailed benchmarking study by AT Kearney, based upon well-established benchmarking techniques and data which serves to underline the problems with the CAA's studies, as well as providing evidence to inform better the debate.

This chapter also provides our response to other opex related points raised by the CAA.

6.2 Gatwick review of CAA's efficiency work

This section provides a summary of our responses to the CAA's efficiency consultant reports, on which the CAA based its initial proposals, under the following themes:

1) **CAA's top down airport benchmarking:** The CAA uses clearly inappropriate comparators and out of date data, which render the conclusions drawn about Gatwick untenable;

2) **CAA's comparison of Gatwick and easyJet:** Such a comparison is unlikely to be informative given the very substantial differences in the business models, as the CAA itself recognises;

3) **CEPA's assessment of top down efficiency:** CEPA's benchmarking material does not compare like with like and fails to take account of Gatwick's most recent performance;

4) **Many of the CAA's bottom up benchmarking consultant studies have been poor quality:** There are questions about the unreliability of much of the evidence and a sense that it has been strained to the limit (and sometimes beyond the limit) to produce findings of inefficiency;

5) **IDS' study over-estimates the scale of potential staff efficiencies, as well as Gatwick's ability to effect change:** The CAA has taken insufficient account of the statistical limitations of the analysis and the practical realities of effecting change without disrupting service;

6) **There are significant errors in the CAA's pension analysis:** There are also unexplained differences in approach between the CAA's treatment of Heathrow and Gatwick;

7) **Helios' central support cost benchmarking is not consistent with reliable evidence:** More detailed evidence from AT Kearney, based on thorough analysis of over 30 airports is at odds with the CAA's conclusions; and

8) **The CAA needs to ensure that it is not double counted opex reductions:** The CAA's analysis considers staff costs and functional costs, as well as a top down view and a bottom up view of costs. Each of these two sets of analysis review the same opex and so there is a significant opportunity for double counting the savings derived in the analysis;

9) **Conclusion:** The CAA does not have an adequate analytical basis to support its conclusions on Gatwick's opex and therefore, runs the risk of setting a price which compromises the service that the airport currently provides to the passenger.

Finally, a set of detailed comments is also provided, along with complete responses on each of the CAA's opex efficiency studies in the appendices.

CAA's top down airport benchmarking

The CAA has undertaken its own top down airport benchmarking analysis and concludes that "*it is clear that several airports outperform Gatwick with arguably higher levels of service quality, scale and complexity. Opex per passenger has also grown at a faster rate than the sample average*." These statements are based upon top down analysis of data, comparing Gatwick's opex with that of other airports.

The analysis presented by the CAA is flawed in a number of significant ways; in particular:

1) Some airport comparators are wholly inappropriate:

The CAA has chosen to compare Gatwick against non-comparable airports:

- **Non-European airports:** Only 43 out of 131 of the airports in the ATRS 2009 report, against which Gatwick is compared are located in Europe. The rest are in Asia-Pacific and North America. Non-European comparisons are problematic because the commercial and regulatory environments within which they operate are very different. For example, Australian airports have a higher proportion of domestic passengers, and terminals are often operated by airlines rather than by the airport; while Northern American airports operate under different funding regimes. In addition to this Gatwick is located in the South East of England, one of the most expensive areas of the world.

  Similar to the ATRS sample, the Leigh Fisher benchmarking report contains a substantial number of airports from outside of Europe. The CAA's own benchmark uses Hong Kong airport randomly as a comparable airport. The basis for this is not clear. For example, Hong Kong was built relatively recently and can be expected to incorporate modern design and associated efficiencies that are simply not available to Gatwick. Further, we note that it is not clear whether the airport receives state subsidies.

When the comparison based on the ATRS data is limited to the European Sample in the ATRS report, then the sample average is £11.86 per passenger (compared to Gatwick at £8.69 per passenger). This suggests that Gatwick is significantly more efficient than the CAA concludes.

- **Smaller regional airports as comparators:** We note that small regional airports such as Aberdeen, Birmingham, Glasgow and Edinburgh have been compared to Gatwick in the initial proposals, but these are not comparable for the purpose of benchmarking costs, because of their limited size and complexity.

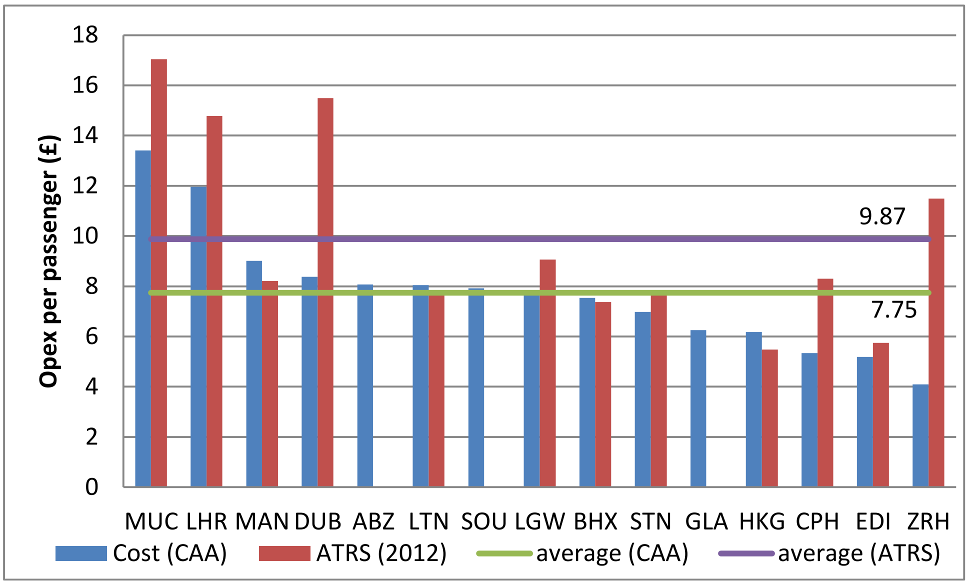
2) The data used by the CAA is out of date:

Both the ATRS 2011 and Leigh Fisher benchmarks use 2009 data. Comparison of BAA Gatwick from 2009, before separation, does not represent the current performance of the airport and is therefore misleading. Further, we note that more recent editions are available for both of these reports, each showing year on year improvements in Gatwick's efficiency. The CEPA study has a similar deficiency, meaning that this is a systematic fault running through the CAA's benchmarking evidence.

3) Unstable comparisons are used:

Comparisons between the CAA's own benchmarking, and the benchmarking reports reveal instability between comparators. The figure below provides a comparison between the CAA's data, and data from the ATRS 2012 report. This suggests that the CAA's data is significantly underestimating opex of some of the airports relative to the sample, particularly that of Zurich airport, but also Dublin, Copenhagen and Munich.

Table: Comparison of CAA opex analysis with ATRS 2012[9]



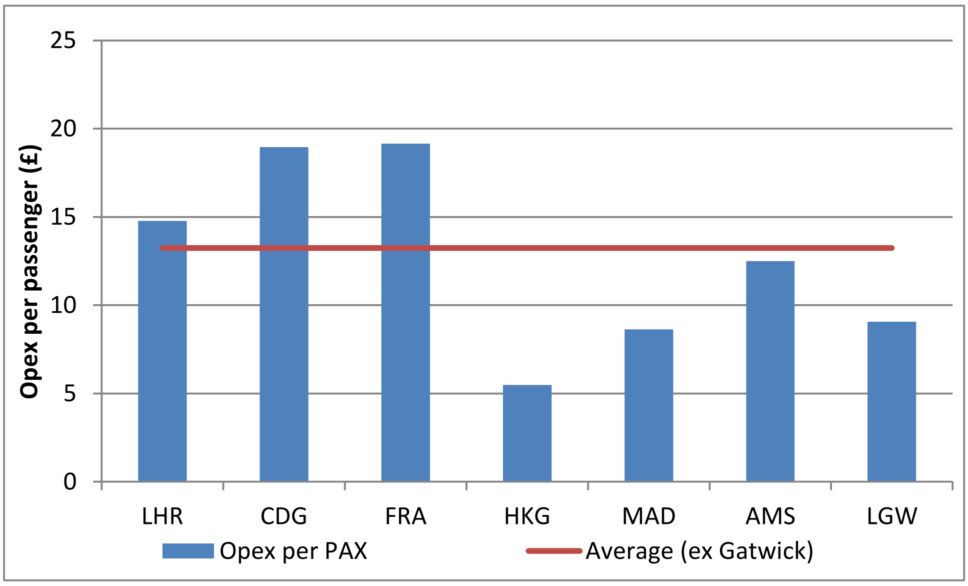
Source: Gatwick analysis; data from CAA figure 6.4 and ATRS 2012.

[9] No ATRS data was available for ABZ, SOU and GLA.

4) Poor interpretation of data presented:
The CAA argues that "*several airports outperform Gatwick with arguably higher levels of service quality, scale and complexity*". We note that of the airports with lower cost than Gatwick, only Hong Kong is larger and "*more complex*" (more on this below), while the others handle at least 8m passengers less (the largest being Zurich at approximately 24m); and similar number of airports of more comparable size (e.g. Dublin, Munich and Manchester) have higher opex, according to the CAA's data.

5) Conclusion based on comparison with Hong Kong (HKG) airport are flawed:
We note that the CAA is comparing Gatwick with Hong Kong (HKG) airport, noting in particular that this airport is more complex, yet cheaper. While we acknowledge that HKG may be considered more complex we note that comparisons of this type need to be treated with caution. In particular, we question whether HKG is representative of airports of similar complexity in Europe. The figure below illustrates the substantial difference between Hong Kong and European Airports of comparable size. In addition comparisons with airports such as Hong Kong need to consider the different institutional contexts within which they operate, for example some opex may not be funded by the airport. The scope for such discrepancies increases as Hong Kong is not subject to the EU State Aid regime. We understand that Hong Kong airport is in receipt of subsidies not available in the EU. The comparison with Hong Kong further highlights that while some opex efficiencies may be achievable with modern, purpose built facility, in the case of Hong Kong this has come as a result of significant capex estimated at over $20bn.

Figure: Opex per passengers of large European Airports



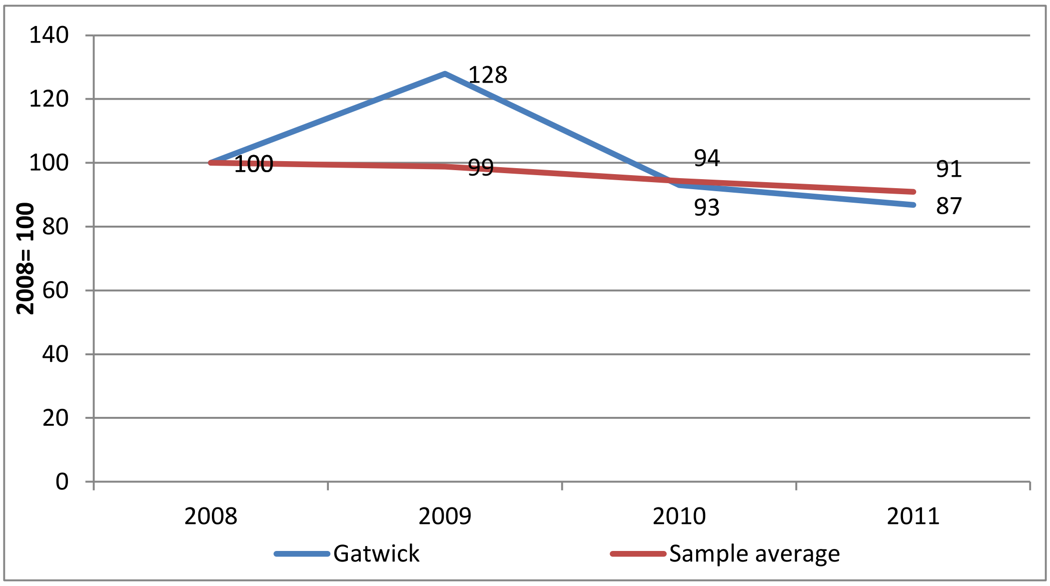
Source: Gatwick analysis using ATRS 2012 data.

6) Evidence of efficiency has been dismissed arbitrarily:
We note that in the Booz Allen 2012 study undertaken for Heathrow the average passenger size of the 13 airports included is 30.6m passengers a year, suggesting it should be very appropriate for

comparisons to Gatwick. However, the CAA states that "*this study was primarily intended to benchmark Heathrow and the average costs of the sample may therefore be less comparable to Gatwick*", and hence, the CAA decided to dismiss the evidence of Gatwick efficiency derived in the benchmarking. There is clearly no sound basis for not taking account of this evidence and we request the CAA to reconsider this evidence that shows that Gatwick is efficient.

7) CAA's time series conclusion of inefficiency is dependent on starting date:
The CAA has calculated an index to compare how opex has developed over time at Gatwick and a sample of other airports, which shows Gatwick to be inefficient. However, this conclusion is dependent on starting the index at the year 2000, which appears to be an arbitrary start date. Taking a Q5 time series comparison, Gatwick has actually outperformed the CAA sample over the Q5 period, as shown in the figure below, which uses the same CAA dataset. Further, we note that a discussion of external factors potentially affecting opex at individual comparator airports is absent[10].

Figure: Opex per passenger index 2008-2011



Source: Gatwick analysis of data in CAA's Figure 6.5.

The CAA's conclusion on Gatwick's inefficiency is found despite the airport achieving significant service quality improvements over the same time period and it ignores the fact that opex at Gatwick was particularly badly affected by the changes to security following the liquid bomb threats.

New evidence

These concerns about the CAA's top down cost benchmarking are serious. They suggest systematic problems of sample selection, periods over which comparisons are made, and judgements drawn. These cast doubt on the validity of their continued use in this regulatory exercise. If the CAA wishes to

10 For example Switzerland (and hence Zurich) only joined the Schengen area in December 2008.

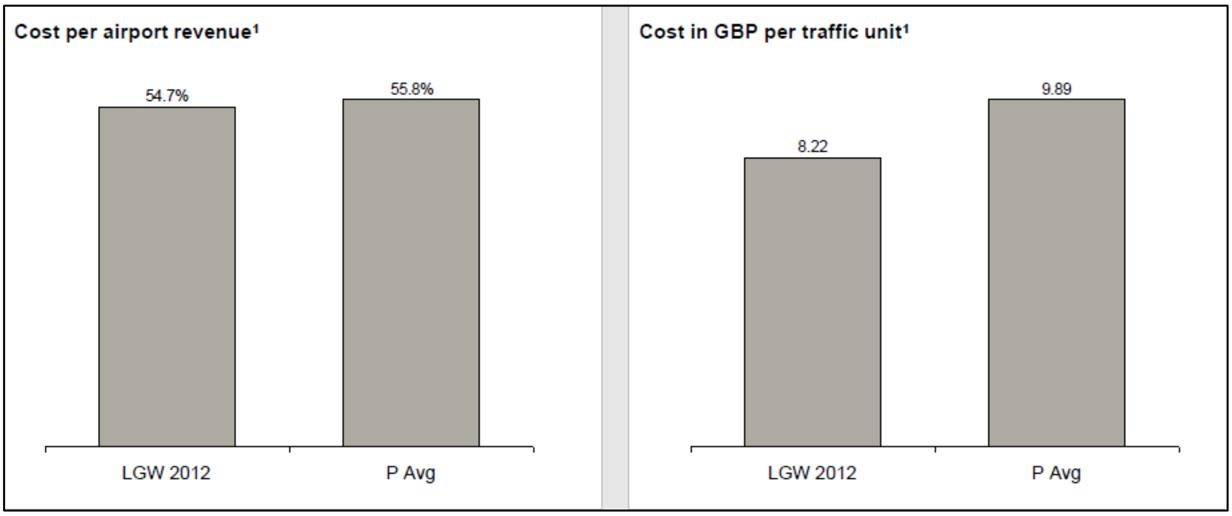
continue using these data, it needs to examine these points objectively. To assist the CAA, Gatwick has commissioned airport benchmarking of its own. This was undertaken by A T Kearney through its well-established 32 airport benchmark.

A T Kearney's airport benchmark

A T Kearney operates a large airport benchmark panel. Each participating airport is subject to AT Kearney analysis, to ensure that opex items are comparable, given that each airport will organise its management and functions differently. When Gatwick participated in the AT Kearney review, we spent a number of months with the consultant's team reviewing functions and cost items for financial year 2011/12. Through this level of rigour, we can be assured that the benchmark against which Gatwick is compared has been carefully assembled, which gives credibility to the outcomes.

At the top down level, AT Kearney reviewed Gatwick's total operating costs for 2012/13 against its panel. This analysis revealed that Gatwick was 2% more efficient than comparable airports when total costs are normalised by traffic and 17% more efficient when normalised by passengers and cargo ("traffic unit"), as shown in the figure below:

Figure: AT Kearney's total operating cost benchmarking



Source: AT Kearney (see Appendix 5); 1. Without groundhandling costs

The greater rigour of the AT Kearney analysis and the flaws in that presented by the CAA suggests that properly constructed top down benchmarking shows that Gatwick's total operating costs are efficient.

CAA's comparison of Gatwick and easyJet

In paragraphs 6.39-6.41, the CAA compares Gatwick to easyJet, and concludes that Gatwick is inefficient. This is despite comparisons with airline opex performance being unlikely to be informative. In particular, we note that easyJet opex performance over the observed time period will also be affected by:

- An increase in fleet size from around 20 Aircraft to 200 in 2011;

- An increase in aircraft size with the proportion of A320s relative to A319s increasing, particularly towards the end of the period; and

- Increased stage length, leading to an increase in the ASK metric.

This suggests that the comparison is not appropriate. An older organisation and growing less is not comparable at all to a new company growing quickly and, as a result, achieving growing opex efficiency over time.

The CAA itself admits that "*comparisons between airlines and airport operators are imperfect*". The weight it places on this piece of evidence depends on it showing "*similar results to the previous inter-airport comparisons*". However, as we have pointed out above the results of these comparisons are themselves flawed and, as a result, the CAA cannot place the weight it does on this evidence from comparison with easyJet.

CEPA's assessment of top down efficiency

CEPA undertook a top down assessment of the potential for opex efficiency at Gatwick, Stansted and Heathrow. The analysis concludes that based on comparisons of change in efficiency, Gatwick has scope for catch-up efficiency. CEPA also estimates that efficient organisations would see a net frontier shift of between 0.9 and 1.0% per year.

Gatwick considers that the CEPA study contains a number of significant flaws which severely limit its applicability and relevance to Gatwick. Notably:

- **The separation of ownership of Gatwick from BAA in December 2009 is not considered:** This has a substantial effect on the analysis of labour productivity as central functions, previously provided at BAA Group level, had to be created afresh at Gatwick. The 2010 Gatwick annual report highlighted this effect and, without adjustment, this change will skew the analysis significantly;

- **Historic analysis:** It is questionable to what extent conclusions drawn from historic performance under BAA ownership are relevant to a separately owned Gatwick which has, since separation, achieved a marked improvement in performance;

- **The CEPA analysis treats the airport product as a constant:** This ignores the fact that service quality at Gatwick has been a major focus in Q5. Since separation Gatwick has improved its service quality offering and is now:
    - Meeting and beating all of our SQR targets consistently; and
    - Investing in quality that has not been entirely caught by the SQR measures; this includes family assistance lanes, better PRM service, south terminal security, train station improvements and south terminal forecourt;

- **CEPA compares Gatwick to network utilities such as electricity and gas distribution networks, transmission networks and water companies:** This comparison is based on these being "large scale customer facing regulated utilities'. While CEPA quotes a precedent from ORR for this approach, we note that Network Rail is a major network infrastructure provider, similar to utilities, while Gatwick is not a network company. There is no proper assessment of whether the ORR precedent is relevant or valid for Gatwick; and

- **Impact of post 9/11 security changes:** We note that while some analysis of this impact was undertaken in relation to labour cost productivity, this was not done for the analysis of Real Unit Operating Cost (RUOE), upon which the assessment of frontier shift is based. We are surprised that this critical driver of our operating costs has not been considered as the scale and scope of changes made since 9/11 have been such that any analysis without consideration of their effect is likely to be unreliable.

Gatwick commissioned the consultancy, Oxera, to undertake a detailed critique of the CEPA assessment. Oxera, which has significant experience in undertaking top down efficiency assessments in regulated sectors, highlights a number of significant concerns with the CEPA analysis as summarised in the table below.

Table: Summary of Oxera assessment of CEPA top down analysis

Concern
RUOE
The rationale for the selection of the comparator airports is not clear
Key differences between Gatwick and other network sectors are not considered
Estimates have been derived over an inappropriate time period
No adjustments for the break-up of BAA
No adjustments for the increase in security costs, which are primarily outside Gatwick's control
Total factor productivity (TFP)
No adjustments for the break-up of BAA
The TFP analysis fails to capture changes in the economic climate
The TFP estimates fail to control for possible transaction costs or structural inefficiencies
Labour, energy, materials and services (LEMS) cost measure
The LEMS analysis fails to capture changes in the economic climate
CAA/CC productivity measure
No adjustments for the break-up of BAA
No adjustments for the increase in security costs, which are primarily outside Gatwick's control
No adjustments for the decline in passenger numbers due to the financial crisis
Output price indices
The LEMS analysis fails to capture changes in the economic climate
Productivity estimates from the Airport Benchmarking Report Study (ATRS)
No adjustments for the break-up of BAA

Source: Oxera analysis.

Oxera concludes that:

The concerns highlighted in this note significantly affect the conclusions that can be drawn from the various CEPA analyses undertaken to date:

- The RUOE estimates are based on inappropriate comparators, and fail to control appropriately for key changes in the airports market in the South East, such as the break-up of BAA. In addition, the RUOE estimates fail to take into account the higher costs as a result of additional security requirements, and Gatwick's higher and improving quality of service;

- The labour productivity measures also fail to control sufficiently for key factors such as the costs associated with the break-up of BAA, the increase in security costs, the decline in passenger numbers due to the financial crisis, and Gatwick's higher service quality; and

- As acknowledged by CEPA, there are a number of limitations associated with the ATRS, including the failure to capture the impacts of sale of Gatwick.

These concerns suggest that the scope for catch-up efficiency at Gatwick derived from the above measures is likely to be overestimated.

In addition, this note has highlighted concerns with estimates of the scope for ongoing efficiency:

- The TFP estimates have failed to account of the break-up of BAA, the deterioration in macroeconomic conditions, and the possible transaction costs or structural inefficiencies experienced by some comparator companies; and

- The LEMS cost measure and output price indices fail to capture the change in the economic climate.

These factors suggest that it would not be appropriate to rely on these estimates without further analysis of the impact of the issues identified by Oxera.

The full report from Oxera is attached as Appendix 6.

Many of the CAA's bottom up benchmarking consultant studies have been poor quality

The CAA engaged a series of consultants to review Gatwick's opex, from a bottom-up perspective. Across the different consultants there have been systematic problems with the quality of the work. Our concerns are summarised as:

- **Problems with benchmarking:** We have a number of major concerns about the consultants' benchmarking work:

    - **Limitations of external benchmarks:** Too little work has been undertaken to normalise Gatwick's data with the comparators, to ensure comparability. We have direct experience of what is required. AT Kearney spent months with our finance team to ensure that a detailed list of activities within each functional area, was consistent with the benchmark. None of the consultants engaged by the CAA interrogated our figures to understand how the airport is organised and ensure that they were comparing like with like. Without this work, we believe that external benchmarking can be of only limited use in understanding the ability of a business to achieve targeted levels of cost;

- **Limited number of comparators:** Too few comparators were sourced to generate any reliable conclusion. If Gatwick is compared to only three other airports, then the benchmark is too sensitive to the arbitrary choices of the other management teams and there can be no assurance that the benchmark represents best practice; and

- **Validity of comparators:** Too many conclusions were drawn from dubious comparisons, including data from the US, with non-comparable businesses and with companies many multiples larger than Gatwick. In one instance, a consultant used promotional material from another consultant's website, rather than sourcing a reliable comparison.

As a result of these flaws, the benchmarking exhibited in the consultant reports cannot be relied upon. Unless it is improved and made more transparent the CAA should attach little weight to its results.

- **Lack of evidence:** The terms of reference for consultants from the CAA clearly required an "*evidenced assessment*". There are many places in the reports where the consultants have derived conclusions without sufficient evidence. This is despite the terms of reference requiring that "*findings should be supported by a clear evidence base*";

- **Achievable efficiencies:** Again, the terms of reference required an assessment of "*efficiencies that might be achievable*". We are very concerned that the consultants have made little attempt to understand the effect of the implied efficiencies on the business and whether they are achievable (let alone realistic). This is despite the consultants spending many months on their projects, with sufficient time to have conducted such an investigation. We believe that such an assessment is required and in its absence many of the consultants' conclusions lack credibility;

- **Level of efficiency targeted:** In addition to the many problems above around the quality of the work conducted, there is also an issue around the target benchmark used. We believe that it is both unreasonable and inconsistent with best practice systematically to expect that the efficiency of all of Gatwick's functions should match the toughest possible external source found. Even the most efficient organisations will find areas where improvements can be made, not least as what constitutes efficiency constantly evolves. The approach conducted in many of the studies is likely to lead to unrealistic efficiency targets; and

- **Unbalanced assessment:** The consultants made recommendations for efficiencies in every area of operation that they investigated, despite even their own workings showing mixed efficiency verdicts for some areas. This leads us to conclude that the assessment is unbalanced –which may have been promoted by the requirement written into the CAA's terms of reference to find "*an evidenced assessment of the scale of efficiencies*", rather than 'an evidenced assessment of the scope for efficiency'. However, that does not excuse the lack of balance in the findings, nor avoid the need for the consultants to balance better the conclusions offered.

We comment on each of the consultant reports in the Appendices. Our concerns stretch across each of the studies and we request the CAA to work with its consultants to assess carefully what evidence has been collated and to amend its final proposals.

IDS' study over-estimates the scale of potential staff efficiencies, as well as Gatwick's ability to effect change

We have two main concerns about implications drawn from the IDS report:

1) Failure to recognise benchmarking limitations; and

2) Achievability of key conclusions.

Failure to recognise benchmarking limitations
We identify in Appendix 7, a number of significant, detailed issues with the IDS report. Here we focus on more generic issues which go to the heart of the conclusions that the CAA is drawing. The nature of benchmarking, not least in area where there may be issues around precise comparisons of roles, is that there is likely to be some statistical noise for which allowance should be made. This was the approach explicitly employed by IDS when it undertook similar pay benchmarking for the CAA in respect of the last NERL review when it effectively disregarded observations within 10% of the median. In the Gatwick report, IDS appear to employ similar statistical caution when they discuss pay rates for individual roles (for instance in paragraph 2.3.2). However, this does not appear to have been carried over into calculation of the overall variance in Gatwick pay from the median.

For consistency with IDS's NERL report, and IDS's observations on individual roles in their current report, the calculation of overall deviation of pay rates from the median should take account of this 10% band. This might be done in a number of ways, but one method consistent with IDS's overall approach might be to disregard, for calculation of the overall pay deviation, all pay observations within 10% of the median. This would mean that only pay rates above 10% would count towards the calculation and only to the extent that they exceeded 10%. An alternative, broader brush approach which would also have merit (because it would offset 'underpayments' against 'overpayments' and therefore present a truer overall picture of Gatwick's pay position) would be to compare the relevant Gatwick cash paybill to the general market median with allowance for the 10% statistical tolerance. On this latter basis any overall pay inefficiency would be in low single figures.

We look to the CAA and IDS (in giving their professional advice) to consider whether the current calculation of pay inefficiency is consistent with best practice as previously identified by IDS and internally consistent within the IDS report. There is a risk (which we have also identified on pensions, as detailed below that the CAA's conclusions are running ahead of the evidence that IDS has provided.

Achievability of key conclusions
Notwithstanding the concerns about the conclusions that the CAA has drawn from the benchmarking – which go to the overall scale of pay changes which may be regarded as justifiable – and some of the detailed reservations around IDS's specific benchmarks, Gatwick acknowledges that a number of our pay rates are above the market levels that we would prefer to see, particularly in our security function. This situation reflects historic wage rates inherited from BAA, before the change of ownership.

However, new management have taken a number of actions since the sale of Gatwick, some of which need to be given due weight by IDS, including:

- Not offering a defined benefit scheme to new joiners;
- Developing rostering efficiencies to ensure that we improve productivity and therefore reduce staff costs per unit of output;
- Reviewing the management structure, thereby reducing internal grading and allowing us to recruit at appropriate market rates; and
- Seeking to de-link pay settlements from a standard 'RPI plus' settlement and to lower pay bands for new employees.

The pace of change is limited by industrial relations constraints, and we have significant concerns about the pace of change implied by the judgements drawn by the CAA from the IDS analysis. In addition to consideration of the appropriateness of the conclusions the CAA has drawn, there also needs to be appropriate focus on the achievability of staff cost related proposals while retaining the continuity of service by which, elsewhere in its proposals, the CAA rightly sets some store.

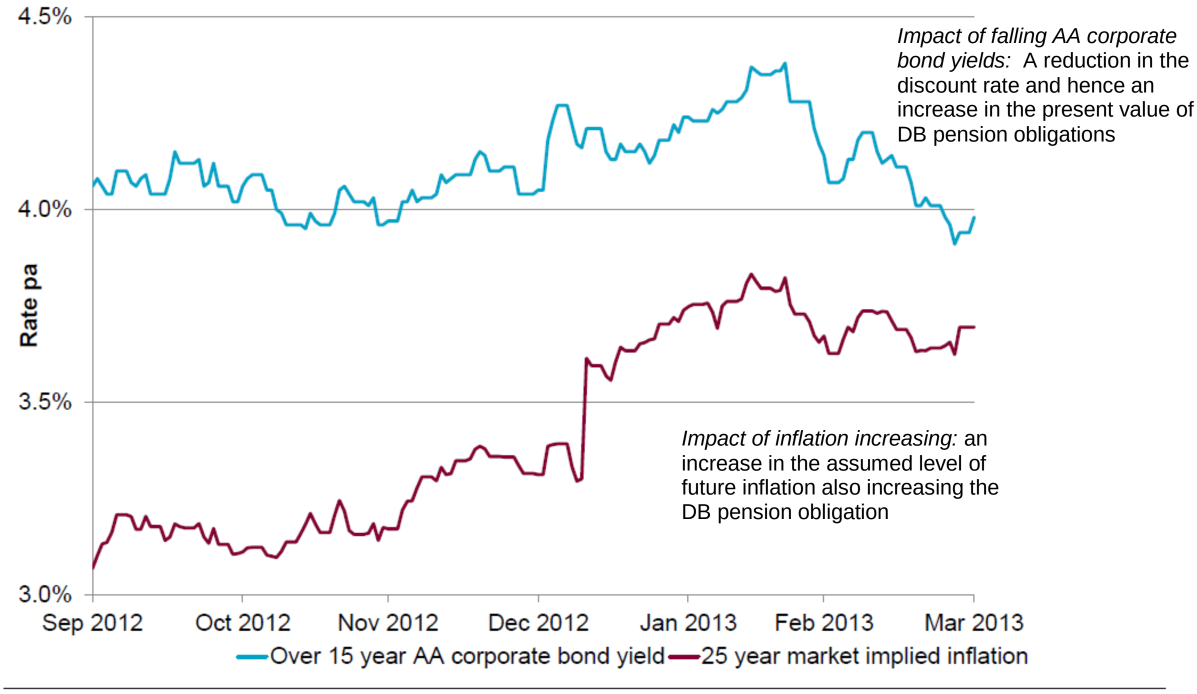
There are significant errors in the CAA's pension analysis

Gatwick is pleased that the CAA has recognised the significant reduction in pension costs that has been achieved through the closing of the defined benefit ("DB") scheme to new entrants and replacing it with a defined contribution ("DC") scheme for new starters. It is also important to note that the closure of the DB scheme to new members limits the obligations on the Company to provide benefits in the future. The DB scheme will effectively 'sunset' over the longer term. This is critical to analysis of Gatwick's overall longer term opex base and the focus the Company has effectively brought to managing future pension costs to an appropriate level. As the CAA itself knows with its own pension fund, the long term nature of pension obligations means that even significant reductions in entitlements delivers significant savings in the near term.

Gatwick is concerned by the comparisons drawn by the CAA in paragraphs 6.50 and 6.51 between Gatwick's pension costs and those of "similar size" companies. The comparator set used in the IDS report includes a significant number of pension schemes of various sizes and from various industries, not all of which are reasonable comparators for Gatwick, thereby distorting the relative positioning of Gatwick's pension benefits. A more appropriate comparator set would focus on other airports, regulated businesses, or state companies (or former state companies). The CAA has the pension data for Heathrow (e.g. DB contribution rate – 40%), Stansted and NATS. These would be more appropriate benchmarks for Gatwick than the broader set used by IDS, as might the CAA's own arrangements which reflect a similar history of DB pensions but a somewhat later effort to grapple with the issues involved.

In addition, the comparator set covers the period from 2007 – 2011. This out-of-date information is then used to benchmark the Gatwick pension costs for 2013 and future years. This renders the benchmarking exercise irrelevant given the significant negative movements, from a pension funding perspective, in both corporate bond yields and inflation from 2012 – 2013 (see below).

Figure: Corporate bond yields and inflation from 2012 – 2013



Source: Bloomberg

Further, we draw the CAA's attention to the following comment made by IDS in their report – "*Please note that the overview of pension trends are provided to set the scene and that a direct comparison between the general information and the specifics of the Gatwick scheme should not be made. A full comparative analysis would require in-depth pension scheme information from a range of similar airport/airline schemes and this is beyond the scope of the analysis here.*" This clearly indicates that direct comparisons between the general information in the IDS report and Gatwick's pension costs should not be made. The CAA has clearly used the information provided by IDS in a way that was not intended. Moreover, even if such comparisons were used, they cannot provide a guide to what can be achieved over the period beyond Q5, given the long term nature of the obligations that Gatwick already has and the many external influences on the cost of existing pension obligations.

Gatwick has implemented a number of pension reforms to reduce the future cost and risk of pension provision. However, in common with other companies across the UK, Gatwick has experienced increases in the cost of providing DB pensions due mainly to changes in corporate bond yields and inflation (see above) which are outside the control of management. As an example, since the Revised Business Plan, our projections for the future service contribution rate have increased from ✂ to ✂. The Company continues to manage actively its pension costs within the parameters of ensuring operational resilience of a key national infrastructure asset (i.e. avoiding industrial action or other service disruption).

Defined benefit pension scheme deficit funding
Gatwick disagrees with the CAA's Initial Proposals that it is "*not minded to include the costs of the pension deficit in the final proposals*". Gatwick's expected pension deficit is only ✂ and is mainly the result of changes in corporate bond yields and inflation (see above) which are outside the control of management. It is not the result of underfunding the scheme during Q5.

As noted above, the IDS analysis of Gatwick's pension costs relative to the comparative set in their report is not directly relevant and has been recognised as such by them (see above). Further, Gatwick's defined benefit pension costs are significantly lower than HAL's (c.40% contribution rate) and within the 25% cap set in the Q5 decision.

Finally, the following is stated in paragraph 5.87 of the CAA's Initial Proposals for HAL – "*HAL has argued that pension deficit costs should be allowable in the settlement. The CAA will consider further the appropriate level of this allowance based on HAL's relatively high pension costs over Q5 relative to the 25% limit set in Q5*". The Company do not understand the inconsistency between the Initial Proposals for Gatwick and HAL in respect of pension deficit funding despite the significantly lower percentage cost of Gatwick's DB pension scheme relative to HAL. Gatwick will be seeking to engage constructively with the CAA on this matter.

Helios' central support cost benchmarking is not consistent with reliable evidence

The CAA engaged Helios to review Gatwick's central support costs. We have not yet received a final version of the Helios report. However, we received a draft final version of the document, within which Helios concluded that in each of the support functions, efficiencies could be found. In Appendix 8, we provide our detailed comments on the Helios study, which highlights the lack of credible benchmarks and many other flaws in the analysis.

While we do not accept the conclusions of the Helios study on the strength of its analysis, we wanted to positively contribute to the analysis by commissioning AT Kearney to consider the same scope of costs. AT Kearney's benchmarks are based on a panel of 32 airports (compared to the 4 airports in the Helios study), each of which has been studied in depth by the AT Kearney team. This team spent a number of months at Gatwick, checking in detail the definitions of the functions and costs to be benchmarked in order to ensure comparability within the benchmark. The credibility of the AT Kearney analysis is confirmed by the fact that each of the airports in which Gatwick is compared has been subjected similarly to painstaking detailed analysis by the AT Kearney team, and by the fact that this is an ongoing, carefully structured benchmarking exercise – very different from the Helios approach. The AT Kearney report is attached in Appendix 5.

We note that Helios concluded that there were efficiencies to be found in every aspect of central costs. This suggests that, despite the substantial overall increase in Gatwick's opex efficiency since break-up, there are no areas in which Gatwick can be deemed 'efficient' – a result which we do not believe to be credible. AT Kearney did find a few areas in which Gatwick was less efficient than comparators: first, in office facility management, where Gatwick's legacy and ageing office stock, combined with legacy BAA utility contracts, hinder efficiency; and in general marketing, where Gatwick, operating in an ever more competitive market, requires more marketing spend than at most comparable airports that are not in competitive markets.

Importantly, the scope of AT Kearney's study incorporated both the staff and non-staff costs elements of the central support cost functions. This means that the level of efficiency derived covers both the Helios and IDS reports. Given this credible analysis, we believe that the CAA, in its final proposals should remove the majority of its claimed efficiency savings against central support costs.

The CAA needs to ensure that it is not double counted opex reductions

The CAA provided a separate breakdown to Gatwick of the way in which its opex reductions had been created, as shown in the table below:

Table: Composition of the CAA's opex cuts

Opex in 2018/19		
£m 2011/12	**Low Stretch**	**High Stretch**
RBP	301	301
Wage efficiency	-13	-19
Frontier shift	-7	-7
Other opex	-0	-6
Pension efficiency	-4	-5
M and A	-1	-4
Central services	NA	NA
Total Efficiency	- 25	-41
CAA	277	260
Cost reduction factor (Approx)	0.8%	2.0%

Source: CAA presentation to Gatwick, 10 June 2013.

The CAA's bottom up opex consultants were asked to provide low and high stretch efficiency options, within functional areas (e.g. HR department) and for staff costs in general (some of which staff members will work in the HR department). In general, the low stretch option was based on some form of benchmark, with the consultant coming up with further ideas for cuts in the form of the high stretch option. Similarly, from a top down perspective, the consultants provided a 'frontier shift' number, which accounts for general efficiencies over time in the economy.

In spite of the flaws and lack of credibility in the many of the individual consultant reports identified in this response, there is a risk that the CAA is double counting efficiencies, both between: i) functional and staff cost assessments (i.e. finding efficiencies for the HR department and then finding staff efficiencies, some of which could work in HR); and between: ii) top down and bottom up assessments. We would expect the CAA to clarify to stakeholders why the difference between the low and high stretch options, over time, is simply a bottom up expression of the ways in which the frontier shift, from a top down perspective, could be achieved. This is particularly important in Gatwick's security function, which is benchmarked to be process efficient.

6.3 Conclusion: Serious effect of opex cuts on the future of Gatwick

In conclusion, the CAA's top down benchmarking has significant flaws which undermine its credibility – a point given further force by the very different results of the AT Kearney work. Similarly, there are flaws in the CAA's bottom up analysis. The combined effect of these flaws is to diminish seriously the credibility of the CAA's judgements and the initial proposals that it has made. The evidence presented in this chapter and in the relevant appendices needs to be reviewed thoroughly by the CAA and reflected in proposals more objectively founded on reliable evidence available.

The clear disconnect between the CAA's proposals and the reality of Gatwick's opex performance means that their implementation would be detrimental to Gatwick and its passenger and airline communities. This is particularly so against the recent history of Gatwick's success in improving its service to passengers, as already reflected in its ASQ ratings. Opex savings that are not manifestly justified by reliable evidence would put recent improvements at risk and compromise the development of the airport's competitive positioning - a result at variance with the CAA's duty to promote competition. As a result the CAA needs to review its proposals fundamentally, in view of the questionable evidence base for them.

6.4 Specific comments on the CAA's initial proposals

6.13/6.23: **Security cost efficiencies:**
The CAA recognises that the scope for reducing Gatwick's security operating costs through further process improvements is limited.

Gatwick does not accept the statement from airlines that there is a "lack of efficiency planning" in the security area. In particular, we draw the CAA's attention to the NT security & CSG projects, both of which were initiated and planned with the intention of achieving opex efficiencies as well as improving passenger experience. Those efficiencies have been reflected in our opex projections.

Further, we challenge the proposition that there are economies of scale to be achieved between Gatwick and Edinburgh airport. The ACC comment that they would expect 'group buying of shared type opex'. Although Gatwick and Edinburgh are not part of the same group from either a legal, tax, regulatory or operational management perspective, we have considered the potential for buying collaboration and synergies. However, Gatwick holds the great majority of the volume in most cases, so the benefit is limited.

The ACC gives a specific example of insurance costs and suggests there are efficiencies from group buying in this area. Gatwick has already looked into this area in depth with our brokers and, while a joint approach to the market is possible, the multi-ownership structure and different risk profiles of individual airports means that separately documented and priced policies are unavoidable.

For security costs there are no economies of scale between Edinburgh and Gatwick. Of our security cost of £80m, £64m is staff costs and £13m is police costs. There is no link between Sussex and Scottish Police making further savings in that area difficult to achieve.

6.54: **Current police cost is efficient:**
We believe that current provision for police costs is efficient. Gatwick airport employed a former Deputy Chief Constable of Sussex Police to ensure these costs are as efficient as we can make them.

6.63-6.67: **Proposals for security costs still have flaws:**
The CAA's reasoning appears to be based on a misunderstanding of the drivers of efficiency at Gatwick compared to other airports. While it is true that some of the short haul airlines, including easyJet, operate a "one bag policy" this is not the most important determining factor behind the efficiency achieved in the South Terminal. In particular:

- The 'pay extra for hold luggage' model adopted by airlines such as easyJet incentivises passengers to use maximum sized cabin bags (and in the case of easyJet of any weight). This leads to Gatwick security processing a greater proportion of densely packed maximum sized bags. These take longer to process;

- Conversely the more traditional 'free hold luggage' model traditionally used by BA encourages passengers to carry less – and less tightly packed - baggage on-board the flight;

- In addition, some short haul airlines operating at Gatwick, such as Norwegian, follow a similar hand luggage model to BA, allowing a personal item such as a laptop bag in addition to the hold luggage, while charging extra to place luggage in the hold; and

- Gatwick notes that it is innovations such as increases in tray size that have allowed Gatwick to deliver efficiency in the South Terminal, not easyJet's one bag rule vs BA's two bag rule as the CAA suggests.

As a business case, the introduction of body scanners is supported by the reduced number of staff manning a lane[11]. We do not consider that any absence reduction at this stage is tangible and hence not included.

We note that the CAA refers to "potential for transition risks" (paragraphs 6.71-6.74). We consider this to represent a substantial understatement. Further, we do not accept the comparison between

[11] We also note that the comment around potential savings from different utilisation of archway metal detectors is flawed. The main security screening element (the only area where multiple lanes are operated for significant periods) represents only 50% of 1200 ASOs and reducing manning from 12 per two lanes to 11 per two lanes is about a 10% reduction, so it may be closer to 60 FTEs (30 per terminal). As part of our work on implementing body scanners (which makes the 12 to 11 move possible due to the reduced hand searching by our officers), we undertook this calculation resulting in a number of 15 FTEs per terminal.

baggage security and passenger security staff. In particular, we note that baggage security requires no actual interaction with passengers. Gatwick has placed considerable emphasis on treating our passengers as guests and consider that comparison between these two work functions is inappropriate in the context of Gatwick.

Additional points:

- **NATS contract costs:** It does not seem to have been recognised by the CAA that a significant component of the NATS contract involves asset ownership and management on the part of NATS. Any revised contract for ATC (with NATS or another supplier) for a services-only provision will result in an increase in capital expenditure by Gatwick for asset management (approximately £2m p.a.) plus the buyout by Gatwick of existing assets on NATS books (most notably the tower). Overall, achieving lower opex in ATC charges, will require an additional significant amount of capex, which is currently unplanned;

- **Utilities/UK Power Networks:** This is the same situation as NATS in that opex charges are larger than perhaps some comparators, due to the inbuilt capital charges. To change this will require a significant amount of currently unplanned capex. The CAA has reviewed this situation before; and

- **Additional runway capacity development costs:** Gatwick believes that any immediate opex of contributing to the Davies Commission should be included in calculations of efficient opex. We estimate the work associated with providing the Airports Commission with evidence is likely to be around £10m. With respect to costs incurred after Government support for additional runway capacity at Gatwick, it would seem that this - in a RAB world - should be the subject of a re-opener.

7 Commercial revenue

7.1 Introduction

We are disappointed that the CAA has accepted the SDG commercial revenue report in its entirety. Prior to the publication of our response to the SDG Draft Final Report, we had met with representatives of SDG to discuss the report, and were able to put forward alternative views which challenged many unsubstantiated assumptions and commercial judgements that SDG have made in their forecasting of commercial revenue. Despite the meetings and our provision of a detailed written document which set out clearly the problems evident with their analysis, we are very surprised that there were no amendments were made between the publication of the “draft” final and the final report from SDG. We are also concerned that the CAA did not itself examine the report in the light of the serious and verified problems identified by Gatwick and seek to adjust its judgements accordingly. Fundamentally, SDG has not identified any major shortcomings in Gatwick’s approach to managing its commercial revenues, but have sought at every point, in largely unsubstantiated ways, and often in the face of contrary evidence generally available in the sector, to stretch the targets to which Gatwick is committed, despite many already being subject to significant downside risk.

In section 7.2, we address the main areas of concern that span most of SDG’s final report, and demonstrate some serious misunderstandings of Gatwick’s commercial business:

- A misunderstanding of the market conditions in which we operate;
- Failure to take a balanced view; and
- Flaws in SDG’s revenue analysis.

In section 7.3, we give a detailed account of the inherent problems in SDG’s analysis and the resulting value of the overstatement of revenues.

In section 7.4, we provide new evidence from AT Kearney’s airport benchmarking team that contradicts SDG’s findings.

Finally, Appendix 11 gives a line-by-line response to SDG’s final report. It is our view that the SDG final report significantly overstates the income potential of the business beyond Q5 and we believe this speculative approach to revenue generation places unacceptable risk on the business. We request the CAA to consider these points in their final proposals and make adjustment for these flaws.

7.2 Core issues with SDG analysis

A misunderstanding of the market conditions in which we operate

SDG’s unrealistic forecasts appear to stem from their over-optimistic assessment of the current strength of travel retail. This sector is strongly correlated to external economic factors and market retail conditions, albeit is slightly more resilient than high street retail, for example. Statements from the British Retail Consortium ("BRC") and other recognised industry expert organisations show worsening retail expectations. The BRC-Nielsen Shop price index recently reported the price of non-food items deflating by 1.5% against last year, accelerating from 1.0% in April. OECD's most recent economic outlook in May 2013 forecasts the Eurozone to shrink by 0.6% this year, which was a downgrade of 0.5 percentage points since their last half yearly outlook. Similarly, it has also downgraded the UK's GDP growth prospects by 0.1 percentage points since its last publication. The CBI also recently released data showing that retail sales fell at their steepest rate for 16 months, citing the main reason as being wage growth not keeping pace with cost of living. A recent survey from TNS in early April also endorsed this view. Out of their survey sample of those anticipating taking an overseas holiday, 31% expected to spend less this year than last.

Within the car park market, SDG failed to recognise the increase in competition at Gatwick over Q5. Meet and greet operators have increased markedly over this period due to few barriers to entry, technological and online advances, as well as a general lack of effective planning enforcement. Off-airport operators are also expanding, with APH only recently being granted planning permission for an additional 1,500 space site. Based on this evidence, Gatwick's view is that off-airport capacity is likely to grow rather than be constrained, as SDG suggests.

SDG also believed Gatwick to be a price leader, which implies that the competition will simply follow Gatwick's price changes. This is absolutely not the case, as raising prices do not equate to a revenue increase. The graph below, taken from recent car park data, shows the elastic nature of the car park market in which we operate. ✂

Figure: The elastic nature of the car park market
✂

Finally, SDG took an overly optimistic view of office rental demand in their report. It disregarded the overall local market for office accommodation and anticipated a faster recovery in this sector than Gatwick has claimed. The local market has in excess of 700,000 square feet of vacant office stock, which is equivalent to c.2.5 times Gatwick's overall office stock, and represents fifteen times the void levels at Gatwick.

Failure to take a balanced view

We do not believe that SDG has taken a balanced view of risk and opportunity. The projections concluded in the report are not balanced, where upside and downside balance out, as they should be for regulatory purposes. Rather, SDG appears to have incorporated all (including a number that are spurious) opportunities, and disregarded significant threats. First, there is no reasonable basis for any of the income initiatives overlaid into Gatwick's business plan. The additional SDG income is undefined and speculative, and in many cases, a full and comprehensive business case has not been considered. Examples of this include speculating about additional revenue from adding new retail space without considering the levels of capital expenditure involved. ✂ This assumption is entirely hypothetical and value destructive over the long term

Second, a realistic business plan needs to recognise that alongside areas that have the potential growth there are some areas that are in decline. This is the nature of a sector subject to significant and continuing changes in technology and related consumer preferences. In particular, SDG disregard the long term structural problems within the bookshop sector, which are akin to the problems faced by Zaavi, HMV and Blockbuster. ✂; such structural problems do not have short term fixes as the companies mentioned above found to their cost. Gatwick's business plan therefore includes steps to mitigate the decline, not completely arrest it. Throughout SDG's review, Gatwick has also highlighted areas that sit outside of the business plan but remain live threats or, in some cases, known downsides. Examples of these include ✂, potential World Health Organisation directives that affect Duty Free income (additional to the Tobacco Display Act), and a further decline of our long stay car park roll up traffic. We believe this latter point has been largely overlooked by SDG, although the structural downshift poses significant risk to our business. This trend is not readily apparent from our trading data and is masked by some one-time benefits that include operational costs savings and higher short stay sales in winter, a large ramp up in valet sales and the opening of MSCP6. The combination of these effects has in previous years offset this roll up decline. However, due to the continuation of this roll up trend, we no longer expect these effects to balance out.

Third, we would like to re-emphasise the caution in using benchmarks to judge performance. Although SDG do mention this point, we believe some of the comparisons they make are over simplistic and warrant a much larger 'health warning' in their report. For example, we believe it is entirely wrong to compare our retail revenue per passenger to Heathrow on an annual basis due to the greater seasonality of Gatwick's business. We asked SDG to normalise for seasonality but this was not done. Further, we challenge the validity and conclusions that can be drawn from comparing Gatwick to a small number of European airports using a dataset that has not been cleansed for comparability purposes – a problem that is not confined to commercial revenues but has emerged in various parts of the CAA's analysis.

Flaws in SDG's revenue analysis

There are a series of spurious assumptions made by SDG in deriving their revenue projections of which we highlight only a few in this section:

- SDG assume that licence agreement charges to 'official' meet and greet operators can generate £1.2m per annum. This assumption is simply unachievable based on the charges that Gatwick has proposed and consulted on. Gatwick has presented its assumptions on revenue potential in Appendix 11, which clearly illustrate that SDG's assumptions are infeasible by a substantial margin - an order of magnitude of three;

- SDG propose property and telecom revenues to increase in line with passengers. There is clearly no causal relationship and the former contradicts the CAA's own analysis on p336 of its consultation document on 'Gatwick Market Power Assessment – May 2013' which identifies a zero per cent sensitivity of property revenue to passengers;

- Our catering forecasts were assessed at the 'draft final' report stage to be at an acceptable level, yet additional stretch was still applied at the 'final' report stage without any explanation; and

- Additional long stay roll up revenue has been incorporated into SDG's forecast when current trading is showing a 25% decline (last quarter results) for this type of traffic.

7.3 Value of SDG's misjudgements

Retail

Our key retail concerns, as published in our response to SDG's 'final' report, remain as follows:

- Under-estimation of the impact of the TSA on tobacco income. SDG are using point in time benchmarks that do not address the underlying decline as well as the impact of a change in law. This is worth £11.4m or 1.3% of aggregate BQ5 income;

- Failure to grasp the threat to bookshop sales; it is wholly unrealistic to expect income from this category to hold steady at £0.29 post 2013/14 in RPI adjusted terms, particularly when the underlying price driver for this sector is CPI not RPI. This is worth £7.8m or 0.9% of aggregate BQ5 income;

- ✂

- Failure to understand that specialist shop margin improvements through churn are already included in our assumptions. SDG suggest – without justification - there is another 1% to be had. This is worth £1.1m or 0.1% of aggregate BQ5 income;

- The assumption that a switch of space from catering to duty free is feasible, even if it were desirable, which we dispute given the adverse effect on passenger experience. This is worth £3.8m or 0.4% of aggregate BQ5 income;

- The notion that we are under-investing in retail space and that we should bake in more income because of this in the period beyond Q5 to 2018/19. Not only has it been very difficult to get the airlines to agree to any retail expansion, but SDG provide no substantive evidence justifying the feasibility and cost/benefit of this suggestion during this period. We believe our proposals are balanced, affordable, deliverable and optimised. This is worth £13.2m or 1.5% of aggregate BQ5 income; and

- Gatwick is projecting advertising income per passenger growth in excess of 50% over the 5 year forecast period. SDG conclude that this projection will place the airport in line with the global average and converge towards the European airports average. Based on these conclusions and the considerable risk already inherent in our projection, we see no evidence for layering further stretch onto these numbers. This is worth £1.2m or 0.1% of aggregate BQ5 income.

Car parks and e-commerce

In summary we consider that SDG's conclusions relating to Car Parks and e-Commerce are substantially flawed for the following reasons:

- The use of over-simplistic single-point price benchmarking to suggest that we are under-pricing our long stay car parking in peaks (when we issue over 50,000 individual price points each day). As well as this the idea that we should do more business with expensive car parking consolidators who demand long term strategic contracts, rather than work effectively with them to target parts of the market that we can't easily reach, or use their distribution reach in low demand periods. Both of these are simply untenable and are worth £2.9m or 0.3% of aggregate BQ5 income;

- The assumption that it is possible to generate £0.4m above RPI through increases in long-stay roll-up prices, which ignores the data provided to SDG showing that revenues from long-stay roll-up have declined by 25% over the last financial year. Our current business plan assumes a constant mix of roll-up and pre-book traffic, so continued decline of roll-up business (which generates 2-3 times the income per space of pre-book traffic) represents a material risk to our business plan, rather than an opportunity as suggested by SDG;

- The assumption that it is possible to generate £3.9m over the period through better enforcement of the no pick-up rule on the forecourts, hence driving increased revenues into our short-stay car parks. SDG have ignored the fact that this would require approximately an extra 200 cars to enter our short-stay car parks every hour of every day throughout the year in order to generate incomes of the order stated. Based on our actual forecourt activity, this level of traffic is simply not credible;

- The assumption that licence agreement charges to 'official' meet and greet operators will generate up to £1.2m p.a. and £4.6m over the period. Again these figures are completely unrealistic, and not evidenced by any calculation. By comparison, our budgeted income this financial year from these charges is £0.2m;

- The assumption that forecourt charging is somehow in the passenger interest, and that it is: a) feasible; and b) worth the value ascribed to it. This is worth £30.9m or 3.4% of aggregate BQ5 income;

- The assumption that e-commerce initiatives will deliver up to £0.3m income p.a., which is entirely speculative, and ignores any downsides. ✂. Negotiations are ongoing. However this illustrates a downside risk that has not been considered in the SDG assessment; and

- At a high level, SDG are suggesting that an extra £3m income p.a. (over and above forecourt charging) is feasible, which equates to an extra £0.08 IPP, with no capital investment in new capacity. ✂. These comparisons illustrate just how unrealistic the SDG assumptions are.

Property

We have previously provided detailed responses as to why we believe that the various recommendations by SDG relating to property are unachievable, but these have been disregarded. In summary, across all products the key issues of concern remain:

1) The UK economic position and the impact this has and is having on the property business nationally;

2) Change in airline mix resulting in smaller property requirements for airlines operating at Gatwick;

3) The aviation related restriction preventing Gatwick from letting to a wider market place; and

4) Significant competition with Crawley. Crawley currently has in excess of 700,000 sq.ft. of void office accommodation equating to over five years supply. Grade A rents are circa £23 per sq.ft. with significant capital contributions and rent free periods offered.

In addition to our previous comments on property income, we do not support the assumptions that continue to be made by SDG with regard to potential income growth for Concorde House, Ramp, Hotels and ad hoc contractors' accommodation. SDG's assumptions are worth £5.6m or 0.6% of aggregate BQ5 income:

- Gatwick currently has excess office accommodation, not unlike any town or city in the UK, in the region of ✂ sq.ft. We do not believe that this will be lettable for the reasons already given above, outlined clearly in our business plan, and explained clearly in our response to SDG's draft final report. Such a situation, if it continues, may indeed give rise to a need to demolish an office block to avoid unnecessary costs such as void rates;

- With regard to Ramp accommodation, SDG make reference to Pier 5 being refurbished and new space being created on Pier 6. The reference to Pier 5 refurbishment is incorrect, as the refurbishment works relate to passenger areas and segregation, not to the property accommodation. SDG have incorrectly assumed that the reintroduction of the Pier 5 ramp accommodation is incremental – in reality Gatwick is just putting back what was temporarily removed, and there is no net gain in space;

- With regard to Pier 6 a small amount of ramp accommodation has been added to the scope of the project to support the airlines operating from this Pier as this is remote from existing ramp accommodation. We fully expect that, should this accommodation be occupied for operational reasons, space on one of the other Piers will be vacated, leaving Gatwick income neutral. Indeed it is worth noting that the accommodation lost as a result of the Pier 1 redevelopment (9,000 sq.ft.) is not being replaced in the scope of the new Pier 1. The net impact on ramp accommodation as a result of Pier 6 increase and Pier 1 closure is a *loss* off 3,500 sq.ft. of lettable accommodation; and

- With regard to hotels and ad-hoc contractors' accommodation, SDG have suggested that the assumptions made for BQ5 are prudent and achievable. We do not support these comments. As previously advised we have allowed for a level of contractor accommodation income in our existing plan which will be a stretch in itself.

In summary, SDG's property assumptions anticipate ramp and accommodation demand that we do not believe exists in the current market, and takes an optimistic view of hotel revenues in a highly competitive hotel market which has only recently seen a significant increase in on-site bed stock e.g. Premier Inn North Terminal opened in December 2012. It is difficult to see how there could be a hurdle set on property revenues which requires Gatwick to buck the market and reverse trends experienced locally. Equally we are concerned that the creation of a per passenger metric somehow confers legitimacy on passenger growth as a driver of property revenues, which it clearly is not as the CAA in its SMP document has itself identified.

7.4 New AT Kearney evidence

In order to address these limitations, Gatwick recently commissioned a report from AT Kearney, which is a specialist consultancy of airport benchmarking. Their data is meticulously harmonised to adjust for factors such as country specific price levels and normalised for airport activity levels. For each benchmark measure, they tailor their data set of 32 international airports to ensure fair and like-for-like comparisons are made.

In this study, it found Gatwick's commercial revenue per passenger to be 13 pence, or 2.2%, above the average benchmark for the financial year ending 31st March 2013. We believe this supports our view that Gatwick's commercial returns are already competitively placed against other airports, and consequently, if SDG's trajectory of further improvement were to be overlaid on this base, it would result in a set of unachievable forecasts. We also note that in interpreting the AT Kearney results one should also take into account, that Gatwick has the largest proportion of low cost carriers out of the comparator set, yet higher than average commercial revenue. In addition to this, it is in the bottom quartile for aeronautical revenue per passenger, which in part demonstrates that commercial revenue is providing a very generous subsidy to aeronautical charges under the single till.

7.5 Summary

In summary, we still see optimistic and unsubstantiated assumptions being taken which, when aggregated, makes SDG's 'core' commercial revenue forecasts unacceptably risky. The use of the word 'super stretch' by the consultants appears indicative of the implied further riskiness of such propositions.

8 Traffic forecasts

8.1 Introduction

In response to Section 4 (Traffic), we consider the main points are:

- Information received by the CAA from airlines operating at LGW indicates that short-term traffic will be above that forecast in the RBP;

- The selected GDP forecast provider does not represent the consensus view; and

- Concerns over the reasonableness of the timing of spilled traffic from LHR.

We address each of these issues in turn in Appendix 13, but first present our latest forecasts for Gatwick below.

8.2 Latest Gatwick forecasts

Gatwick is pleased that the Initial Proposals endorsed our forecast methodology.

The forecast provided in the RBP was made with the information available at that time. Given the summer peak had passed, and the (limited) information SH&E had received from LGW's airlines, we believed the forecast to be reasonable. As noted in the Initial Proposals the variance for 2012/13 was just 1%.

Many factors have changed since the RBP forecast was produced in September 2012 and, as part of our annual business planning cycle, we completed a forecast during April 2013 using the existing methodology, with revised variables and data.

The results presented to Gatwick in May are shown below, alongside previous Gatwick forecasts and those of the Initial Proposals and the ACC. Further detail on the new forecast and approach are documented by SH&E in Appendix 12.

Table: New SH&E passenger forecast and comparison of forecasts (millions)

	CAA	ACC	Gatwick		
	Apr 2013	Jan 2013	May 2013	Sep 2012	Jan 2012
2012/13		33.8	34.2	33.8	34.6
2013/14		34.0	34.4	34.0	35.2
2014/15	35.0	34.5	35.0	34.5	35.7
2015/16	35.5	35.2	35.5	34.7	36.0
2016/17	36.1	36.0	36.1	35.0	36.4
2017/18	36.8	36.8	36.6	35.4	36.8
2018/19	37.6	37.6	37.0	35.9	37.2
2019/20	38.5	38.6	37.6	36.6	38.1
2020/21	39.3	39.5	38.2	37.2	39.1
2014/15 - 2018/19	**181**	**180**	**180**	**176**	**182**
2014/15 - 2020/21	**259**	**258**	**256**	**249**	**259**

Source: SH&E, the CAA and the ACC.

This May 2013 forecast reflects the latest market conditions and outlook at the time of its preparation. It should be noted that very recent developments, such as Flybe's slot deal with easyJet, were not known at the time the forecasting was carried out and are thus not reflected in these forecasts. It is not clear how easyJet propose to use it slots, nor can it be clear how competition between airlines between now and 2019.

9 Pension commutation

9.1 Introduction

The chapter outlines Gatwick's fundamentally disagreement with the CAA's initial proposals that the pension commutation payment should not be included within the settlement beyond Q5.

9.2 CAA has unfairly ignored Gatwick's pension commutation payment

The pension commutation payment removed any obligation from the Company in respect of former Gatwick employees whose benefits remained in the BAA scheme. This included retirees and deferred members of the BAA scheme, not just "*employees who did not transfer into the new pension scheme*".

The key point is that this payment substantially reduced the payments that had to be made by the new defined benefit scheme established by Gatwick on the date of sale and its future risks. Without the pension commutation payment there would have been two impacts. First, a higher level of pension contribution to reflect the greater number of members within the scheme and, second, an increase in those contributions in future reflecting the general factors weighing on pension costs discussed later in this note. In the absence of the pension commutation payment the liabilities involved would have increased significantly since 2009 and been factored into the cost projections contained in the RBP.

This is in line with views expressed by IDS – "*if this payment had not been made, Gatwick would have been required to extinguish this liability over time through regular DB pension contributions, which would have been included in future regulatory* settlements".

The CAA suggests that it is not inclined to make allowance for the commutation payment because it would have been reflected a lower sale price. There are three points to be made on this.

First, the construction of a RAB price is concerned with the appropriate cost base of the Airport. It is clear that the pension liabilities transferred by the pension commutation payment were part of Gatwick's cost base. It is perfectly legitimate for the CAA to consider whether the commutation payment reflected a reasonable payment in respect of those liabilities and the future risks involved although it is very likely that, given the evolution of pension costs since, it provided good value for money. It is not, however, consistent with the RAB approach to exclude it and it should therefore be included in the RAB.

Second, there are precedents in airport regulation for adjustments to the RAB in respect of pension liabilities – in that case effectively to reinstate payments that had been made from the pension scheme by BAA at a time when it was in surplus. The CAA rightly determined that users should not bear pension costs that would otherwise have been met by the surpluses transferred to the company. This is a precise parallel, if in the opposite direction. Users should not benefit from a payment made by Gatwick but, rather, in line with RAB methodology, should bear costs reasonably incurred in the past.

Third, the reference to sale proceeds cuts across CAA and more general regulatory precedent that such transactions are a matter for the parties involved. To do otherwise would have significant implications for regulation generally. In particular, if the benefit of a "*lower sale price*" (to use the CAA's words) is to benefit users then would not that logic suggest that higher sale prices should also impact regulation, with the possible implication that sale prices above the RAB should in future be reflected in the cost base of the airport. Such an approach would be judged inconsistent with a cost-based methodology, but so should, on the same grounds, exclusion of the commutation payment.

10 Licensing

10.1 Introduction

This chapter responds to the issues raised by the CAA in Chapter 17 of the Initial Proposals, the draft RAB based licence provided at Appendix B of the Initial Proposals, the further licensing issues raised in the letter of 31st May (Further Information on the CAA's Initial Proposals for the economic regulation of Gatwick Airport Limited after April 2014) and the draft price control and service quality draft conditions provided at Annex A and B of that letter.

Gatwick maintains its position that it does not meet the market power test under section 6 of the Civil Aviation Act 2012 and that accordingly it does not require a licence under the Act. Gatwick's comments on the form of light licence that might be employed in conjunction with the Commitments should not be seen as its acceptance that such licence is necessary. Gatwick remains of the view that the Commitments without any regulatory licence can provide legally binding obligations which address the key interests of airport users including the range, availability, continuity, cost and quality of airport operation services.

In the following paragraphs we comment on the main aspects of the Part I – VI of the draft licence.

10.2 Part I : Scope and interpretation of the licence

In the 31st May letter the CAA suggests that Gatwick is the operator (as defined by section 9(1) of the Act as the person who has overall responsibility for the management of an area) of the core area of the airport as defined in section 5(4). We do not believe Gatwick can be considered the operator of the area for servicing aircraft or the cargo processing area.

10.3 Part II: Conditions on fees and revocation

We do not believe the licence should be revocable in the event of Gatwick failing to comply with orders under the Competition Act 1998 or the Enterprise Act 2002. Those acts contain sufficient enforcement powers which do not need enhancing by the threat of removal of the licence. There is no reason why Gatwick should be subject to additional and enhanced remedies to which other entities subject to those Acts are not.

Termination of the licence for non-payment of the CAA fees for carrying out its regulatory function and for failure to pay a penalty under section 52(1) or 52 (3) of the Act is wholly disproportionate. The CAA has other remedies available to it in these circumstances which do not constitute what the CAA describes in paragraph 17.21 as *"behaviour by Gatwick where lack of compliance with regulatory requirements cannot be resolved through any other channel."*

10.4 Part III: Price Control Conditions

We comment elsewhere in this response on issues raised by the proposed price control condition and the specified activity transparency condition. In the scenario of Commitments backed by a licence framework as discussed in paragraphs 12.37-12.41 of the Initial Proposals there would be no price conditions as these would be replaced by a price commitment. The price condition would be replaced by a condition requiring Gatwick to enter into and comply with the Commitments. Gatwick has provided in the draft Commitments in Appendix 1, a proposal that it would not be able to alter the price commitment without support of a stipulated level of airlines or if the Airports Commission recommends that a second runway be built at Gatwick. However Gatwick opposes the conditions suggested by the CAA in paragraph 12.38 allowing the CAA to direct changes to the Commitments or to freeze charges as this would undermine the commercial basis of the Commitments.

10.5 Part IV: Service quality conditions

Service quality levels and rebates

We comment elsewhere in this response on issues raised by the proposed service quality and rebates conditions. In the scenario of Commitments backed by a licence framework as discussed in paragraphs 12.37-12.41 of the Initial Proposals there would be no service quality and rebates conditions as these would be replaced by a service commitment. The service quality and rebates conditions would be replaced by a condition requiring Gatwick to enter into and comply with the Commitments. Gatwick has provided in the draft Commitments in Appendix 1, a proposal that it would not be able to alter the service commitment without support of a stipulated level of airlines. However Gatwick would oppose conditions suggested by the CAA in paragraph 12.38 allowing the CAA to direct changes to the Commitments as this would undermine the commercial basis of the Commitments.

Operational resilience

We query whether a licence condition will add anything to the good progress Gatwick has made and continues to make in developing plans and coordinating responses to disruption and maintaining the operational resilience of the airport. The commercial and reputational impact of failings are likely to render licence conditions otiose. In recognition of the importance both Government and the CAA attach to the operational resilience we have provided in the Commitments what we believe to be proportionate obligations in relation to an operational resilience plan and coordination of responses.

10.6 Part V: Financial conditions

Regulatory accounts condition

We see no need for separate regulatory accounts where there is no RAB. We are of the opinion that Gatwick's statutory accounts provide sufficient disclosure for the CAA and airlines in relation to the operating cost and revenue components of EBITDA and in relation to capex and depreciation of Gatwick's asset base. In the Commitments we undertake to provide similar levels of information as included in our most recent accounts.

Financial resilience

We concur with the CAA conclusion it is not clear that licence based restrictions are necessary in light of the "contractual ring fence" provided by Gatwick's debt covenants. In so far as any comfort is required on financial resilience Gatwick can see additional comfort might be added by providing notice of any amendment to the debt covenants pertaining to credit rating. The debt covenants also include restrictions on business activities and following the same logic we see no benefit to licence base restrictions. We query the benefit of a parent undertaking particularly with the ownership structure of Gatwick. While in theory we can see the benefit of a continuity of service plan, in practice we are not convinced of its purpose. It is unrealistic to envisage that key operational knowledge will be lost in the event of financial distress. Bearing in mind the requirement for an aerodrome licence, the need to have an aerodrome manual and the business risk contingency plans which are in existence we believe any licence condition requiring a continuity of service plan should be very light touch. We concur that including provision as to cross guarantee would involve the CAA in Gatwick's actual financing at a level rarely seen in economic regulation.

10.7 Part VI: Other licence conditions

We have the following comments on the CAA's suggestions on other potential licence conditions:

- 17.83: We see no purpose to a provision that Gatwick should continue to comply with its other legal obligations since those other legal obligations are subject to specific enforcement regimes and there is potential for conflict and inconsistency if the CAA seeks to enforce them through the licence;

- 17.84: We agree that reopening a price commitment or price settlement should only be in specified extreme circumstances. In the Commitments we have provided for amendment to the price path in the event of the Government supporting a second runway at Gatwick;

- 17.85: We have also specified the airline mandate required for amendments to the price or service Commitments;

- 17.86: We have also set out suggestions for a more workable consultation process than that contained in Annex G;

- 17.87: Conditions as to how Gatwick should deal with passenger complaints would in our opinion be over intrusive and unwarranted in an economic licence. We are not aware of our complaints handling process having being raised as an area of concern;

- 17.88: Non-discrimination is adequately covered in the ACR, the Competition Act and the Groundhandling regulations. We see no benefit to the inclusion of a licence condition to that effect; and

- 17.89: We are pleased that the CAA has now concluded that there should be no discretionary revocation for insolvency. We would want to consider the drafting in detail of any obligation to notify the CAA in the event of the Licensee seeking advice on insolvency. Any provision enabling the CAA to revoke the licence on an insolvency event would have potentially very significant implications for Gatwick in terms of ratings, cost of funding and market appetite for its debt.

11 Specific comments on the initial proposals

11.1 Introduction

This chapter provides the remainder of Gatwick's specific comments on the CAA's initial proposals.

11.2 Specific comments on the CAA's initial proposals

CAA's chapter 1: Introduction

1.8-1.9: **CAA's consultation questions:**
The CAA poses a number of questions in section 1.8 and 1.9 of the introduction. Of these questions the ones outlined in 1.8 are addressed in the body of this document. In 1.9 the CAA however asks:

> *"The CAA is currently working with the DfT to assess the effects of the Airport Economic Regulation provisions contained in the Act. In order to assist with this process, the CAA invites views from stakeholders on the following question:*
>
> - *"What do you expect the CAA to undertake for Q6, using its powers under Part 1 of the Act, which it could not have undertaken using its powers under Part 4 of the Airports Act 1986? In particular, are there any benefits/costs in relation to future opex, capex and the WACC?"*

Gatwick welcomes the introduction of the Civil Aviation Act 2012 ("CA Act") and actively participated in the development of the Government's proposals and the passage of the Bill through Parliament. We consider that the CA Act is a much needed update of the previous regulatory framework which had been in place since privatisation in 1986.

We particularly welcome the revised focus in the CA Act on the interests of passengers and the general duty on the CAA to promote competition between airports where appropriate. Increased competition, with the break-up of BAA, will be the best way of delivering in the interests of passengers. This point has been explicitly recognised by government, Parliament, the CAA and the Competition Commission ("CC"), among others.

We also consider that the CAA's current review of competition and of regulation at the currently designated airports provides a unique opportunity for the CAA to transform the south east airports market. In particular, the CAA has an opportunity to secure the gains from increased competition arising from the break-up of BAA and to promote increased competition between airports, in the interests of passengers.

However, we believe that the CAA has not taken advantage of this opportunity. Instead of fulfilling its general duty through proposals that would promote increased competition between airports and the associated increase in rivalry, innovation, price and service discovery that would go hand in hand with this, the CAA is regressing to regulatory solutions designed for network natural monopolies. Instead of promoting competition, this will more likely stifle it and reduce the gains that have already been achieved by the CC's break-up of BAA.

The CAA, in its initial proposals, does not adequately recognise the increase in competition that has already occurred and the further increase that inevitably will occur as Stansted shifts from a strategy of cannibalising earnings from Heathrow (or Gatwick) to one of maximising profits as an independent airport. Indeed, as the CAA is aware, we are strongly of the view that the increase in competition negates the need to continue with economic regulation of Gatwick. Nevertheless, even if the CAA considers that there is a need to license Gatwick, its initial proposals based on a traditional RAB-based price control, do not adapt the regulatory response to the change in market fundamentals and the increase in competition. The CAA's initial proposals also fail to adequately take into account the impact of our Commitments to airlines, which in our view address any competition concerns that the CAA could have.

The CAA's focus on a RAB-based price cap calculation, and using this as a basis for its appraisal of different regulatory options, will not do anything to promote competition between airports. On the contrary, that approach is likely to undermine competition as it detracts from the flexibility that should be available to operators in competitive markets.

On the specific issues of opex, capex and WACC, we do not see how the provisions in the new Act give the CAA new powers in these areas. However, the new Act does provide the CAA with an opportunity to step away from detailed regulation of these individual cost components and rely more on the dynamic impacts of increased competition, an opportunity that the CAA has so far not taken up.

CAA's chapter 2: Background

2.26: **Opex information provided to Constructive Engagement:**
The CAA states its disappointment that Gatwick was not able to provide the desired level of detail on opex to CE. We note that we agreed to engage in CE and to abide by the CAA's mandate. Gatwick provided the level of detail required by the CAA's mandate, to which we had agreed. This was more than sufficient for the ACC to present a reasoned challenge to Gatwick's opex proposals. We were disappointed that the ACC did not engage consultants to review Gatwick's opex efficiency, as had been decided.

CAA's chapter 3: Passengers' interests:
We note the conclusions drawn from the bodies of research provided by Gatwick and the CAA, particularly the fact that they are largely consistent. However, there are three areas which are worthy of highlighting where the logical end conclusion has not been clearly articulated in this chapter.

The research clearly indicates a 'persistent trend for arriving passengers to be less satisfied than departing passengers.' In recognition of this we have proposed investment in both the North Terminal Border Zone and the North Terminal Arrivals Hall (landside) in order to bring them up to a similar environmental standard as the South Terminal, and, most importantly, to ensure they can meet the future capacity requirements. Both projects have limited or no support from the ACC, which indicates an area where airline interests are not closely aligned with the passengers' needs.

The Consumer Panel encouraged the CAA to consider the needs of different passenger sub-groups; again we have already recognised this requirement and have incorporated these needs within our product matrix which informs our business cases. These 'softer' factors are often those least supported by the airlines as they consider them 'ambience' and not relevant to the speed and efficiency of the passenger journey. One example of catering for different passenger sub-groups is to incorporate segregated areas, this is something that passengers have stated is important to them (YouGov research) and was tested in the willingness to pay research (Accent); where it came out as the attribute the passengers were willing to spend the most to achieve.

We are pleased that the majority of passengers believe that Gatwick does not need major improvements as it shows the success of investment decisions we have made in Q5. However, we ask that the CAA recognise that in order to meet passengers' expectations we must continually invest; not just in our asset stewardship programme, but also in projects to provide capacity for future demand while maintaining the service levels at their current level. That the majority of passengers are happy today does not mean that they will be happy in future – history shows that passenger expectations continually increase – we must meet these to continue to compete and offer the Airport experience that passengers deserve.

CAA's chapter 8: Other charges and revenues

Specified charges:
Since the Revised Business Plan submission, Gatwick has been looking at ways in which to streamline the process for agreeing specified charges, while maintaining its transparency obligations. Therefore, Gatwick intends to make a small structural change to the make-up of these charges and, in particular, to change the way we treat allocated costs. These are costs that are indirectly related to the delivery of the specified activity, and are subject to judgemental apportionment assumptions. Gatwick proposes to remove a proportion of these allocated costs, or where appropriate, ensure there is an alternative apportionment basis for the period post Q5. Also, in the case of electricity charges, Gatwick proposes to remove both an allocated cost and a legacy capital charge, and replace with our direct infrastructure distribution costs. Gatwick has engaged with the ACC on these principles and will continue to consult on these changes over the coming months through the Regulated Charges Group.

As well as this change, Gatwick has been running a series of consultation meetings on staff car park and 'bus and coach' charging. While the latter is still to conclude, the staff car park working group has agreed to uplift the mid-Q5 price per pass in line with the price increases evident in the local car park market. Therefore, it has been agreed to set the 2014/15 charge at £534.60, which is a 10% increase on the mid-Q5 price[12].

We anticipate the lower revenue as a result of the structural changes will broadly offset the additional revenue from the increase in the staff car parking rate. Therefore, Gatwick does not propose to amend its aggregate revenue forecasts, in relation to other non-regulated revenue. However, we would like to re-emphasise that a major portion of specified revenue follows a cost recovery mechanic, so should proportionately adjust to changes in opex. We noted that this principle was not

12 Excludes a £10 contribution to the Public Transport Fund.

adhered to in the CAA's initial proposals.

CAA's chapter 9: Regulatory asset base

9.8: **Regulatory depreciation:**
Gatwick has refreshed its depreciation forecast since the publication of its Revised Business Plan in January. We continue to follow the same methodology, which broadly comprises of the following parts:

- A depreciation forecast of Q5 assets within our Regulatory Asset Base;
- A depreciation forecast that relates to the remaining Q5 capital spend; and
- A depreciation forecast of proposed capital projects post Q5.

In relation to the first two components, our forecast now reflects a greater degree of certainty as more projects are delivered and a greater level of asset information transfers into the fixed asset register. Nevertheless, as the overall level of Q5 spend remains unchanged, and asset life policies remain consistent, the projections are immaterially different to our Revised Business Plan. Small alterations are the result of asset mix, project mix, and timing changes.

The third part of our depreciation calculation also remains relatively unchanged to the Revised Business Plan, with small scale changes as a result of project mix and phasing differences. We have provided an updated depreciation schedule below, which reconciles our update to the CAA's Initial Proposal.

Depreciation Charge - New Assets 2013/14 Prices	Beyond Q5 to 2018/19					
	2014/15	2015/16	2016/17	2017/18	2018/19	Total
CAA Initial Proposals	1	17	24	31	45	118
Update to Business Plan	2	20	31	39	56	148
Variance	1	3	7	9	12	30
Variance Breakdown						
CAA: Correction of timing of depn	1	1	4	4	2	13
CAA: Impact of lower CAA Capex	0	1	2	4	6	14
Gatwick: Project mix and phasing differences	(1)	0	(0)	1	4	4
	1	3	7	9	12	30

Note: small discrepancies in numbers are due to rounding differences

CAA's chapter 11: A fair price

11.13: **P_0 adjustment:**
Gatwick proposed a P_0 adjustment in its Revised Business Plan to reflect the significant difference between the originally forecast and actual levels of traffic at the end of Q5+1. Such an adjustment did

not aim to recover lost revenue because of poor forecasting for the Q5 and Q5+1 periods. Rather, it reflected the reality of the price level that should have been charged through Q5 and Q5+1 and it reduced both the amount of annual price increase and revenue transfer within the 5 years beyond Q5.

Differences between a price profiles with and without a P_0 adjustment are NPV neutral and so Gatwick does not stand to benefit from application of either profile over the other. However, given that without an adjustment, the CAA is growing the amount of transferred revenue between years within the period, we request the CAA to reconsider its position.

CAA's chapter 12: Form of regulation

12.17: **Commercial negotiations:**
The CAA summarises Oxera's analysis, which considered the need for commercial negotiations in deciding the future of the airport. The CAA states that it "*tried to increase the scope of CE for Q6, although Gatwick was reticent about providing the level of detail on opex and commercial revenues requested by the airlines*", thereby implying that CE is a commercial negotiation.

We are alarmed at the CAA's misunderstanding what constitutes a commercial negotiation and how this obviously differs from CE. Constructive Engagement is a multilateral forum, in which agreement is sought, but is not required because the regulator acts as a final arbiter regardless of agreement or non-agreement. Commercial negotiations are rarely multilateral and they do not have an automatic arbiter. Such negotiations aim to grow value, through finding win-win solutions to bilateral problems, which are tailored to suit the parties. In contrast and as part of a regulated system, CE aims to set a one-size-fits all lowest common denominator outcome; in which tailored win-win opportunities are shared between all parties in a single till and hence disincentivised; with the regulator acting as final arbiter aimed at maximising theoretical efficiency, rather than value to individual customers.

Further, we entered CE at the CAA's request and in agreement with the CAA's mandate. We provided information to CE on opex and commercial revenue, as well as many more areas in between, in accordance with that mandate.

12.19: **Evaluation criteria:**
The criteria appear reasonable, being based on the CAA's statutory duties. However, as explained in Chapter 3 above, we have three main overarching observations about how the CAA has implemented this framework:

1) From the general duty, the CAA focusses only on "the protection against the potential harm against market power", particularly regarding cost, and does not focus on the promotion of competition, which is a key part of its general duty;

2) Throughout the assessment of the different forms of regulation, we are concerned that the CAA has mis-specified the concept of "price protection". This is because the CAA focusses on price protection to "users", which includes airlines, whereas it should in line with its new statutory duty to passengers (distinct from the Airports Act) focus on the price protection to

"passengers". This distinction is important as it is clear that airlines set their prices in relation to demand, and not cost; and

3) The CAA introduces a criterion of "Practical implementation, stakeholder confidence", which does not have a clear link to its duties, although the CAA seeks to link this to its duty for "regulatory activity to be transparent, accountable, proportionate, consistent and targeted only at cases where action is needed". The wording of this duty in the Act has more precision than the CAA's criterion and is more clearly directed to regulatory outcomes as well as process.

We now set our comments on the different forms of regulation considered by the CAA.

12.23: **Gatwick's commitment proposals**:
The CAA provides a description of Gatwick's Commitments, including the draft term sheet.
The CAA frames its consideration of the Commitments in terms of Test C of the Market Power Test (MPT). The Commitments are, of course, also relevant to Test B. Leaving that to one side, we are concerned that the CAA's framing of this Test is not accurate and potentially leads it to an erroneous conclusion. In particular the CAA states that for the presence of Commitments to lead to the CAA concluding it is not appropriate to introduce licence regulation:

> *"The regime created by the Commitments would need to be reasonable and effective for passengers in that the overall deal would have to be reasonable compared to a regulatory settlement."*

We do not believe this to be an appropriate formulation of Test C of the Market Power Test. Test C requires the CAA to assess whether the benefits of licence regulation are likely to outweigh the adverse effects. As such, in a world where the Commitments are the counterfactual, the question is not whether the overall package offered by the Commitments would have to be reasonable compared to the CAA's calculation of a regulatory settlement. The relevant question for the CAA is whether the benefits of regulating Gatwick by means of a licence over and above Commitments, outweigh the adverse effects (costs) of the licence.

The CAA goes on to state:

> *"Given the lack of an express statutory power to accept voluntary Commitments, the CAA would need to be satisfied that accepting Commitments was a suitable exercise of its discretion under the Act. In particular, given the risks of abuse of SMP identified under Test A, the CAA would need to be satisfied that the Commitments proposed would better protect passengers' interests than licence regulation."*

Again, we are concerned with the CAA's view. First, we do not agree that the CAA would have to "accept" voluntary Commitments and second, the CAA would not be exercising its discretion. This is because, in the context of the CAA conducting Test C, the Commitments exist. We therefore consider that the question for the CAA is the extent to which the presence of the Commitments protects against the adverse effects on passengers of any abuse of identified market power. In principle, the answer to this could be anywhere between not at all, and fully protects. However, regardless of the answer, it is not a requirement that the CAA accepts them. Therefore, we consider that there is no need for the CAA to exercise any discretion.

We also do not agree that the CAA would need to be satisfied that the Commitments would better protect passengers' interests than licence regulation. As noted above, the relevant test is whether the benefits of licence regulation outweigh the adverse effects.

The CAA also set out a number of specific concerns with the Commitments as they were at the time of the initial proposals. We have amended our Commitments in a number of respects to address these concerns and we have set these out in Chapter 1.

In the CAA's appraisal of the proposed Commitments against its evaluation criteria, it assesses the price protection provided by Commitments against its calculation of a RAB-based price. However, we consider that a more appropriate evaluation would be to identify what the incremental protection that would be afforded to passengers by a RAB-based control (and lost if the CAA were to rely on Commitments).

12.37: **Gatwick Commitments backed by a licence framework:**
To overcome what the CAA's perceives as weaknesses in our Commitments, the CAA considers whether Commitments could be satisfactorily encompassed into a licence framework. The CAA considers that this would require some key licence conditions:

- CAA enforceability;
- Remove the ability for Gatwick to unilaterally alter the terms;
- Allow CAA to direct changes; and
- Allow CAA to freeze charges if it instigates an investigation.

The CAA also identifies areas where it proposed changes to the terms of the Commitments. This, in the CAA's view, would need to cover many aspects of the Commitments: price, cost pass through, service quality bonuses, capex delivery, increased capex consultation, transparency of cost and revenue data to airlines, operational resilience and financial resilience. As we explain in Chapter 1, while there is scope for Gatwick to amend the Commitments to reflect some of the CAA's concerns – and Gatwick has done so – in others, the CAA's proposals would undermine the main benefit of the Commitments, which is to improve behaviours and incentives on all parties to deliver in the passenger interest and promote competitive rivalry.

From the CAA's assessment, if the Commitments were amended in the way set out by the CAA, this would appears to satisfy all areas of the CAA's evaluation criteria and thus would be preferred by the CAA over a RAB based control. However, it should be noted that such an outcome would in effect deliver a broadly similar, if not the same, outcome (and associated incentives) as a RAB based control, due to the amendments being requested by the CAA.

We consider that our revised Commitments satisfy the CAA's evaluation criteria. As such, Commitments would be preferable to a RAB-based control should the CAA substantiate that a licence is required.

12.42: **RAB based cap:**
The CAA provides a description of the RAB based framework and talks about the potential, under the Civil Aviation Act, to introduce increased flexibility into the traditional model. However, the CAA does not provide details on what this increased flexibility would amount to. As far as we can tell, increased flexibility appears to be limited to the proposed introduction of the category of "development" capex which, far from introducing flexibility, risks creating greater regulatory intrusion and delay in capex implementation to the detriment of passengers.

The CAA's discussion of the disadvantages of RAB based controls makes a number of observations:

- Can be costly and time consuming and require the provision of large volumes of information;
- Can distort investment incentives – either too much or too little or distort incentives at competitor airports; and
- Can introduce rigidities into the capital planning process and service quality regime, although this may be addressed to a degree by a more flexible approach.

In its assessment of the benefits of price protection, the CAA focuses on the protection to users – including airlines – and does not limit this to passengers, as its general duty requires. As noted above, it is not clear to us that airlines will set lower charges under a RAB based price control. We consider it more likely that airlines will continue to set prices in relation to demand and not on a cost-plus basis. Moreover, in a capacity constrained environment it is likely that depressing prices below market levels will translate to higher airline profits and increased return to airline shareholders and will not necessarily result in a benefit to passengers.

We are also concerned that the CAA's assessment under the criteria on "promote competition" does not consider whether or not RAB based regulation achieves this key part of the CAA's general duty. The CAA acknowledges that this form of regulation can distort investment and could discourage commercial agreements, but states that it does not prevent such agreements. We consider that this falls short of the CAA fulfilling its general duty to promote competition. The CAA also argues that setting a RAB based cap will ensure that any subsequent commercial agreements are "fair". However, the CAA has not explained what this means, or why any counterparty would enter into a commercial agreement that was unfair.

12.45: **Long run incremental costs:**
The CAA's assessment of a LRIC based control takes much of its input from a report it commissioned from Europe Economics (EE). The issues we have previously raised with EE's report also stand in this assessment and we do not raise these again here. The CAA identifies some key drawbacks of a LRIC approach in general:

- Data intensive and requires regulatory judgement to define the increment and can lead to variable charges, limiting protection to users. However, the CAA has not yet explained why increasing prices, particularly in an environment of insufficient supply of capacity, would be detrimental to the passenger interest. Previously the CAA has argued that prices that reflect forward looking costs of additional capacity are in the interests of passengers;

- It creates a risk of over and under recovery in a particular period and as such may not be indicative of the competitive price at any given time. However, the CAA has not yet explained why over and under recovery is an issue or why LRIC would not be indicative of the competitive price level; and

- It is not an effective proxy for competitive prices where investments are lumpy and for example, may not reflect the capacity cycle. We are not clear about the point the CAA is trying to make here.

The CAA then sets out drawbacks identified by EE in its report, specific to the use of LRIC at Gatwick:

- It is difficult to identify the appropriate increment – and EE advises using the modern equivalent asset valuation ("MEAV") of the existing airport infrastructure;

- It has associated greater uncertainty as it is not based on historical values;

- It has greater uncertainty on the remuneration of investment; and

- It has greater potential for volatility, if for example input prices or technology changes.

All of these drawbacks relate to uncertainty and volatility. We consider that EE over plays the extent of these issues. Nonetheless, these are key features of competitive markets and so it is not surprising that they flow through when regulating in a way consistent with a competitive market. The CAA has not explained why these issues are against the interests of passengers.

The CAA discusses Gatwick's response to the EE report, and we note that EE has slightly amended its approach and model. However, EE did not fully reflect all of our comments in its revised report.

In terms of the CAA's assessment of LRIC against its criteria, under "promote competition" it states that in theory LRIC better reflects competitive outcomes. However, we consider that an assessment under this criteria requires more than reflecting a competitive outcome. In particular, we consider that regulation to promote competition requires the creation of incentives that are consistent with those in a competitive market and thus allow market dynamics to reveal solutions and develop innovations to meet passenger needs.

Under "efficient and effective investment" the CAA states that LRIC reduces the incentives towards capex spending as the company would not be compensated for over spending. The implication is that adopting LRIC would increase the incentive for the airport to only undertake efficient investment and avoid inefficient investment that might otherwise be rewarded under the RAB approach. The implication of the CAA's view is that this is a negative factor in the evaluation of LRIC. However, we consider this to be a positive factor.

Under the final category of "practical implementation and stakeholder confidence", the CAA makes a number of statements with which we do not agree:

- *"Introducing a LRIC price cap would require a long-term commitment from the regulator to move from the current RAB approach…"* While any regulatory innovation which provides a context for long term investment is better associated with a long term commitment from the regulator that does not preclude the CAA taking a different approach in the future if it was merited, given the CAA's duties. Indeed, the RAB approach itself involves a significant degree of long term commitment but that has not prevented the CAA, initially at Q5 and more comprehensively in its current proposals, suggesting that the RAB approach should effectively be discarded at Stansted; and

- *"… and to even out under and over recovery over time."* It is not clear to us why this would be the case as it is not necessary for charges to be cost based for the charges to be in the interest of passengers.

12.56: **Price caps based on pegging tariff to comparator airports:**
The CAA appointed consultants Leigh Fisher ("LF") to assess the appropriateness of using benchmarking as a basis for setting price caps, and to develop a methodology and to generate values for what this might be in practice. The CAA considers the conclusions of the LF report and concludes that this approach is not appropriate to setting precise price caps, but could provide a useful indicator of the possible range for a competitive price.

While we would not disagree with the conclusion that the approach is not appropriate for setting price caps, the CAA has not as yet responded meaningfully to the serious concerns and misgivings we continue to have with LF's final prototype analysis. We further note that LF has only prepared this prototype methodology to answer the question of whether it is "*possible to benchmark prices at comparable airports in order to regulate charges at Gatwick and/or Stansted*", and they note that significant issues would need to be addressed in order for the methodology to be used successfully to cap airport charges.

Gatwick further notes that given the intent of LF's analysis outlined above it is clear that in addition to not being useful to benchmark airport charges in its current form (as recognised by LF), the analysis was not intended to assess the competitive price level. As such, we continue to be of the view that the analysis, as currently formulated, is not useful for indicating the levels of prices that could be expected in a competitive market.

12.64: **Price monitoring:**
The CAA explains that this form of regulation would provide a regulatory backstop to incentivise behaviour that did not abuse any market power. There would be no explicit price cap, but a monitoring regime which would ensure that the CAA was informed of Gatwick's performance across a range of measures, and which would introduce a threat of re-regulation.

To inform its thinking on this issue, the CAA appointed First Economics ("FE") to advise it on potential approaches to price monitoring. FE identifies three options for the design of a price monitoring regime, but dismisses one: monitoring against an external price. The other two options were variants of each other, with the second being a lighter touch variant of the first.

The CAA in its assessment considers neither of these options would be appropriate for Gatwick given the extent of market power. In its assessment, the CAA has said it has considered two options: i) in the absence of Commitments and ii) in combination with Commitments. In its assessment of price monitoring with Commitments, the CAA again raises its concerns it outlined in its assessment of Gatwick's Commitments (e.g. enforceability, level and consultation and that Commitments within a licence would be necessary). Moreover, the CAA states that with the degree of market power held by Gatwick, it is not clear there would be sufficient discipline on Gatwick's behaviour to rely on price monitoring.

In our view, the CAA should have placed more emphasis on the presence of Commitments in its assessment of price monitoring. In addition, where the CAA considers the presence of Commitments in addition to price monitoring we do not share the CAA's view that the CAA would have to rely on Commitments and not price monitoring.

CAA's chapter 13: Service quality

13.6: **'Events'-based rebates:**
While we agree with the CAA that all passengers should experience a consistent performance from the airport, our opinion is that the proposed event based measure for security central search is not the best way to achieve this for the security experience. If the old system, under manual measurement was continuing this could be a way of setting a minimum level of performance for all passengers. This could potentially be implemented in North Terminal until the automated queue measurement system was implemented. However, the system, already introduced into South Terminal central search, is more sophisticated and lends itself to a robust process capability indices measure rather than the retrograde step of fitting an old methodology to a new system. As such we suggest that Gatwick and the CAA work together over the next few months to establish the new methodology, using the capability of the new automated queue measurement system, to provide a consistent performance measure for passengers processing through Security central search.

13.7 & 13.36: **Financial risk:**
We agree with the CAA approach to maintain a similar level of overall financial risk to Gatwick by reducing the measures of average performance and setting an annual maximum for event based rebates. We also agree with the CAA's conclusion that there is no justification for increasing the overall total rebate from 7% as it has proved sufficient to drive improved performance during Q5.

13.41: **Timing of rebates and bonuses:**
We note that rebates will continue to be set according to an annual maximum but spread over 6 months. We think it would be more appropriate to spread the rebate over 12 months, hence, each month in which there is a failure a rebate will be payable.

13.45: **Events based rebates:**
We support the logic of introducing such rebates however, caution that sufficient consultation between the CAA and the Airport must take place before the metrics and methodology can be agreed in order to ensure they carry out the purpose for which they are intended, which is to incentivise consistency and not add undue cost or complexity.

13.50 to 13.54: **Inclusion of bonuses:**
We note the CAA's view that the use of bonuses is to incentivise terminal equivalence. We are therefore surprised that Pier Service Levels are not included, as historically the South Terminal has always attained a higher level than North Terminal. To ensure terminal equivalence, Pier Service Levels should be included within the bonus incentives. In order to keep symmetry with the rebates this should be 0.5% for each terminal (as per Gatwick's proposal, due to the importance of this measure to the airlines and the passengers). In addition the new measure for outbound baggage should have a bonus attached, also in order to meet the CAA's stated aim of incentivising terminal equivalence. This too should be equivalent to the rebate, which the CAA has suggested be 0.2% for each terminal. However our proposal (recognising the importance of this area to the airlines for impacting on time performance, and the importance to the passenger that their bag is on their plane) suggests 0.3 per terminal. Taking both these elements into account the total bonus available would be 3.04%, this still falls far short of the symmetry between bonuses and rebates that Gatwick believes is fair and reasonable.

We believe the SQR scheme, together with the additional airline/UKBF measures proposed by us, are sufficiently robust to ensure that the passengers' interests are upheld, we therefore see no need to make provision for modifications to the bonuses/rebates during the agreed period. We also agree with the CAA that the area of operational resilience is not suitable for deploying SQR bonuses.

13.56 to 13.58: **Publication of results under the SQR scheme:**
We note the continued requirement to publish on our website the performance against standards and any rebates paid. We also note the further requirement to publish the detail of bonuses earned. It is worth pointing out that Gatwick already publish details of the bonuses earned on our website. We note the requirement to reduce the number of elements published within the Terminal buildings and the additional information requirement. We are agreeable to implement these changes.

13.59 to 13.62: **Content of the SQR, overview**:
We note that the CAA has included the ACT in the absence of a new target on airfield availability. We have had some discussion with the ACC members about this target, but as yet an alternative has not been tabled. We recognise that if a proposal is not forthcoming then the ACT will remain in force.

We have had progressive discussions with the ACC members regarding an outbound baggage measure and the proposal is almost agreed. The proposal is based around measuring the system performance rather than system availability.

With regard to flight information it is clear that some passengers are wishing to rely on personal technology to advise them of the details of their flight timings. Under current technology available and deployed, we do not have the ability to supply this to the passengers; however as part of our business systems transformation capital project we seek to offer this ability in the future. Until that time and indeed for many of our passengers anyway, flight information screens remain the key source of information, hence why we have continued to include this measure within our SQR scheme. On the specific question of wi-fi, this is available throughout the passenger areas of the terminal and is free for the first 30 minutes of use.

13.74 to 13.75: **Departure Lounge Seating Availability QSM:**
The significant improvement in this score is almost certainly due to the fact that the passenger numbers fell heavily in the first 3 years of Q5 and even now have not recovered to the levels seen in 2006/07 or the highest numbers seen at Gatwick during 2007/08, which was when the current targets were set.

The improvements currently underway in South Terminal departure lounge, and those due to start in North Terminal are based on the current target. In order to meet an increased target we would need to revisit the ST IDL project to incorporate more seating and we would need to revisit the business case for the NT IDL expansion and reconfiguration to amend the target and assess the impact that had on the proposed design, both in terms of capex and revenue.

13.77: **Cleanliness QSM:**
We note that the CAA does not expect an increase in costs for cleaning the airport due to an increase in standard. However, unlike the more facility based measures of way finding and flight information; in order to maintain these new higher standards for cleaning, the budget will increase due to staff and product costs, particularly for the former as, if predicted, the UK economy recovers and quality staff become harder to attract. Past experience has shown a direct correlation between the cost of cleaning and the QSM scores obtained (Gatwick reduced the budget soon after new ownership and the scores fell by up to 0.05 in the South Terminal, the budget was increased and several months later we reached the 4.0 target). Therefore an increased budget to meet the higher standard should be allowed for by the CAA when reviewing Gatwick's operating costs.

13.86: **Bonus 'deadband'**:
Gatwick are surprised by the CAA's approach of creating a bonus 'deadband' of 0.2 or 0.3 above the required standard, prior to a bonus being payable. The CAA refers to genuine out performance, implying that increasing the standard by 0.1 is not a genuine out performance. This is contradicted by the CAA's own findings, where with the exception of departure lounge seating (and the performance of this lends itself more to the decline in passenger numbers than any other reason) the QSM scores have increased by 0.1 or at the maximum 0.2 over the entire 6 year period of Q5. To increase scores above 4.0, passengers, must rate their experience excellent, to deliver excellence rather than merely good exponentially costs more and is harder to achieve. For these reasons we disagree with the CAA's approach to creating a 'deadband' for the bonus elements and would instead request the fair reflection that 0.1 (already far harder to achieve due to the change proposed in rounding protocol) is genuine out performance when the QSM standard is above 4.0.

13.91 to 13.93: **Measurement issues:**
We agree with the logic of retaining the current moving annual average measure for the QSM targets.

Gatwick understand the logic behind the CAA's proposal to report the QSM measures to two decimal places and to use this for the purposes of rebate and bonus calculation. However by changing this at the same time as uplifting the standards for each of the QSM elements the CAA is significantly increasing the service standard from that achieved today – a standard that the passengers are generally satisfied with. Indeed, if these two changes had been in place last year, Gatwick would have failed every single QSM target; NT Cleanliness and ST Departure lounge seating for the entire 12 months, and we would still be failing them now. To increase the performance in these areas to pass the new standards would take significant injections of capex and opex, none of which are currently within our budget/business plan. While we are committed to offering good service, we also wish to provide value for money and therefore not increase the standards when doing so means the costs outweigh the benefits. Bearing in mind the CAA's comment that 'there is no pressing reason to increase standards where this would likely result in increased expenditure', we suggest further discussion and analysis on this topic with the CAA is necessary before a final decision is taken.

13.94 to 13.109: **Central Search formulation of metric:**
We agree with the CAA that the new technology that we have developed and implemented in South Terminal provides the opportunity for re-formulating the metric and as mentioned earlier in this section we propose to work with the CAA to arrive at a robust process capability indices measure for this element. When the principles of the measure are agreed we would suggest involving the airlines in consultation to finalise the operating protocols of the measure. This would then be rolled out to North Terminal central search once the proposed capital project is complete. We do not currently intend to roll this technology out to the transfer search areas; we have no projects proposed to do this. Therefore, we anticipate these areas continuing to be manually measured.

We note that the CAA proposes to keep the same metrics as Q5 for 2014/15 and then move to an agreed new methodology and metric from April 2015. It should be noted that the current programme for North Terminal security completes the project in 2017/18; it may be possible to bring forward the automated queue measurement system installation, but this would need to be confirmed.

The CAA's own survey shows that passengers queue at security for less than half the time they believe is the maximum reasonable, therefore we are not sure why the CAA believes there is a need to introduce a maximum queue length target when there is not a problem to address. We do not think that the addition of another measure is necessary when account is taken of the evidence of what actually happens and the passengers own perception that the service is satisfactory.

We note the proposal to include the moving annual average measure for security from the QSM survey in the published monthly results.

13.112: **Outbound baggage availability:**
The proposed measure from the CAA is based on system time available throughout the month. The measure that we have been discussing with the ACC is related to baggage performance each month; we are close to agreement on the details of the measure and will be forwarding this separately to the

CAA in due course.

13.117: **Aerodrome congestion term (ACT):**
There have not been any material events during Q5 as the operation has been very well managed and all protocols followed. There have been investigations during this period, but none which have caused the ACT to fail. If the ACC do not suggest an alternative proposal (nothing has been suggested to date) we will continue with the ACT with the addition of a snow SLA as proposed by Gatwick to the ACC earlier this year.

13.121 & 13.125: **Airline/handling agent measures:**
Gatwick are disappointed that the CAA has not included minimum airline standards within their initial proposals, although we note that the CAA opine that they might find a place in a Commitments based regime and further work is required before they might be introduced. We reiterate our point that many of the passenger facing experiences at the airport are delivered by the airlines via their handling agents and that one of these in particular, time waiting to reclaim baggage, is consistently our top complaint from passengers. It does not seem to be in the passengers' best interests for the CAA to ignore these areas of complaint. While the CAA sees merit in the publication of performance, this incentive only goes so far to improve behaviours and therefore performance.

Appendix A – We have made comments on the proposed new metrics for security earlier in this section. Please note that the correct terminology for the Shuttle between the two terminals is 'inter-terminal shuttle'. We note that a pier service standard has not been proposed, however the text states 'subject to exceptions to be agreed by Gatwick and the AOC' so should we assume that 95% is the default standard?

We note that the CAA has proposed different levels of rebate to those proposed by Gatwick and would suggest further discussion between us, prior to finalising the rebates for each item.

CAA's chapter 16: Other price control issues

16.2: **Transparency condition:**
Gatwick proposed in the draft conditions of use, submitted to the CAA in March 2013, that we would maintain financial transparency in relation to the specified charges. After reviewing the CAA's initial proposals we have considered some changes which are reflected in our updated contracts and Commitments.

16.9: **Safeguarded assets:**
The approach to safeguarded assets provides an incentive for the airport to consider the longer term effects of its developments and to develop its assets in a more integrated manner. We do however note that, at the moment, this mechanism is seldom used in practice at Gatwick.

Under Gatwick's Contracts and Commitments there is not a direct link between capital expenditure and price. As a result the approach to how to address what the CAA terms safeguarded assets is less important and therefore our comments are not relevant in the Contacts and Commitments world. We do however note that under our proposals for financial transparency an Asset Base ("AB") will be calculated to provide sufficient information to airlines.

We question whether a change in approach to safeguarded assets, such as that suggested by the CAA would be appropriate, given that this would mean exposing the airport to additional risk, as well as additional consultation and negotiation requirements. This will weaken the incentive for the airport to make use of the mechanism.

16.16: **Security cost claims mechanism (the S-factor):**
Costs arising from changes to security arrangements expose airports such as Gatwick to substantial risks. We believe that the requirement for the pass through has in no way diminished and that it should therefore be maintained. Gatwick supports retaining the S-factor at the pass through level of 90% and considers that increasing the deadband to reflect inflation (to £8.5m) is appropriate.

16.19: **Opex efficiency incentive mechanism:**
Gatwick notes that an opex efficiency incentive mechanism, has been used in other sectors. We do however consider that the implementation of such schemes can be complex and in addition to that such mechanisms are more appropriate in contexts where the regulatory regime will continue perpetually. Given that the Competition Commission considered it likely that regulation would be removed at Gatwick we do not consider that such a regime would be appropriate for Gatwick.

16.23: **Traffic risk sharing:**
Gatwick notes that the traffic risk facing the airport is substantially higher than what CAA is currently recognising due to the emergence of competition with the four larges London airports now in separate ownership and competing. We do however consider that this step change increase in traffic risk is better dealt with through the cost of capital.

16.25: **Within period traffic mix forecast correction (K) factor:**
Gatwick supports the CAA's proposal to not change the within period traffic mix correction (K) factor mechanism.

16.28: **Inflation:**
Gatwick notes that the ONS undertook a review of the RPI inflation index in 2012 and published a decision in to retain the current index in January 2013, citing the value in preserving the continuity of the index. Gatwick considers that it is reasonable for the airport to manage the risk derived from routine revisions to the RPI index. We do not agree with the CAA that we can reasonably be expected to carry the risk of fundamental reviews to the RPI index without an appreciable impact on our risk level. Following the ONS review the UK Statistics Authority has launched a wider review of the "*governance arrangements and structures supporting the production of price indices to ensure that these statistics best meet user needs in the future*."[13]

Given this review we consider that the risks arising from more fundamental reviews to inflation has not been removed and indeed increased compared to previous periods.

[13] http://www.statisticsauthority.gov.uk/reports---correspondence/current-reviews/Review-of-Governanance-of-Prices-Statistics---Terms-of-Reference.doc

16.34: **Non-passenger flights:**
Gatwick has no comments on this proposal by the CAA.

Detailed comments on draft licence formulae
This section provides more details on the price control formulae set out in the CAA's paper "Further information on the CAA's initial proposals for the economics regulation of Gatwick Airport Limited after April 2014", published 31 May 2013.

We note that some of the comments we have made in relation to the other chapters of this document (particularly capex and the section on service quality) area also relevant to the considerations on the licence design.

Annex A:

Main formula in Condition 3:
1) We note that the variable "T" used twice, for capital trigger factor in 3.1 and for total revenue in 3.5. Another variable tag is required.

S Factor:

1) In general, we request a review of the complex security formula ahead of the publication of the final proposals. We believe that the opportunity for unintended consequences to arise through the complexity is legion;

2) We note that the security deadband has been increased from £7m to £8.5m for inflation between Q5 and BQ5; and

3) CAA will be effectively claiming back money from security spend in 2013/14 – 3.2 shows the formula for 2015/16 yield and the S factor for that year will depend on security spend in t-2 (2013/14). If a claim is made, then it could be double counting the effects internalised in the price control building blocks decision.

K factor:

1) The K factor formula wrongly includes "q_{t-2}", this should be "Q_{t-2}". The effect of the formula as written is: total revenue less actual traffic multiplied by the price cap per passenger. This will always equal zero. We presume this is meant to be: total revenue less forecast traffic multiplied by the price cap per passenger.

Trigger payment:
The CAA has introduced inflation into this formula, so that monthly trigger payments will be inflated from today, to the point of payment. We note that this did not exist in Q5.

Development capex:

1) The definition of "o" could be improved. We are assuming it refers to the value of development capex agreed and going ahead;

2) A valuation of the "v" is not given;

3) It is important that all development capex related depreciation and return is included in the price control calculation at the start of the Q;

4) The formula implies that the return on the development capex not going ahead is clawed back, but the associated depreciation is not clawed back. This appears to be a good thing for Gatwick, because cash flow is retained for projects that don't go ahead (subject to a clawback at the end of the Q); and

5) The accounting for inflation within the formula doesn't work correctly. The "o" term is valued in outturn prices (i.e. 2015/16 prices, but expected in 2013/14); whereas the "v" term is updated for actual inflation (i.e. 2015/16 actual prices). Some correction of the "o" term for the difference between expected and actual outturn prices is required.

3.11: The drafting of this clause is very unclear.

3.12: "P80" concept is not defined.

Annex B (SQR):

1) Modification of SQR: We can request a modification from the CAA, if we have the agreement of the AOC (representing an undefined % of passenger). The AOC can request a modification from the CAA, even if it does not have the agreement of Gatwick. The CAA can modify the SQR, following consultation. However, Gatwick cannot request a modification without the AOC agreement. We consider that this is this is an omission, particularly as the CAA has admitted that there are times where airlines do not represent passenger interests. The CAA should add the possibility of the airport requesting a change to the SQR without AOC agreement, given its duty to passenger interests; and

2) What can't be modified: the element (i.e. the definition of the SQR - "cleanliness"), the bonuses for the QSM (but you can modify the bonuses on non-QSM) and the total bonus calculation. It is not clear why QSM is fixed and non-QSM is not fixed.

12 Way forward

This document has detailed our revised Commitments proposal to airlines and our response to the CAA's initial proposals. We request the CAA to consider the points raised, ahead of forming its final proposals, which are scheduled to be published in October 2013.

Specifically, we request the CAA to consult on our Commitments proposal. We are more than ever convinced that Commitments represent the best future for our passengers and for the airline community.

We will be issuing a separate document in response to the CAA's minded to proposals for its market power assessment of Gatwick.

Appendix 1: Gatwick's Commitments proposal term sheet

Section A	**General Conditions**
Parties	Gatwick Airport Limited (GAL) and all airlines operating at Gatwick Airport.
Regulatory background	The CAA published (April 2013) its initial assessment of the three elements of the "Market Power Test" in accordance with the Civil Aviation Act 2012 (the Act). The CAA has concluded that the Market Power Test is met in relation to GAL as operator of Gatwick Airport, and that it is minded-to issue Gatwick with a Licence. GAL disputes the CAA's assessment and believes it does not meet the Market Power Test and, accordingly, should not be issued with a Licence. GAL remains subject to the provisions of Airport Charges Regulations 2011 (the ACR) and, where applicable, general competition law. The CAA will have concurrent powers under competition law through the framework of the Act. Nevertheless, GAL has decided that it would be commercially expedient for it to put in place the Airport Commitments for the benefit of all airlines operating at Gatwick Airport. The Commitments address the key interests of airport users including the range, availability, continuity, cost and quality of airport operation services. These Airport Commitments will create binding contractual arrangements between GAL and airlines operating at Gatwick. They have been drafted on the basis that GAL is not issued with a Licence. However, without prejudice to our contention that GAL does not require a licence under the Act, the Commitments would be effective if backed by a licence framework as discussed in paragraphs 12.37-12.41 of the Initial Proposals.
Conditions of Use	GAL undertakes to incorporate the Airport Commitments into GAL's Conditions of Use, for the benefit of all airlines who may operate at Gatwick Airport during the period covered by the Airport Commitments. Set out below is indicative drafting to be incorporated into the Conditions of Use: • *"Applicability and Enforceability* *The publication of these Conditions of Use constitutes an offer by Gatwick Airport Limited to permit the use of its facilities on the terms set out herein. The use of any facilities at the airport whether airside or landside other than as a passenger constitutes acceptance of these Conditions of Use. It is intended that these Conditions of Use constitute a contract as between Gatwick Airport Limited and each and every Operator using the facilities at the airport.* • *Variation* *Gatwick Airport Limited may at its sole discretion vary amend or add to these Conditions of Use and any such variation, amendment, or addition may be promulgated by means of a Gatwick Airport Directive (GAD) save that no variation may be made to clauses ● and ● [i.e. those dealing with the substantive provisions of the commitments including: initial term; contractual remedies and independent adjudication; price commitment; service commitment; investment & consultation commitment; information commitment; and operational & financial resilience commitments], other than in accordance with the variation provisions contained in clauses ● and ● respectively."*
Initial term of Airport Commitments	7 years to 31 March 2021
Extension of Airport Commitments	It is envisaged that, over time, the number of airlines operating under bilateral contracts rather than under the Conditions of Use will increase, such that the majority of passenger traffic is under contract. The scope of any future airport commitments will be a matter for commercial consideration by GAL and its airline customers prior to the end of the initial term of the Airport Commitments. GAL will notify the CAA and the airlines operating at Gatwick at least 2 years prior to the end of the initial term of the Airport Commitments of its intention with regards to the modification, extension, termination, or otherwise of the Airport Commitments.
Bilateral airline-airport contracts	Airlines operating at Gatwick Airport will operate under the terms of either: • the airport's Conditions of Use which will incorporate a published airport tariff and set out airport wide service standards consistent with the Airport Commitments; or

	• bilateral contracts setting out the commercial arrangements between the airport and airline, including price and service standards. Such bilateral contracts may contain additional service penalty/bonus mechanisms and may include prices that are at a discount or premium to the published airport tariff. Alternatively, such contracts may place reliance on the Conditions of Use save for limited, specific alterations. The charges for services rendered under the Conditions of Use and bilateral contracts will need to be consistent with the requirements of the ACR and any relevant provisions of competition law, but no prior regulatory approval of the detail of these contracts will be required.
Pricing principles	GAL will provide users, from time to time, with a summary of the pricing principles it has adopted in setting the airport tariff and entering into bilateral contracts. These pricing principles do not form part of the Commitments, but for information an extract has been set out at Attachment 1.
Contractual remedies and independent adjudication	Normal contractual remedies will be available to airlines operating under the Conditions of Use, within which the Airport Commitments have been incorporated. The right of redress would be to the courts but with an adjudication provision (of the type imposed by section 108 of the Housing Grants Construction and Regeneration Act 1996) built in to encourage speedy resolution of disputes by providing for non-binding adjudication by independent experts drawn from an agreed panel. Airlines will continue to have separate rights of redress under the Airport Charges Regulations 2011 where the airport operator has failed to set airport charges in accordance with the Regulations. In addition the CAA will continue to have rights to investigate and make compliance orders in relation to the airport operator's failure to comply with the Regulations. Set out below is indicative drafting to be incorporated into the Conditions of Use: *"Dispute Resolution Procedure* • *Either party shall refer any Dispute to an Expert for determination by serving notice in writing to that effect on the other party. The notice shall contain sufficient particulars of the Dispute to be referred to an Expert.* • *The parties shall agree the identity of the Expert to be appointed. In default of agreement, within ten working days of the date of service of a notice referring a Dispute to an Expert for determination, the Expert shall be appointed on the application of any party to the President of the Law Society or the Chairman of the Bar Council.* • *The Expert shall not act as an arbitrator and the provisions of the Arbitration Act 1996 shall not apply.* • *The Expert shall determine the Dispute referred to him impartially and acting reasonably. The Expert will establish the procedural rules to be applied to the determination which must include the following steps:* - *each party will be entitled to make submissions to the Expert;* - *the Expert may request any party to provide him with any further information as he may require in order to determine the Dispute provided any such information is made available to the other party to comment;* - *all communications between a party and an Expert shall be copied to the other party;* - *any failure by a party to respond to any request or direction by the Expert shall not invalidate the Expert's determination.* • *Unless a shorter period is agreed between the parties at the time of the Expert's appointment, a fully reasoned written determination must be delivered to the parties within 21 working days of the Expert's appointment.* • *The fees and expenses of the Expert shall be borne by the parties in equal shares unless the Expert determines otherwise. Each party shall be solely responsible for bearing its legal and other costs arising out of any reference of a Dispute to an Expert.* • *Any decision of the Expert shall be binding until the Dispute is finally determined by legal proceedings or by agreement.* • *Neither party shall make any application to a competent court in relation to the conduct of the*

	determination or the Expert's determination or the Dispute after ninety days from the date of the Expert's determination or, in the event the Expert has failed to reach a decision, the date on which the Expert should have reached a determination. • *The dispute resolution procedure set out in clauses [●] above is without prejudice to, and does not impact upon, Gatwick Airport Limited's right to exercise its power to detain aircraft for the non-payment of Airport charges, pursuant to the Civil Aviation Act 1982. Gatwick Airport Limited may at all times exercise that power without recourse to this dispute resolution procedure.* • *The dispute resolution procedure set out in clauses ● above shall not prevent either party from seeking urgent relief by applying to a competent court for injunctive relief."*

Section B	**Price commitment**
Published airport tariff	The published airport tariff will include the following elements: (1) <u>Core Service Charges</u> for commercial passenger flights receiving the Core Service Standard. This will include: • ATM fees (landing & take-off) • passenger fees • aircraft parking fees The Core Airport Charges may include general discount and incentive structures available to all airlines operating under the Conditions of Use. (2) <u>Premium Service Charges</u> for commercial passenger flights receiving Premium Service Products. (3) <u>Selected Ancillary Service Charges</u> for other services provided by the airport including for: • certain currently Specified Activities, namely: - Staff ID - airside licences - FEGP (net of cost of electricity) - Airside Parking - Hydrant Refuelling (4) <u>Other Ancillary Services Charges</u> for other services provided by the airport including for: • PRM services • Property related charges (rental, utilities, etc) • Certain currently Specified Activities, namely: - Check-in & Baggage Charges - Staff car parks - Facilities for bus & coach operators - Utilities (gas, water, electricity, heating) - Cable routing (5) Other Airport Charges for cargo, general aviation and other non-passenger flights including related landing and parking fees and ancillary charges. Public interest conditions in relation to currently Specified Activities to be removed. Check-in & Baggage Charges and other charges for groundhandling activities remain subject to the provisions of the Groundhandling Regulations.
Scope of price commitment	<u>Core Service Charges and Selected Ancillary Service Charges</u> in the published airport tariff will be set at a level such that the indicative price path condition is met (see below).
Indicative price path condition	GAL intends for the Aggregate Core Revenue per Passenger (the "Core Yield") and the Aggregate Blended Revenue per Passenger (the "Blended Yield") to be set in line with, respectively, the Indicative Gross Yield profile and the Indicative Net Yield profile (set out below). The actual Core Yield and Blended Yield may deviate from its associated indicative yield in any given year. GAL undertakes that, taking the period of the airport commitments as a whole, there will be no aggregate "over-recovery" in airport charges relative to the indicative yield profiles. The Indicative Net Yield profile in a relevant year t (NY_t) is defined as:

	$$NY_t = U_t + B_t + S_t$$ The Indicative Gross Yield profile in a relevant year t (GY_t) is defined as: $$GY_t = W_t + B_t + S_t$$ These are indicative profiles since, in any given year, the actual Core Yield and Blended Yield may be less than, or greater than, its associated Indicative Yield. Such phasing differences may be due to unanticipated circumstances (e.g. changes in actual vs. expected mix of traffic) or deliberate business decisions (e.g. to alter charges below/above that implied in the Indicative Yield profiles taking into account factors such as: prior year under- or over-recoveries, economic conditions, competitive threats, growth opportunities, etc).
	
	The amount by which the actual Core Yield differs from the Indicative Gross Yield in a relevant year t will generate a revenue difference which, over time, will give rise at the end of a relevant year t to a Cumulative Gross Revenue Difference ($CGRD_t$) defined as: $$\mathrm{CGRD_t} = (\mathrm{T_t} - \mathrm{Q_t} \cdot \mathrm{GY_t}) + \mathrm{CGRD_{t-1}}(1 + \mathrm{I_{t-1}})$$ and where, $$\mathrm{CGRD}_{2013/14} = 0$$ Similarly, the amount by which the actual Blended Yield differs from the Indicative Net Yield in a relevant year t will generate a revenue difference which, over time, will give rise at the end of a relevant year t to a Cumulative Net Revenue Difference ($CNRD_t$) defined as: $$\mathrm{CNRD_t} = (\mathrm{T_t} - \mathrm{Q_t} \cdot \mathrm{NY_t}) + \mathrm{CNRD_{t-1}}(1 + \mathrm{I_{t-1}})$$ and where, $$\mathrm{CNRD}_{2013/14} = 0$$ GAL undertakes that:
	• the Cumulative Gross Revenue Difference shall not exceed:
	  - £nil at the end of the initial term of the Airport Commitment i.e. $CGRD_{2020/21} \leq 0$; and
	  - £10m in any year during the initial term of the Airport Commitments i.e. $CGRD_t \leq £10m$.
	• in setting airport charges each year, GAL will do so with the objective that the change in estimated Core Yield between any year “t-1” and subsequent year “t” should not exceed RPI+10%, provided that this objective shall not limit GAL from attaining a $CGRD_{2020/21}$ of £nil;
	• the Cumulative Net Revenue Difference shall not exceed:
	  - £nil at the end of the initial term of the Airport Commitment i.e. $CNRD_{2020/21} \leq 0$

Publication of Cumulative Revenue Differences	The Cumulative Revenue Differences (CRD, meaning both CGRD and CNRD) will be published by GAL as part of the annual airport charges consultation, updated with actual data and revised estimates. As the consultation in relation to year “t” is undertaken part way through year “t-1”, GAL will publish at this time: • the actual CRD_{t-2}; • a revised estimate of CRD_{t-1}; and • an estimate of CRD_t. Assumptions underlying the estimated figures (including outturn charges, traffic and revenue data for historic years, as and when available) will be provided to enable airlines to verify the calculations.
Adjustments to indicative price path upon airline approval	Amendments to the indicative price path may be made by GAL, following consultation by GAL with the Gatwick Airline Consultative Committee (ACC): • if approved in writing by airlines paying charges under the published tariff that together account for at least 51% of the passengers (in the 12 months immediately preceding the month in which GAL requested written approval from the airlines of the proposed amendment) travelling through the airport on airlines paying charges under the published tariff, and representing at least 51% of the airlines responding in writing.

Second runway costs and potential adjustments to the indicative price path	Amendments to the indicative price path may be made by GAL, following consultation by GAL with the Gatwick ACC and the CAA: • if following the completion of the Airports Commission the Government supports the development of a second runway at Gatwick Airport, to allow for the recovery of the reasonable costs of applying for planning permission for a second runway and the subsequent development of the second runway and associated airport infrastructure. The recovery of costs associated with an application for planning permission will not be on the basis of an annual pass through, but on the presumption of recovering such costs over a [10 year] period by way of equal instalments.
Annual consultation on charges	Consultation on charges in the published airport tariff of the Conditions of Use, together with associated service standards and investment, will be undertaken annually in accordance with the Airport Charges Regulations 2011. GAL will provide additional financial information to support this consultation as set out in "Information Commitment" below.
Definitions for the Price Commitment	Set out below.
Aggregate Core Revenue	Aggregate Core Revenue is the sum of: (i) revenue arising from Core Service Charges and Selected Ancillary Service Charges for relevant commercial passenger services operated under the terms of the published airport tariff set out in the Conditions of Use; and (ii) revenue arising from charges equivalent to the Core Service Charge and Selected Ancillary Service Charges for relevant commercial passenger services operated under the terms of bilateral contracts, but substituting for the actual revenue received the revenue that would have been received if such services had been offered and charged under the published airport tariff. For the avoidance of doubt: • Aggregate Core Service Revenue does not include: revenue from Premium Service Charges, Other Ancillary Service Charges, Other Airport Charges and Ancillary Charges arising under the terms of the published airport tariff; nor revenue arising from equivalent charges under the terms of bilateral contracts; and • Revenue from FEGP charges, included in Selected Ancillary Service Charges, is net of the cost of electricity.
Aggregate Blended Revenue	Aggregate Blended Revenue is the sum of: (i) revenue arising from Core Service Charges and Selected Ancillary Service Charges for relevant commercial passenger services operated under the terms of the published airport tariff set out in the Conditions of Use; and (ii) revenue arising from charges equivalent to the Core Service Charge and Selected Ancillary Service Charges for relevant commercial passenger services operated under the terms of bilateral contracts. For the avoidance of doubt: • Aggregate Core Service Revenue does not include: revenue from Premium Service Charges, Other Ancillary Service Charges, Other Airport Charges and Ancillary Charges arising under the terms of the published airport tariff; nor revenue arising from equivalent charges under the terms of bilateral contracts; and • Revenue from FEGP charges, included in Selected Ancillary Service Charges, is net of the cost of electricity.
Passengers	For the purpose of the calculation of the Core Yield, "Passengers" includes all passengers, whether carried by an airline under the terms of the published airport tariff or a bilateral contract.
t	The annotation "t" denotes the relevant year t, being a period of twelve months starting on 1 April and ending on 31 March in the following year, the annotation "t-1" denotes relevant year "t-1" immediately preceding relevant year "t", and so forth. By way of example, the annotation "2014/15" denotes the year commencing 1 April 2014 and ending on 31 March 2015.
U_t	U_t is the underlying net yield in relevant year t, defined as: $U_t = U_{t-1}(1 + RPI_{t-1} + X)$ and, $U_{2013/14} = [\bullet]$

W_t	W_t is the underlying gross yield in relevant year t, defined as: $$W_t = W_{t-1}(1 + RPI_{t-1} + X + 1\%)$$ and, $$W_{2013/14} = U_{2013/14}$$
RPI_{t-1}	RPI_{t-1} means the percentage change in the Retail Price Index between that published with respect to August in relevant year t-1 and that published with respect to August in relevant year t-2.
X	X is 1.5%
B_t	B_t is the bonus per passenger earned in relevant of year t, if any, being: • the amount of the Core Service Bonus calculated as set out under "Service Commitment" below; divided by • the number of passengers using the airport in year t (Q_t) Any estimate of B_t prepared prior to the start of year t will be assumed to be £nil.
S_t	S_t is the permitted security cost per passenger in relevant year t, if any, being: • the aggregate of: - 90% of the amount by which the increase in security costs at the airport in year t, which arise as a result of a change in required security standards at the airport, exceeds £1m; and - the cost of installing new hold baggage screening equipment in accordance with the requirements of Gatwick's security regulator and as agreed through the capital investment programme consultation process. The recovery of the capital costs and associated funding costs will be presumed to be made over the assessed life of the equipment, in equal annual amounts. • divided by: - the number of passengers using the airport in year t (Q_t).
T_t	T_t is the Aggregate Core Revenue in relevant year t.
Q_t	Q_t is the total number of passengers using Gatwick airport in relevant year t. This includes all passengers, whether carried by an airline under the terms of the published airport tariff or a bilateral contract.
I_{t-1}	I_{t-1} is the annual percentage interest rate equal to the sum of (i) the average of the UK Treasury Bill Discount Rate (expressed as an annual percentage interest rate) published weekly by the Bank of England, during the 12 months from the beginning of September in relevant year t-1 to the end of August in relevant year t; and (ii) if the relevant CRD_t has a positive value, 3%, otherwise, 0%.
Specified Activities Charges	Gatwick Airport Limited shall ensure that those charges relating to Specified Activities are set at a level which is fair, reasonable and non-discriminatory. Specified Activities for these purposes will comprise: • Staff ID • airside licences • FEGP • Airside parking • Hydrant refuelling • Staff car parks • Facilities for bus & coach operators • Utilities (gas, water, electricity, heating) • Cable routing At least 3 months prior to making any amendments to those charges relating to Specified Activities, GAL will provide to users of the Specified Activities and the CAA: • relevant information (including cost information, where relevant, or other information if charges for the specified facilities are not established in relation to cost) and assumptions adequate to verify the basis upon which the charges have been calculated. GAL will provide additional financial information to support this consultation as set out in "Information Commitment" below.
PRM and Check-in & Baggage Charges	GAL will comply with the relevant legislation in relation to the setting of check-in & baggage charges and PRM charges. GAL will provide additional financial information to support this consultation as set out in "Information Commitment" below.

Section C	Service commitment
Airport-wide standards to be monitored <u>and</u> subject to penalties/bonuses	The Core Service Standards are as set out in Table A (appended), together with Service Bonus Standards. These are broadly based on the existing Q5 SQR scheme with some modifications as to: • the inclusion of an outbound baggage target; • the inclusion of an airfield availability metric or retention of the existing aerodrome congestion term (but to include a measure of snow event readiness); • the maximum annual rebate amount remains 7% of Core Service Charge Revenue; • the maximum annual bonus amount is 3.5% of Core Service Charge Revenue, relating only to certain selected passenger facing measures and maintaining symmetry with the rebate; • a single maximum potential rebate percentage for each service standard, equally applicable to a month or year. In Q5 a monthly maximum and a separate annual maximum is specified; • an incremental penalty factor of 25% applied to the rebate percentage for certain selected passenger facing measures if the relevant service standard has not been met for six consecutive months; • bonuses change the indicative yield profiles and, therefore, may give rise to adjustments in airport charges in subsequent years (as in Q5); and • failure of an airline to meet certain Airline Service Standards will reduce the amount payable by GAL in any month to such airline under the Core Service Rebates.
Adjustments to service standards upon airline approval	Amendments to the Core Service Standards may be made by GAL: • following consultation by GAL with the Gatwick Airline Operators Committee (AOC) & Gatwick ACC; and • if approved in writing by airlines paying charges under the published tariff or under bilateral contract (save for those airlines that have expressly waived the application of these service standards under the terms of their contract) that together account for at least 51% of the passengers (in the 12 months immediately preceding the month in which GAL requested written approval from the airlines of the proposed amendment) travelling through the airport on airlines paying charges under the published tariff or under bilateral contract (save for those airlines that have expressly waived the application of these service standards under the terms of their contract), and representing at least 51% of that airlines responding in writing.
Airline Service Standards to be monitored and published, and subject to penalities / bonuses	GAL will monitor and publish the performance of individual airlines in relation to certain airport-wide activities. These include: • Check-in queue performance; • Arrival bag performance; and • PRM service and pre-notification. GAL may amend the airline service standards that it is monitoring and publishing from time-to-time, following consultation with the Gatwick AOC & ACC. The first two of these standards are designated as Airline Service Standards for the purposes of determining the Core Service Rebate for individual airlines. These standards are set out in Table B (attached). The third standard (in relation to PRM) is already a factor that determines the PRM charges payable by individual airlines.
Airport-wide standards to be monitored <u>but not</u> subject to penalties/bonuses	• Airlines & airport: On-time performance (departures and arrivals); • UKBF: Immigration performance • Airport: ASQ
Publication of standards	GAL to publish monthly report on achievement of Airport-wide standards and the Airline Standards.
Payment of Core Service Rebate	The Core Service Rebate is the amount payable by GAL for a failure by it to meet the Core Service Standards. The Core Service Rebate will be paid quarterly, within 1 month of the end of each quarter (end June, September, December, March) to those airlines operating exclusively under the terms of the published airport tariff during the relevant period. An airline operating under the terms of a bilateral contract will not be entitled to the Core Service Rebate, unless otherwise provided for in such an agreement. The rebates will be calculated by terminal by month, and then allocated to the relevant airlines that used the terminal pro-rata with the Core Service Charges payable by each airline in relation to that month.

	An airline that has not met the applicable Airline Standards (as set out in Table B) will have its entitlement to Core Service Rebates reduced. Further, GAL shall be under no obligation to pay the rebate to an airline if there are unpaid amounts outstanding from such an airline to GAL. If the entitlement of an individual airline to Service Rebates is so reduced, there will be no change in the entitlement of other airlines to the Core Service Rebate.
Core Service Rebate	The amount ("Core Service Rebate") payable by GAL to an airline "a" in month "j" for a failure to meet the Core Service Standard Levels will be calculated as: $$Core\ Service\ Rebate_{a,j} = \sum_{t} Net\ Rebate\ Percentage_{a,t,j} \cdot Core\ Service\ Charge_{a,t,j}$$ Where: $$Net\ Rebate\ Percentage_{a,t,j} = Service\ Rebate\ Percentage_{t,j} - Airline\ Standard\ Rebate\ Percentage_{a,t,j}$$ $Core\ Service\ Charge_{a,j,t} =$ Core Service Charges incurred by each airline "a", in respect of terminal "t", in relevant month "j".
Service Rebate Percentage	Rebates shall be calculated separately for each terminal based on the performance against the standards for that terminal; with the exception of airfield availability, which will be calculated at an airfield level and the same percentage applied to both terminals. As noted in Table A, the inter-terminal transit availability standards and potential rebate percentages relate only to the North Terminal. For each terminal t, the Service Rebate Percentage for the month j shall be calculated as: $$Service\ Rebate\ Percentage_{t,j} = \sum_{standard\ i} p_{i,t} \cdot x_{i,t,j}$$ Where: $p_{i,t} =$ the potential service rebate percentage per month for standard "i", for terminal "t", as set out in Table A. $x_{i,t,j} =$ 0 if the standard "i", for terminal "t", in month "j" is greater than or equal to the service rebate level, as set out in Table A; or 1 if the standard "i", for terminal "t", in month "j" is less than the service rebate level, as set out in Table A; or in relation only to Selected Passenger Facing Measures, 1.25 if the relevant standard "i", for terminal "t", in months "j" and in each of the five immediately preceding months (i.e. "j-1", "j-2", "j-3", "j-4", "j-5") is or was less than the service rebate level, as set out in Table A . Provided that the maximum aggregate Service Rebate Percentage payable in relation to all Selected Passenger Facing Measures shall not exceed 3.50% in any financial year ending 31 March. For the purposes of this calculation, the Selected Passenger Facing Measures comprise those that are eligible for a Core Service Bonus, namely: Departure Lounge Seat Availability; Cleanliness; Way-Finding; Flight Information; Central Passenger Search (times<5minutes, times < 15 minutes); Passenger Sensitive Equipment (General); Passenger Sensitive Equipment (Priority); and Arrivals Reclaim (Baggage Carousels).
Airline Standard Reduction Percentage	For each airline "a", Airline Standard Reduction Percentage for the month j shall be calculated as: $$Airline\ Standard\ Reduction\ Percentage_{a,t,j} = \sum_{standard\ k} r_{k,t} \cdot z_{k,t,j}$$ Where: $r_{k,t} =$ the potential airline standard reduction percentage per month for standard "k", for terminal "t", as set out in Table B. $z_{k,t,j} =$ 0 if the standard "k", for terminal "t", in month "j" is greater than or equal to the standard reduction level, as set out in Table B; or 1 if the standard "k", for terminal "t", in month "j" is less than the standard reduction level, as set out in Table B.

Core Service Bonus	The amount ("Core Service Bonus") earned by GAL each year for meeting the Service Bonus Standard Levels will be calculated as: $$Core\ Service\ Rebate \; = \sum_{t,j} Service\ Bonus\ Percentage_{t,j} \cdot Core\ Service\ Charge_{t,j}$$ Where: $Core\ Service\ Charge_{t,j} =$ Core Service Charges in respect of terminal "t", in relevant month "j".
Service Bonus Percentage	Bonuses shall be calculated separately for each terminal based on the performance against the standards for that terminal. For each terminal t, the Service Bonus Percentage for the month j shall be calculated as: $$Service\ Bonus\ Percentage_{t,j} = \sum_{standard\ i} q_{i,t} \cdot y_{i,t,j}$$ Where: $q_{i,t} =$ the potential service bonus percentage per month for standard "i", for terminal "t", as set out in Table A. $y_{i,t,j} =$ 1 if the standard "i", for terminal "t", in month "j" is greater than or equal to the service bonus level, as set out in Table A; or 0 if the standard "i", for terminal "t", in month "j" is less than the service bonus level, as set out in Table A.
Repeated failures by GAL to meet service quality targets	In the event that any service quality target is not met for a period of 6 months, in addition to the increase in service rebate percentage that this would attract and the requirement for monthly publication of its performance standards, GAL will draw up an improvement plan in consultation with the ACC. In preparing such a plan, GAL and the ACC will consider any representations from the CAA made in the passengers' interest.
Premium Service Products	GAL may provide airlines and their customers with products and services over-and-above the Core Service Standard. These may be offered under the terms of the Conditions of Use or a bilateral agreement.

Section D	**Investment & consultation commitment**
Service enhancement through investment	GAL shall retain sole responsibility for managing the capital investment programme to enable it to meet its obligations regarding airport-wide service standards. GAL commits to maintaining the airport to comply with all applicable safety and environmental requirements and to maintain and develop the infrastructure of the airport to enable the airport-wide service standards to be achieved. In doing so, GAL commits to investing a minimum of £100m p.a. on average over each year of the initial term, although there is no binding programme of specific capital expenditure nor are there projects that are subject to capital expenditure triggers. GAL will undertake appropriate consultation in relation to capital investment, as described in the following sections. This approach to consultation goes beyond the capital expenditure consultation requirements of the Airport Charges Regulations 2011.
Categorisation of capital expenditure	• For the purposes of consultation, GAL proposes categorising capital expenditure into one of three areas: - Major Development Projects, comprising those individual projects or individual programmes of projects in excess of £10m (excluding the Asset Stewardship Programme) and the Second Runway Project; - Minor Development Projects, being those individual projects or individual programmes of projects less than £10m (excluding both the Asset Stewardship Programme and Second Runway Project); and - Asset Stewardship Programme, comprising all asset stewardship projects split into five broad elements - Airfield, Commercial, IT, Facilities and Compliance/Risk.
Airline consultative groups	• Consultation with the airlines will need to be undertaken at a number of different levels, with groups formed appropriately: - ACC: to consider strategic matters involving the medium- to long-term development of the airport;

	- Capital sub-committee of ACC: to consider tactical matters involving the delivery by GAL of the capital development programme; and - Working groups (informal and formal): to consider operational impacts of projects on the day-to-day activities of the airlines operating at the airport. These working groups (where required) will be project specific, involve affected airlines, and may require a formally constituted working group (e.g. the AOC) for significant projects requiring a high degree of airline input into the design and execution planning (e.g. check-in transformation).
Master Plan	• GAL published a Master Plan in July 2012. GAL will publish a revised Master Plan every five years, in consultation with airlines (including the ACC), other business partners and the local community. The exact timing of Master Plan updates will be dependent on Government airport policy consultations/decisions (e.g. in relation to the Airports Commission) and on the need to keep the overall long-term vision for the airport up-to-date.

Capital Investment Programme	• GAL will publish annually a rolling five year Capital Investment Programme
	
	• The CIP will be the key document around which strategic-level consultation on future airport development will take place. This consultation with the ACC will address:
	- the principal business drivers behind the airport's development strategy, including service levels;
	- forecast traffic demand and associated demand for airport capacities and services;
	- the capacities that the airport intends to provide, taken in the context of forecasted demand; and
	- the cost of the capital investment programme, and the resulting effect on the Asset Base of the airport.
	
	• The forecast cost of the capital investment programme will:
	- summarise expenditure on each of the Major Development Projects;
	- summarise aggregate expenditure on the Asset Stewardship Programme (across all five elements);
	- summarise aggregate expenditure on Minor Development Projects;
	- be at a level of detail that naturally reflects the planning horizon and Tollgate status for projects, with those in the short-term being more granular and certain than those in the final years of the forecast.
	- provide an explanation as to any material differences between the latest forecast and:
	  o the prior year forecast; and
	  o the forecast per the CAA's price control review

Individual Major Development Project consultation	• As part of the annual Capital Investment Programme consultation with the ACC, GAL will consult with airlines in relation to Major Development Projects (with the exception of "commercial return projects" and "dedicated airline projects") covering: - high-level options for the development of Major Development Projects and the trade-offs involved between alternatives; - the outputs that are expected to be delivered in terms of service, capacity, operating cost, and revenue; - scope, programme and cost of the project required to deliver the business objectives; and - the business case for the project. (This would be in a form consistent with those prepared by GAL for the ACC in Q5 and in preparation for BQ5). • GAL will consult with the Capital sub-committee of the ACC in relation to the Major Development Projects at Tollgate 2, Tollgate 3, and Tollgate 4. This will require meetings on a more frequent basis than annually. • Following Tollgate 4, progress with the delivery of Major Development Projects will be reviewed by the Capital sub-committee of the ACC as part of its annual Capital Investment Performance Review (see below). • A "commercial return project" is any project with associated commercial revenues that has a positive NPV not taking into account incremental airport charges. • A "dedicated airline project" would be a project undertaken for the benefit of one or more specified airlines and which is remunerated by a separate commercial arrangement or specific airport charge payable by users of the project.
Annual Capital Investment Performance Review	• GAL will meet annually with the Capital sub-committee of the ACC to review GAL's delivery of the Capital Investment Programme, specifically:

	- in relation to the following 12 months: o the schedule and expenditure for each Major Development Project; o the priorities and aggregate expenditure of the Asset Stewardship Programme across each of the five broad elements (separately identifying individual projects in excess of £1m). o the expenditure on Minor Development Projects (separately identifying individual projects in excess of £1m). - in relation to the preceding 12 months, works undertaken and progress with: o each Major Development Project; o Minor Development Projects (separately identifying individual projects in excess of £1m); and o Asset Stewardship Programme across each of the five broad elements (separately identifying individual projects in excess of £1m).

Section E	**Information commitment**
Financial performance	• GAL publishes detailed statutory accounts consistent with its status as a UK registered company, with debt securities listed on the London Stock Exchange, and falling within the Walker Guidelines relevant to a private equity owned company. • These statutory accounts (refer, for example, to GAL's Report & Financial Statements for the year ended 31 March 2012): - provide greater disclosure than the current regulatory accounts; and - contain sufficient, meaningful data in relation to the operating cost and revenue components of EBITDA, and in relation to the capital expenditure and depreciation components of GAL's asset base, to enable airlines, the CAA, and other users of GAL's accounts to undertake an analytical review of GAL's on-going business performance, capital investment, and financial returns, (including relative to the CAA's financial projections prepared as part of the Q6 review) and to assess whether charges are reasonable. • GAL will not publish separate regulatory accounts. • To ensure there continues to be the provision of sufficient information for airlines to understand whether charges are reasonable, GAL will ensure that the scope of disclosure in its statutory accounts is maintained to be consistent with that of its most recent accounts (i.e. GAL's Report & Financial Statements for the year ended 31 March 2012) in so far as it relates to the operating costs, revenues, fixed asset base, depreciation and capital expenditure. If GAL's statutory accounts do not meet these requirements, GAL will ensure a separate audited statement meeting this standard will be provided confidentially to airlines and the CAA. • GAL proposes to publish annually a statement of GAL's assessment of the value of its asset base. This will set out the underlying assumptions and calculations, including: the initial asset based (carried forward from the end of the prior year); depreciation; additions; disposals; indexation factors; other adjustments that may be relevant; and the closing asset base (carried forward to the start of the next year). The material provided, together with the audited financial statements, will enable stakeholders to verify the calculation. • GAL will provide such further financial information required (if any) to ensure compliance with the Airport Charges Regulations 2011.
Financial information in relation to Specified Activities, PRM Service, and Check-in & Baggage facilities	• GAL will provide to users of the Specified Activities, PRM Services, Check-in & Baggage Facilities, and the CAA, by 31 December in each year a statement of actual costs and revenues in respect of each of the specified activities for the year ending the previous 31 March.

Section F	**Operational and financial resilience commitments**
Operational resilience	GAL will develop and maintain an operational resilience plan which will set how GAL intends to operate an efficient and reliable airport to the levels required by the Commitments or otherwise agreed with users and, in particular, how it will secure the availability and continuity of airport operation services, particularly in times of disruption. GAL will consult annually on the resilience plan with all interested parties including the CAA.

	In pursuance of the above obligation GAL will by [1 October 2014] publish one or more plan(s) or other documents setting out the principles, policies and processes by which it will comply with Condition [●]. Such plans and any amendments will have regard to any relevant guidance issued by the CAA. Prior to publishing any plans or other documents under Condition [●]. GAL shall consult all relevant parties on those plans or documents. GAL shall so far as is reasonably practicable coordinate and cooperate with all relevant parties at the airport to meet the requirements of this operational resilience commitment and shall at least once a year hold a meeting to which all relevant parties or organisations representing them shall be entitled to attend to discuss any issues pertinent to this operational resilience commitment. The Conditions of Use shall require all providers of air transport services and groundhandlers to comply with rules of conduct relating to minimum service provision and in particular to actions to be taken during periods of disruption. During periods of service disruption GAL shall use reasonable endeavours to coordinate the communication of operational information and to ensure the provision of timely, accurate and clear information about its operations to users of air transport services as well as information as to their rights under denied boarding regulations.
Financial resilience	The Conditions of Use will include the following financial resilience obligations to users: • The Directors of GAL will provide an annual confirmation of adequate financial resources to operate the airport and provide the Core Services; and • GAL shall not amend, vary, supplement or modify or concur in the amendment, variation, supplementation or modification of any of the finance documents in respect of credit rating requirements (whether in each case in the form of a written instrument, agreement or document or otherwise) (a "Variation") unless it has given prior written notice thereof to the CAA. GAL shall, as soon as reasonably practicable: - notify the CAA of the possibility of any such Variation; and - provide a summary of the executed change. The provisions of this Condition shall not apply to any administrative or procedural variation.
Continuity of Service Plan	GAL shall prepare and at all times maintain a continuity of service plan. The plan shall describe such legal, regulatory, operational and financial information that an administrator, receiver, or new management might reasonably be expected to require, in addition to the aerodrome manual and other statutory or regulatory documents which GAL is required to maintain, in order for it to efficiently carry out its functions and to remain compliant with its aerodrome licence. GAL shall supply such continuity of service plan to the CAA by 1 October 2014 and shall make such reasonable amendment to the form, scope and content of the plan as the CAA may reasonably require. GAL shall provide the CAA with details of any material variations to the continuity of service plan.

YOUR LONDON AIRPORT Gatwick

Table A – Airport Service Quality Targets (Rebates & Bonuses)

	Standard "i"	Metric	Rebate Level	Maximum potential rebate (both terminals, unless noted)	Bonus Level	Maximum potential bonus (both terminals, unless noted)
(i)	**Passenger satisfaction measures**			**1.40%**		**1.40%**
1	Departure Lounge Seat Availability	Moving Average QSM Score	3.8	0.35%	4.0	0.35%
2	Cleanliness		4.0	0.35%	4.2	0.35%
3	Way-Finding		4.1	0.35%	4.2	0.35%
4	Flight Information		4.2	0.35%	4.3	0.35%
5	Security		n/a	n/a	n/a	n/a
(ii)	**Security**			**2.00%**		**0.80%**
6	Central Passenger Search	Times <5 Minutes Times ≤15 Minutes	95% 98%	0.80%	97% 99%	0.80%
		Day when single time slice > 30 Minutes	t.b.d	0.20%	n/a	n/a
7	Transfer Passenger Search	Times <10 Minutes	95%	0.40%	n/a	n/a
8	Staff Search	Times <5 Minutes (terminal) Times <10 Minutes (crew)	95%	0.30%	n/a	n/a
9	External Control Posts Search	Times <15 Minutes	95%	0.30%	n/a	n/a
(iii)	**Passenger operational measures**			**1.30% (ST) 1.60% (NT)**		**1.30%**
10	Passenger Sensitive Equipment (General)	% Time Available	99%	0.40%	99.5%	0.40%
11	Passenger Sensitive Equipment (Priority)	% Time Available	99%	0.45%	99.5%	0.45%
12	Inter Terminal Transit System	% Time 1 Car Available % Time 2 Cars Available	99% 97%	0.30% (NT)	n/a	n/a
13	Arrivals Reclaim (Baggage Carousels)	% Time Available	99%	0.45%	99.5%	0.45%
(iv)	**Airline operational measures**			**1.65%**		**n/a**
14	Outbound Baggage	t.b.d	t.b.d	0.30%	n/a	n/a
15	Stands	% Time Available	99%	0.30%	n/a	n/a
16	Jetties	% Time Available	99%	0.30%	n/a	n/a
17	Pier Service	Moving average % passengers pier served	95%	0.50%	n/a	n/a
18	Fixed Electrical Ground Power	% Time Available	99%	0.25%	n/a	n/a
(v)	**Aerodrome congestion term**			**0.50%**		n/a
19	Airfield congestion / availability	t.b.d	t.b.d	0.50%	n/a	n/a
	Total			**7.15% (NT) 6.85% (ST)**		**3.50% (NT) 3.50% (ST)**

Table B – Airline Service Quality Targets

Standard "k"	Metric	Target Level	Airline Rebate Percentage
Check-in performance – queue time	Times <30 Minutes	95%	0.80%
Arrivals bag performance – last bag on carousel	Times <45 Minutes (long-haul)	95%	0.80%

The check-in performance metric is not routinely measured, although the use of automated queue measurement in South Terminal security indicates that this is feasible. GAL will consult with the Gatwick AOC to determine the appropriate approach for implementing such a measurement.

Appendix 2: Oxera’s advice on cost of capital

Attached overleaf

Response to initial proposals: cost of capital

Note prepared for Gatwick Airport Ltd

June 24th 2013

The CAA has proposed a calculation of a regulated price for Gatwick Airport that assumes a real, pre-tax weighted average cost of capital (WACC) of 5.65%.[1] Since publication of the initial proposals (IPs), government bond yields have increased by over 80bp, with a significant negative impact on the values of a broad range of asset classes. The estimate of WACC in the IPs does not reflect the level of uncertainty in current capital markets. In this context, the CAA and its advisers not only assume a risk-free rate which is inconsistent with the uncertainty that current low rates will persist, but dismiss inappropriately the evidence that the fundamental risk of Gatwick is higher than assumed in Q5.

Oxera remains of the judgement that the most appropriate estimate of the real pre-tax WACC for Gatwick is 7.1%. This note focuses on the IPs and presents the combined impact of making the adjustments to address the fundamental concerns about the analysis in the IPs as they relate to Gatwick's risk and cost of debt. The cumulative impact of these adjustments alone is a real pre-tax WACC that is 100 basis points (bp) higher than that put forward in the IPs.[2]

There are two over-riding concerns with the CAA's analysis and IPs:

- first, the complete disregard for the WACC impact of the increase in risk over the period since February 2006, the cut-off data for analysis of the BAA Q5 beta, which underpinned the WACC assumptions for Q5; and
- second, the conclusion that Gatwick and Heathrow have the same cost of debt despite the former having a lower credit rating and higher bond yields reflecting the higher risk of Gatwick relative to Heathrow. The evidence provided by the CAA's advisers does not support an assumption of the same cost of debt for the two airports. In any event, the cost of debt applied to Gatwick is too low.

[1] CAA (2013), 'Economic regulation at Gatwick from April 2014: initial proposals', para 10.158.

[2] The calculated estimate of 6.59% has been rounded to 6.60%.

Dealing first with the risk point, Oxera and Gatwick undertook a forward-looking analysis of a range of credible but low-probability scenarios faced by the three designated airports over the period 2014–19, to understand the range of potential outcomes for profitability. This analysis suggested an increase in systematic risk for Gatwick Airport of 15–25% relative to the period preceding Q5. The recent announcement of a long-term framework deal for growth between Stansted Airport and easyJet suggests that one of the scenarios anticipated in this analysis is more likely now than when the analysis was undertaken last year.[3] The conclusion of the CAA and its advisers that market developments since February 2006 have had zero impact on systematic risk and the WACC is not a credible interpretation of the evidence.

Turning to the cost of debt, it is clear that Heathrow and Gatwick should not have the same cost of debt and that, in any event, the CAA analysis results in an inappropriate outcome for the Gatwick rate. In particular, we would highlight the following:

- Gatwick has less debt than Heathrow relative to RAB but nevertheless has a lower credit rating on senior debt (BBB+ compared with A–). No recognition is given to the rating differential despite the CAA's advisers acknowledging that it exists.
- The spreads on Gatwick debt in the market are 30bp wider than equivalent Heathrow debt based on calculations by the CAA's advisers.
- Gatwick has a smaller and less regular issuance programme, which significantly increases the costs of issuance compared with Heathrow.
- The balance between embedded and new debt is incorrect given Gatwick's Q6 investment aspirations, with more weight needing to be given to embedded debt.
- The cost of the embedded debt is incorrectly calculated with no allowance being made for hedging costs, despite these being a requirement of the banking market to arrange debt finance at the time of issuance.

In addition to the concerns about the risk analysis and debt, the calculation of the pre-tax WACC by the CAA and its advisers assumes that tax is paid on real rather than nominal profits. If this difference in tax is not accounted for in other components of the allowed revenue calculation, there will be an inconsistency in the calculation of the regulated price. This in turn means that the forecast post-tax return for Gatwick will be significantly lower than the post-tax WACC in the IPs.

Our conclusion that the WACC proposed by the CAA for Gatwick is inappropriate is reinforced through some simple cross-checks. In particular:

- the WACC for Gatwick has been reduced relative to that for Heathrow since Q5. This does not reflect the increase in risk for Gatwick following the break-up of BAA.
- The IPs imply that Gatwick is significantly less risky than BT Openreach, without any evidence to support this risk differential.
- The proximity of the WACC proposed for Gatwick to that assumed by Ofgem for electricity transmission networks does not reflect the relatively higher risk of Gatwick.
- The transaction value of Gatwick for the sale in Q5 at 0.88 of the RAB supports the analysis of fundamental risk drivers that suggests that forward-looking risk at Gatwick has increased. The analysis by the CAA's advisers that suggests transaction values of around 100% of RAB is incorrect.

Although government bond yields currently indicate a risk-free rate that is low by historical standards, the highly unusual capital market conditions mean that yields are unlikely to remain at this level during the period up to 2019. The combination of the CAA's low

[3] Oxera (2013), 'What is the cost of capital for Gatwick Airport beyond Q5?', methodology and estimation, prepared for Gatwick Airport, January 31st.

assumption for the risk-free rate and all the factors summarised above gives an unjustifiably low estimate of the WACC, which should be increased at a minimum by 100bp.

1 The proposed WACC does not reflect the risk of Gatwick

1.1 The evidence that the risk of Gatwick is higher than assumed in the Q5 WACC has been dismissed based on flawed reasoning

The IPs contain the same asset beta for Gatwick as in Q5 and maintain the same positioning of Gatwick relative to Heathrow and Stansted. This is despite significant evidence that Gatwick's risk has increased in both absolute terms and relative to that of Heathrow and Stansted, despite being subject to regulation.

The evidence supporting a higher asset beta than in Q5 comprises two categories:

– increase in demand risk;
– increase in operational gearing.

The CAA and its advisers have failed to give due consideration to this evidence base, and have sought to provide reasons to avoid engaging with the analysis of risk provided by Gatwick.

The CAA and its advisers have provided three reasons for dismissing the evidence:

– the evidence was known at the Q5 review, and hence reflected in the Q5 asset betas;
– the evidence represents diversifiable risk, and hence would not be reflected in the cost of capital;
– the significant literature supporting a positive relationship between competition and systematic risk relies on businesses with market power using their pricing behaviour to reduce their exposure to systematic risks. The CAA and its advisers have argued that this relationship does not apply to Gatwick because 'prices are set by a regulator in relation to economic costs'.[4]

An important document submitted by Gatwick and Oxera to the CAA explained why this reasoning is flawed and unsupported by contemporary documentation.[5] This document has not been referenced in the IPs.

1.1.1 Increase in demand risk

Traffic volatility at Gatwick during Q5 was more than double its level in Q4. This increase in volatility has been greater than that at Heathrow or Stansted. The historical data is therefore consistent with an increase in risk both relative to the previous assumption for Gatwick and relative to the assumptions for Heathrow and Stansted. As data on Q5 volatility was not available at the time of the Q5 determination, the CAA and its advisers cannot claim that this was reflected in the disaggregation of the BAA Group beta into estimates for the designated airports.

Separately, a forward-looking analysis of risk must account for the range of possible commercial and profitability outcomes for the airport and how this range has changed over time. The risk analysis for Q5 was tied to an estimate of the BAA Group asset beta, and therefore the latest relevant date against which to assess changes in risk is February 2006, the cut-off date for estimation of the BAA Group beta. At that time the prospect of the three

[4] PwC (2013), 'Estimating the cost of capital in Q6 for Heathrow, Gatwick and Stansted—a report prepared for the Civil Aviation Authority (CAA)', April, p. 76.
[5] Oxera (2013), 'How does competition affect Gatwick's cost of capital in the period beyond Q5?', March 18th.

largest London airports being in separate ownership was at best a remote possibility—the Office of Fair Trading market study was not launched until four months later, in June 2006, and the reference to the Competition Commission did not happen until March 2007. The range of outcomes is self-evidently wider today than in the period leading up to February 2006.

Oxera has worked with Gatwick to translate scenarios around the central traffic forecast into a quantitative estimate of financial risk. These scenarios describe outcomes for traffic, aeronautical, and non-aeronautical yields at the level of individual airlines, and how the mix of traffic could change over time. The scenarios are an output of the normal commercial planning process of the business and represent downside outcomes that are expected to occur with low probability (10–20%). The recent announcement of a long-term framework deal for growth between Stansted Airport and easyJet suggests that one of the scenarios anticipated in this analysis is more likely now than when the analysis was undertaken last year. The combination of these scenarios shows an increase in systematic risk of 15–25% relative to the period preceding Q5.

Therefore, the CAA and its advisers cannot dismiss the evidence on the increase in demand risk on the basis that this was known and incorporated in the asset beta estimate at the time of the Q5 review.

It is highly unlikely that all of the increase in risk reflects greater exposure to diversifiable risk and that Gatwick's asset beta is now in the same position relative to Heathrow and Stansted as was assumed in the Q5 determination. There are two main drivers of risk:

– more widespread management by airlines of yields and route capacity, which redistributes systematic risk in the value chain from airlines to airports;
– increased competition between the designated airports, which means that there is a greater risk that the airports will be unable to price to the cap if faced by a negative systematic demand shock. Published research supports a positive relationship between competition and systematic risk.[6]

Therefore, the evidence on the increase in demand risk can also not be dismissed on the basis that it is entirely non-systematic, diversifiable risk.

Gatwick's cost of capital is increased by the heightened competitive pressure, despite being subject to regulation. In an unregulated setting, the impact of competition is to increase the operational leverage of the industry and the sensitivity of profits to systematic demand shocks. The CAA's advisers argue that this relationship is invalidated by a regulated price cap. However, with a regulated price cap, greater competition means that there is a greater risk that the regulated airports will be unable to price to the cap if faced by a negative demand shock. Expected profitability, weighted across different scenarios for demand, is therefore lower and operational leverage is higher.

Therefore, the evidence on the increase in demand risk can also not be dismissed on the basis that a regulated price cap removes the established relationship between competition and systematic risk.

1.1.2 Increase in operational gearing

Fixed costs are now a higher proportion of the cost base than at the end of Q4. This is due to changes in three areas:

[6] Lee, C., Liaw, K. and Rahman, S. (1990), 'Impacts of Market Power and Capital-Labor Ratio on Systematic Risk: A Cobb-Douglas Approach', *Journal of Economics and Business*, **42**, p. 240; Chen, K., Cheng, D. and Hite, G. (1986), 'Systematic Risk and Market Power: An Application of Tobin's q', *Quarterly Review of Economics and Business*, **26**:3; and Subrahmanyam, M. and Thomadakis, S. (1980), 'Systematic Risk and the Theory of the Firm', *The Quarterly Journal of Economics*, **94**:3.

1) the increase in the proportion of operating costs accounted for by security costs, which are to a large extent delivered according to rigorous externally set standards and are therefore less easily varied in response to demand shocks;

2) the increase in capital investment, which, once committed, is a sunk cost that cannot be varied with traffic volumes;

3) efficiency improvements that have reduced the scope for making further cost reductions in response to negative traffic shocks.

The CAA and its advisers are incorrect to claim that there has been no fundamental change in the underlying structure of costs and asset beta since the estimation of the BAA Group asset beta using data up to February 2006.

An increase in operational gearing implies a significant increase in the sensitivity of profit to demand volatility, and amplifies the business's exposure to both systematic and non-systematic risk.

1.1.3 Overall impact on risk and asset beta

As the Q5 asset beta assumption was based on the information set embedded in the BAA Group asset beta (ie, information up to February 2006), it could not have fully reflected the risks to which Gatwick Airport Ltd was exposed during Q5, which started in April 2008. Moreover, the evidence strongly suggests an increase in the systematic risk exposure of Gatwick Airport since the Q5 determination and the BAA Group asset beta on which it was based, and hence that the asset beta relevant to the period beyond Q5 is significantly higher than was assumed in Q5.

1.2 The WACC for Gatwick is incorrectly positioned relative to that of Heathrow, and Gatwick's cost of debt is too low

The IPs reflect the higher risk of Gatwick relative to that of Heathrow in two ways: an asset beta that is 10% higher than that of Heathrow; and a notional gearing assumption of 55% compared with 60% for Heathrow. However, a comparison of the asset risk premium implied by the Gatwick and Heathrow proposals shows that the WACC reflects only 6% higher risk at Gatwick.[7] By reducing Gatwick's notional gearing from 60% to 55%, the pre-tax WACC has perversely decreased by 6bp, which is contrary to the expectation that the tax-adjusted WACC would be higher with more equity in the capital structure.

A contributory factor to the disproportionately low differential in WACC relative to the differential in asset beta is that the IPs assume the same cost of debt for the two airports.[8] There is no empirical evidence that can support this premise and this conclusion is inconsistent with the analysis presented by the CAA's advisers.

Considering the actual cost of debt, Gatwick pays more than Heathrow to raise debt. There is a spread between the yields of the bonds issued by the two airports, which reflects the debt market view that Gatwick bonds are more risky than those of Heathrow. Analysis presented by the CAA's advisers shows yields on Gatwick bonds trading 30bp higher than Heathrow bonds of a comparable maturity.[9] Assuming the same cost of debt for the two airports is also inconsistent with the views of credit rating agencies, which rate Gatwick's bonds BBB+ compared with the A– rating of Heathrow's senior bonds despite the fact that Heathrow supports a meaningfully higher level of gearing than Gatwick.

[7] The asset risk premium is the difference between the vanilla WACC and the risk-free rate.

[8] The IPs assume a real cost of debt of 2.15–2.85% for both Heathrow and Gatwick, before allowing for issuance costs.

[9] PwC (2013), 'Estimating the cost of capital in Q6 for Heathrow, Gatwick and Stansted—a report prepared for the Civil Aviation Authority (CAA)', April, Table 6.4.

This evidence is also supported by bond indices, used as a proxy for the notional cost of debt. Evidence presented by the CAA's advisers shows a difference of at least 60bp between A rated and BBB rated bonds based on indices compiled by the Bank of America Merrill Lynch.[10]

The combination of assumptions for the cost of debt and gearing therefore reduces the WACC for Gatwick relative to that for Heathrow. This is inconsistent with the view of the relative risk of Gatwick and Heathrow that was embedded in the WACC assumptions for Q5, let alone the evidence which suggests that the risk differential between these two airports is now larger than assumed in Q5.

The cost of debt assumed in the IPs is also based on a 50:50 weighting of the cost of existing and the cost of new debt. As acknowledged by the CAA's advisers, this is inconsistent with the fact that Gatwick does not need to issue a significant amount of debt over the next five years and will therefore not receive much benefit from relatively low current market rates.[11]

The actual cost of debt faced by Gatwick over the next five years is expected to be approximately 3.2%, inclusive of issuance and hedging costs.[12] The CAA has asserted that the timing and nature of Gatwick's current financing was in the control of management, and that there is no justification to reflect the actual cost of debt in the WACC. The assertion that management had a choice about when to issue debt is unsound, given that this was driven by the timing of the sale of Gatwick by BAA, which in turn was related to the Competition Commission's regulatory process. It was a requirement of the banking market at the time that 75% of the debt was hedged. Accordingly, management had no opportunity to raise debt at materially different levels.

A new issuance premium (NIP) of 40–50bp has been assumed by the CAA's advisers, which has then been treated as an annual cost of 4–5bp if amortised over ten years.[13] This is incorrect as the NIP is already expressed as an annualised yield spread. Amortising the NIP significantly understates its impact on the cost of issuing debt, and casts doubt on the 20bp that the CAA's advisers have assumed as the annualised value of the debt issuance fees paid by Gatwick.

It is therefore necessary to assume a significantly higher cost of debt in order to:

– achieve consistency with the asset beta differential between Gatwick and Heathrow;
– reflect the market data on the relative yields on the two airports' bonds;
– recognise that Gatwick does not need to issue a significant amount of debt over the next five years, and had no opportunity to raise the existing debt at materially different levels.

[10] PwC (2013), 'Estimating the cost of capital in Q6 for Heathrow, Gatwick and Stansted—a report prepared for the Civil Aviation Authority (CAA)', April, Table 6.3.

[11] PwC (2013), 'Estimating the cost of capital in Q6 for Heathrow, Gatwick and Stansted—a report prepared for the Civil Aviation Authority (CAA)', April, pp. 38–9.

[12] Oxera (2013), 'What is the cost of capital for Gatwick Airport beyond Q5?', methodology and estimation, prepared for Gatwick Airport, January 31st.

[13] PwC (2013), 'Estimating the cost of capital in Q6 for Heathrow, Gatwick and Stansted—a report prepared for the Civil Aviation Authority (CAA)', April, p. 37.

1.3 Further cross-checks that support the contention that the WACC for Gatwick is too low

1.3.1 The IPs imply that Gatwick is significantly less risky than BT Openreach, without any evidence to support a risk differential

The asset beta and cost of debt proposed for Gatwick (0.55 and 2.9%[14]) are significantly lower than Ofcom's current estimates for BT Openreach (0.60 and 3.0%[15]). The gearing proposed for Gatwick is also higher than for Openreach (55% compared with 40%). This seems inconsistent with the relative demand volatilities of these businesses. It is also inconsistent with investor perceptions of risk prior to the break-up of BAA, when BT and BAA were assessed as having similar risk.[16] The CAA and its advisers have not provided any evidence of, or explanation for, why investors would view Gatwick as less risky than BT Openreach.

1.3.2 The proximity of the WACC proposed for Gatwick to that assumed by Ofgem for electricity transmission networks does not reflect the relatively higher risk of Gatwick

The vanilla WACC assumed for National Grid Electricity Transmission (NGET) in the RIIO-T1 price control is 4.55–4.80%. The point estimate for Gatwick is at the top of this range. This is inconsistent with investor perceptions of risk prior to the break-up of BAA, which ranked electricity transmission as the least risky utility sector and significantly less risky than BAA.[17]

In view of the CAA's apparent comfort with the near equivalence of Gatwick and electricity transmission risk, Oxera has reviewed Ofgem's own assessment of NGET to understand whether there have been developments in transmission that might have increased NGET's risk and therefore justified the proximity accorded the respective risks by the CAA. In fact, for the RIIO-T1 price review, Ofgem assumed an asset beta for NGET that was lower than in the previous price control (TPCR4) and stated that the overall risk of the price control package is 'broadly comparable to TPCR4'.[18] This clearly suggests that, in Ofgem's view expressed in the Final Proposals, there have not been developments at NGET which have increased its risk, and thereby could justify its positioning relative to Gatwick.

Even allowing for the impact of indexation of the cost of debt and the likely downward drift over time in the vanilla WACC for RIIO-T1, the IPs contain a WACC for Gatwick that will be only slightly higher than the WACC applied to control prices for electricity transmission networks over the 2014–19 period, despite investors perceiving Gatwick to be significantly higher risk. This casts doubt on the analysis and conclusions of the CAA and its advisers.

1.3.3 The transaction value of Gatwick supports the analysis of fundamental risk drivers that suggests that forward-looking risk at Gatwick has increased

The CAA and its advisers have interpreted market-to-asset ratios (MARs) based on the purchases of equity stakes in Gatwick relative to the RAB value as evidence that Gatwick's risk has not changed compared with the assumptions in the Q5 WACC. This assessment is based on erroneous calculations that the MARs for the Gatwick transactions were in the range 0.93–1.04.[19]

[14] Measured at the 75th percentile point estimate.

[15] Measured at the midpoint of Ofcom's estimate for BT Openreach. Ofcom (2013), 'Business Connectivity Market Review—review of retail leased lines, wholesale symmetric broadband origination and wholesale trunk segments', March 28th.

[16] Indepen (2008), '2008 Investor Survey: a report by Indepen for Water UK—Appendix B survey results', March, section 3.2.

[17] Ibid.

[18] Ofgem (2012), 'RIIO-T1: Final Proposals for National Grid Electricity Transmission and National Grid Gas—finance supporting document', December 17th, p. 20.

[19] PwC (2013), 'Estimating the cost of capital in Q6 for Heathrow, Gatwick and Stansted', prepared for the Civil Aviation Authority, April.

First, the MAR should be a single number based on the December 2009 acquisition by Global Infrastructure Partners (GIP), not a range based on the syndication of equity to: the Future Fund of Australia; National Pension Service of Korea (NPS); and the California Public Employees Retirement System (CalPERS). These investors bought into the equity on equivalent terms to the original acquisition, as if they had invested at the same time as GIP.

Second, the CAA's advisers have calculated the MAR for the December 2009 acquisition as 0.97 based on an implied enterprise value of £1,516m and assuming a RAB value of £1,570m, which is approximately the March 31st 2009 RAB value.[20] This calculation uses the value of regulatory assets at a date nine months prior to the transaction, rather than the value at the time of the transaction. The calculation also uses an enterprise value that includes an amount of consideration that was contingent on future traffic performance.[21] The correct calculation of the MAR is 0.88 based on the weighted average RAB value of £1,660m for the period March 31st 2009–March 31st 2010 and an enterprise value of £1,455m (excluding the contingent consideration). A MAR of 0.88 is a 12% discount to RAB.[22]

In addition, it is important to allow for the control premium that is typically observed in these types of transaction. Recent transactions in other regulated sectors have occurred at MARs of approximately 1.15–1.25, so the control premium could be significant.

Separately, we note that the advisers to British Airways have suggested that the enterprise value should be increased to account for the £105m pension commutation payment[23]—this is incorrect as the quoted enterprise value of £1,455m is already stated after accounting for the pension commutation payment. Gatwick was acquired at a very substantial discount to its RAB.

The evidence from MARs strongly supports the analysis of fundamental risk drivers that suggests that forward-looking risk at Gatwick has increased.

2 The pre-tax WACC in the IPs assumes that tax is paid on real rather than nominal profits

The pre-tax WACC has been calculated on a real basis, whereas tax is a nominal cash flow. If this difference in tax is not accounted for in other components of the allowed revenue calculation, the forecast post-tax return for Gatwick will be significantly lower than the post-tax WACC in the IPs.

The CAA and the Competition Commission have made the tax adjustment to the real WACC in past airport determinations. However, since the Q5 determinations, regulatory best practice has evolved towards making the tax adjustment to the nominal WACC. Ofcom uses this approach to calculate the pre-tax WACC, and this approach has been robust to several appeals at the Competition Commission. Under this approach, an assumption about expected inflation is used to convert the real, post-tax cost of equity into a nominal post-tax cost of equity. The tax allowance is then calculated based on the nominal post-tax cost of equity, which reflects the fact that tax is a nominal cash flow. The real, pre-tax cost of equity can then be calculated from the nominal pre-tax cost of equity.

[20] Transaction to RAB ratios_PwC analysis_280513.xlsx, data provided to Oxera by Gatwick.
[21] Dealogic (2009), 'Gatwick Airport Ltd deal profile', December.
[22] 'Gatwick Airport Limited (2010), 'Regulatory Accounts for the year ended 31 March 2010'.
[23] CEPA (2013), 'Setting the Weighted Average Cost of Capital for Heathrow and Gatwick in Q6', February 15th, p. 34.

3 Combined impact of adjustments on the WACC

Although government bond yields currently indicate a risk-free rate that is low by historical standards, the highly unusual capital market conditions mean that yields are unlikely to remain at this level during the period up to 2019. The combination of the CAA's low assumption for the risk-free rate and all the factors summarised above gives an unjustifiably low estimate of the WACC.

The combined impact of the fundamental adjustments for risk, debt and tax highlighted in this note is a pre-tax WACC that is 100bp higher than the IPs. The table at the end of this note shows the incremental impact of each adjustment, assuming that the adjustments are made in the order presented above. We consider that the WACC should be increased by this amount as a minimum and remain of the judgement that a WACC of 7.1% is appropriate.

4 The case for annual indexation of the cost of debt for Gatwick is weak

As the CAA notes, the Q5 approach to the cost of debt had properties similar to the indexation mechanism applied by Ofgem, but applied at a five-year rather than annual frequency.[24]

As Gatwick Airport Ltd is a smaller company than Heathrow Airport Holdings Ltd, it has less flexibility to adopt a rolling refinancing programme. Updating the cost of debt for Gatwick on an annual basis is unlikely to be a significant improvement to the match between the allowed and actual cost of debt. Instead, annual indexation is likely to increase the gap between the allowed and the actual cost of debt, as well as introducing additional uncertainty into the price cap, creating significant complexity when determining an appropriate and objective annual index and the additional costs associated with implementing an annual update. Methodological challenges aside, indexing also adds uncertainty to annual airline charging levels and leaves customers exposed to price increases as debt funding costs rise.

On balance, the case for moving to an annual update of the cost of debt for Gatwick is weak, and therefore Gatwick does not support annual indexation of the cost of debt.

[24] CAA (2013), op. cit., para 10.31.

WACC based on cumulative adjustments to the CAA’s initial proposals

	CAA Q6 initial proposals						Combined impact of adjustments on the estimate	
			Adjustment 1— increase in asset and debt betas		Adjustment 2—increase in cost of debt		Adjustment 3—correct tax uplift	
	Low	high	Low	high	Low	high	low	high
Real risk-free rate (%)	0.25	0.75	0.25	0.75	0.25	0.75	0.25	0.75
Asset beta: range	0.46	0.58	**0.60**	**0.65**	0.60	0.65	0.60	0.65
Debt beta	0.10	0.10	**0.12**	**0.13**	0.12	0.13	0.12	0.13
Gearing	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55
Equity beta	0.90	1.17	1.19	1.29	1.19	1.29	1.19	1.29
Equity risk premium (%)	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Real post-tax cost of equity (%)	5.65	7.75	7.37	8.46	7.37	8.46	7.37	8.46
Inflation	n/a	n/a	n/a	n/a	n/a	n/a	**2.50**	**2.50**
Nominal post-tax cost of equity (%)	n/a	n/a	n/a	n/a	n/a	n/a	**10.87**	**12.06**
Tax	0.202	0.202	0.202	0.202	0.202	0.202	0.202	0.202
Nominal pre-tax cost of equity (%)	n/a	n/a	n/a	n/a	n/a	n/a	**13.63**	**15.12**
Real pre-tax cost of equity (%)	7.08	9.71	9.24	10.61	9.24	10.61	9.85	11.22
Real pre-tax cost of debt (%)	2.35	3.05	2.35	3.05	**3.20**	**3.20**	3.20	3.20
Real pre-tax WACC: range (%)	4.48	6.05	5.45	6.45	5.92	6.53	6.19	6.81
Percentile	0.75		0.75		0.75		0.75	
Real pre-tax WACC: point estimate (%)	5.66		6.20		6.38		6.66	
Real vanilla WACC: point estimate (%)	4.83		5.27		5.45		5.45	
Asset risk premium (vanilla WACC – risk-free rate)	4.21		4.64		4.82		4.82	
Asset risk premium relative to Heathrow			1.17		1.22		1.22	

Note: Adjustments performed sequentially from left to right and highlighted. The asset risk premium is the difference between the vanilla WACC and the risk-free rate. In the IPs, it is 4.21% at Gatwick compared with 3.97% at Heathrow. Numbers may differ slightly from the IPs due to rounding.
Source: CAA (2013), ‘Economic regulation at Gatwick from April 2014: initial proposals’; Oxera (2013), ‘What is the cost of capital for Gatwick Airport beyond Q5?’, methodology and estimation, prepared for Gatwick Airport, January 31st; Oxera analysis.

Appendix 3: Capital consultation proposal (RAB based regime)

1. Introduction

1.1. This document looks forward to the period from 1 April 2014 and recognises the need for Gatwick to continue consulting airlines on capital projects. We have reviewed how consultation has added value to projects throughout Q5 and seek to carry the lessons learnt forward. We have also considered how more streamlined consultation processes could result in more efficient execution.

1.2. The key lessons learnt were:

- To ensure a good quality business case is available at tollgate 2 and is updated at each consultation point thereafter;
- To focus consultation on the key strategic projects only (much time and resource, both ACC and airport were wasted consulting on minor projects before and during the last year of the extended Q5);
- To have continuity of airline representatives and their experts to ensure the correct skills and knowledge are available to assess the projects; and
- To spend time prior to a further regulatory period in consultation around the outcomes required during that period and the likely projects that will achieve them, up to a tollgate 2 level of development.

1.3. Under our proposals for capital consultation Gatwick will, as currently, retain sole responsibility for managing the capital investment programme to enable us to meet our obligations regarding airport-wide service standards. Gatwick will maintain the airport to comply with all applicable safety and environmental requirements and to maintain and develop its infrastructure to enable the airport-wide service standards to be achieved.

1.4. Prior to April 2014 it will be agreed by the CAA and Gatwick, in consultation with the ACC, which of the major development projects will have triggers applied. For such projects, trigger definitions will be agreed post Tollgate 4 at which programme and cost is confirmed. This process is in line with the protocol agreed between Gatwick, the ACC and the CAA for Q5+1.

1.5. Gatwick will take a programme approach to delivering capital, seeking to maximise efficiency by grouping projects together into logical programmes of work. The CAA have agreed to assess the efficiency of the investment programme overall, recognising that higher than expected costs on some projects might be offset by lower than expected costs on other projects. There is no expectation that higher than expected costs overall will necessarily indicate ‘inefficiency’. That will depend upon an examination of the precise circumstances facing the airport and the options open to it at the time.

2. Categorisation of Expenditure

2.1. For the purposes of consultation, capital projects have been categorised into three areas:

- ***Major development projects***: comprising of all individual projects or individual programmes at £10 million or more (excluding the Asset Stewardship programme).
- ***Minor development projects***: comprising of all individual projects or individual programmes of projects less than £10m (excluding the Asset Stewardship programme).
- ***Asset Stewardship programme***: comprising all asset stewardship projects split into five broad elements – Airfield, Commercial, IT, Facilities and Compliance/Risk.

3. Capital Investment Programme

3.1. Gatwick will continue to publish annually a rolling five year Capital Investment Programme (CIP)

3.2. The CIP will be the key document around which strategic level consultation on future airport development will take place. The consultation with the Airport Consultative Committee (ACC) will address:

- The principal business drivers behind the airport's development strategy, including service levels;
- Forecast traffic demand and associated demand for airport capacities and services;
- The capacities that the airport intends to provide, taken in the context of forecasted demand; and
- The cost of the capital investment programme and the resulting effect on the Asset Base of the airport.

3.3. The forecast cost of the capital investment programme will:

- Summarise expenditure on each of the Major Development Projects;
- Summarise aggregate expenditure on the Asset Stewardship Programme (across all five elements);
- Summarise aggregate expenditure on Minor Development Projects;

- Be at a level of detail that naturally reflects the planning horizon and Tollgate status for projects, with those in the short-term being more granular and certain than those in the final years of the forecast; and

- Provide an explanation as to any material differences (+/- 10% cost and/or programme) between the latest forecast and:
    - The prior year forecast; and
    - The forecast per the CAA's price control review.

4. Airline consultation

4.1. Consultation with the airlines and their chosen representative(s) will take place at a number of different levels, with groups formed appropriately. We anticipate that the structure set out below is sufficient; however this may evolve over time:

- ACC – to consider strategic matters involving the medium to long term development of the airport;

- Capital sub-committee of ACC (Currently known as the Capital Programme Board – CPB) – to consider tactical matters involving the delivery by Gatwick of the capital development programme; and

- Working groups (informal and formal) to consider operational impacts of projects on the day to day activities of the airlines operating at the airport. These working groups (where required) will be project or programme (e.g. North Terminal Programme) specific, involve affected airlines and may require a formally constituted working group (e.g. the AOC) for significant projects requiring a high degree of airline input into the design and execution planning (e.g. check-in transformation).

4.2. As part of the annual CIP consultation with the ACC, Gatwick will consult with airlines in relation to Major Development Projects covering:

- High-level options for the development of Major Development Projects and the trade-offs involved between alternatives;

- The outputs that are expected to be delivered in terms of service, capacity, operating cost and revenue;

- Scope, programme and cost of the project required to deliver the business objectives; and

- The business case for the project. (This would be in a form consistent with those prepared by Gatwick for the ACC in Q5).

4.3. Gatwick will consult with the Capital sub-committee of the ACC in relation to the Major Development Projects at Tollgate 2, Tollgate 3 and Tollgate 4. This will require meetings on a more frequent basis than annually; the exact frequency is to be agreed with the airlines.

4.4. Following Tollgate 4, progress with the delivery of Major Development Projects will be reviewed by the Capital sub-committee of the ACC as part of its annual Capital Investment Performance Review (see below).

4.5. Gatwick will meet annually with the Capital sub-committee of the ACC to review Gatwick's delivery of the Capital Investment Programme, specifically:

- In relation to the following 12 months:
  - The schedule and expenditure for each Major Development Project;
  - The priorities and aggregate expenditure of the Asset Stewardship Programme across each of the five broad elements (separately identifying individual projects in excess of £1m); and
  - The expenditure on Minor Development Projects (separately identifying individual projects in excess of £1m).

- In relation to the preceding 12 months, works undertaken and progress with:
  - Each Major Development Project;
  - Minor Development Projects (separately identifying individual projects in excess of £1m); and
  - Asset Stewardship Programme across each of the five broad elements (separately identifying individual projects in excess of £1m).

Master Plan

4.6. Gatwick published a Master Plan in July 2012. Gatwick will aim to publish a revised Master Plan every five years, in consultation with the airlines (including the ACC), other business partners and the local community. The exact timing of Master Plan updates will be dependent on Government airport policy consultations/decisions (e.g. in relation to the Airports Commission) and on the need to keep the overall long-term vision for the airport up to date.

5. Development capital

5.1. Gatwick is proposing, as part of its business plan, two development capital projects, that is projects that are not sufficiently advanced in their development (i.e. not yet reached tollgate 2) to be included within core projects. These are:

- Requirement to replace HBS equipment to meet standard 3 by 2018; and

- Further liquid explosive detection requirements

There are also potential projects, which Gatwick identified in the RBP which may come to fruition during the next period; there may also be other projects identified during the period that neither Gatwick nor the airlines are currently aware of – such as mandated changes or technological developments. The mechanism for introducing these projects into the capital programme is set out below:

- The inclusion of new development projects will be consulted upon by Gatwick with the ACC. Unless there is a dispute, the price cap will be adjusted and the capex incorporated;

- In the event that the ACC disputes the new project, the CAA will decide whether the price cap should be adjusted and the project included. The CAA needs to establish a formal process for adjusting the price cap in a RAB based model;

- Irrespective of the category of project, the consultation will follow the same format as that set down in paragraph 4.2 until it is incorporated within the price cap. It will then follow the consultation format applicable for its category;

- Airlines have the ability to suggest new development projects and these will also be consulted upon prior to automatic inclusion in the price cap in the absence of any dispute, or included within the price cap following a CAA decision where a dispute has been raised; and

- Except in the case of dispute (see above) incorporation into the price cap will be automatic once consultation has taken place to Tollgate 2 stage as this is the point at which Gatwick commits capital to a project based upon the business case. For the avoidance of doubt, inclusion in the price cap also means the relevant amount of capital expenditure will be included in the core capital budget.

Appendix 4: Gatwick comments on Davis Langdon's assessment of capital costs

Introduction

We recognise that this is the first of two reports, the second more comprehensive report being available in August 2013.

This section is focused on the two areas of fundamental differences of opinion we have rather than individual comments on projects. The two areas are the on-cost target of 17% and the unit cost rates applied to the Pier 6 Southern extension project. This is in recognition of the fact that owing to ongoing development there has been various changes to the projects which will be picked up by Davis Landon in their August, final version. It therefore does not seem sensible to comment on conclusions which have been reached on information which is now out of date.

On Costs Target of 17% - we do not agree that to standardise total on-costs across all projects is the right methodology for the stage that the projects are at, however we would welcome further discussion and explanation from Davis Langdon for their assessment of why 17% is the right figure. Our position on this is explained below.

Gatwick's on-costs are split into two distinct areas; the first, Gatwick overhead, which is a fixed percentage applied to all projects to cover the cost of managing the overall Capital Programme and ensuring it is governed, developed, coordinated, controlled, reported and delivered effectively – this is the cost of the Product Development and Construction central teams as well as some others not directly charged to a project including Regulation and engagement with airlines related to the investment programme[14]. The second is made up of the internal Gatwick management costs for the project specific personnel (i.e. project manager, field engineer, site management etc.); external design and commercial management including specialists such as Retail, Assistance and Bomb Blast input specific to that project.

Gatwick's approach to assessing on costs for the second element is for each project to be assessed individually and the level of on costs percentage applied to a project with the aim of providing a project team that has the right skills, specialist knowledge, competency and is sized appropriately to manage the contract and design activities. Accordingly the on costs percentage will vary on a project by project basis and a general application of on cost percentage cannot be made. We continually review the on costs attributable to projects to ensure that efficiency and value is delivered. Our assessment takes cognisance of a number of airport related factors including the delivery of projects within a 24 hour 365 day environment, recent project delivery experience and the continuously changing demands and requirements of our customers. There can be no direct comparison made between Gatwick and other airport or non-airport projects.

Many of the cost sheets have been updated over the past few months as a result of further development and refinement of the scope for each project; on-costs have been revised in line with

[14] Explanatory document available (as given to ACC consultants in December 2012).

these and range between 14-22% of the construction cost. We believe that this is reasonable and in line with the varied and often complex nature of construction projects within airports.

Pier 6 Southern Extension – this section addresses Davis Langdon's suggested opportunities to reduce unit costs and explains why our original decisions were taken and why we believe they are reasonable and in line with the tollgate process for this stage of project design.

Substructure: based on our initial survey results, Atkins (the primary designers) do not believe that it will be possible to build off the existing slab or utilise pad foundations in the solution. The substructure costs reflect the current design developed by Atkins, which is a combination of piles, pile caps, ground beams and reinforced concrete slabs. It also reflects the fact that the substructure has to support a CIP Lounge at mezzanine level. This is not something that we believe is included in a typical pier facility. The cost plan has assumed that all excavated material will be disposed of offsite, there is a potential opportunity to dispose of excavated material on site at Gatwick and if this could be achieved it will reduce the cost of the substructure element. If the project continues to progress, we will establish whether Gatwick has the capacity to dispose of this material on site prior to the project going out to tender, as per the tollgate process. With regard to the comment on the quantity of reinforcement included, it is based on Atkins' current design proposal.

Frame: the rates for steelwork included within the cost plan reflect the rates obtained by a number of projects through competitive tendering. We believe they are reasonable and reflective of the building as it is currently designed.

Roofs: the roof includes the cost of the roof trusses that are required in order to achieve the required spans within the building. With regard to the roof cladding system, a Kalzip aluminium standing seam roof is the system that Gatwick prefer, particularly for projects the scale of Pier 6. This system can span greater distances than a single polymer membrane system and therefore requires less structure to support it. The system is also more robust than a single polymer membrane system which is more vulnerable to penetration both during and after construction. The costs for roof protection reflect the requirements in Atkins' design. It should be noted that the roof for the Pier 6 Extension includes a significant area of photovoltaic panels and recessed plant space with a requirement to access all of these areas, hence the need for the extent of roof walkways and handrails included in the estimate.

External walls, windows and doors: there is a significant extent of glazing within the proposed envelope design for the Pier 6 Extension. As a result the curtain walling has been designed to ensure that the building does not experience excessive heat gain and allows the right level of natural light into the building. The rates for the curtain walling reflect this design and we believe that they are reasonable for this stage of the project. We believe that the proposed solution for this system cannot be compared with the curtain walling system utilised on Pier 5 as the design parameters for the Pier 6 system are different. However, as the design for the project progresses, we will be challenging the proposed specification for the curtain walling and soffit panels to establish whether the cost of this element can be reduced.

Preliminaries: The allowances of 15% for prelims and 4.5% for OH&P are reasonable for this stage of the project. These percentages compare with the Gatwick CEG percentages of 15% and 5% respectively. With regard to the allowance for contractors design, it is approximately 3% of the project construction cost. This is a reasonable allowance for this element at this stage in the project, and is in line with what other major projects at Gatwick have incurred.

Appendix 5: A T Kearney's airport operating cost benchmarking report for Gatwick

Attached overleaf

ATKearney

Gatwick Airport Ltd

Report FY 2012

Report S&O, IT
June 2013

ATKearney

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The various results, conclusions and recommendations contained therein, represent an expert opinion based on the information available at the time of compiling the report and have not been updated since. Such forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause the actual results/performance to differ materially from the anticipated results/performance expressed or implied by such forward-looking statements.

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A.T. Kearney used the text and graphs compiled in this report in a presentation; they do not represent a complete documentation of the presentation.

Source: A.T. Kearney

- **Introduction**
- Summary
- IT Benchmark
- S&O Benchmark

ATKearney

GCB is different from all other benchmarks because…

Introduction - Unique and standardized methodology

… is comparing your own inside-out data[1] only with **inside out data of other participating airports**

… is **not** using any public sources

… **creates real comparability** by holistic approach and standardized data collection

… methodology has proven itself for **over 10 years** and is executed continuously

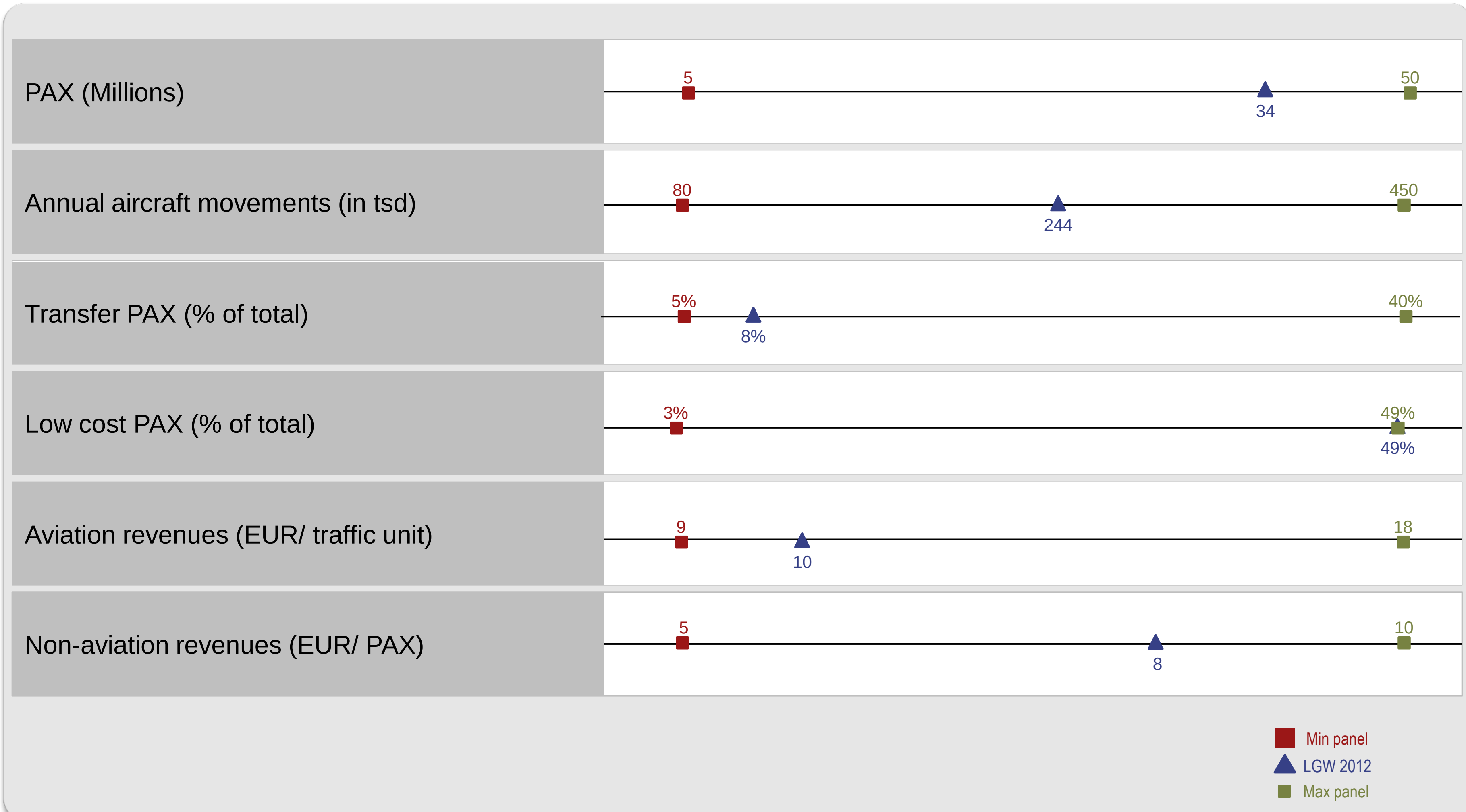
… is providing **absolute data confidentiality** for you and your peers

1. Inside out data: Participating airports allocating their internal ERP data and KPI´s into the GCB data base structure
Source: A.T. Kearney

ATKearney

The GCB panel includes 32 international airports in Europe and Asia with diverse characteristics

Introduction - GCB airports panel[1]



1. This introduction represents the full participating panel (airports not comparable will be excluded in the individual activity analysis)
Source: A.T. Kearney

ATKearney

The GCB collects and processes data in a standardized three step process

Introduction - The three Step Process of the GCB

Input

Standardized input of

- **Cost** split by activities and cost types, and
- **Drivers / KPIs**

Consistent due to a large set of **precise definitions** in the **Manual**

Analysis

- **Harmonization** to adjust for country specific price levels

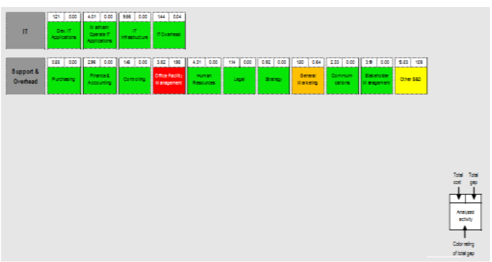
Indirect costs – "raw" data	÷	Harmonization factor
Personnel		Labor cost index
External services/outsourcing		Labor cost index 1)
Power		Power cost index

- **Normalization** (Calculation of cost per driver)

Indirect costs per activity	÷	Main cost driver
Airside facilities		# of traffic units
Terminal		# of PAXs

Output

- Process-related cost **dashboard**



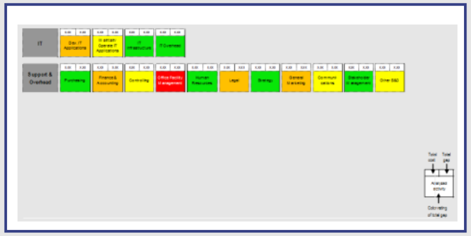
- **Main analyses per area / activity**

Source: A.T. Kearney

The GCB results mirror the pyramidal structure of activities; The dashboard being the executive overview

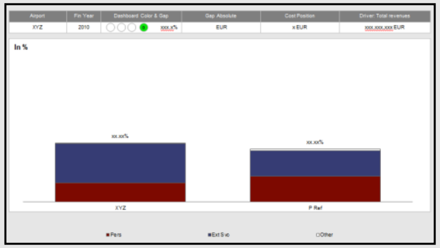
Introduction - Benchmarking Result Structure

Dashboard
Overview of operator's cost performance for all major activities per functional area



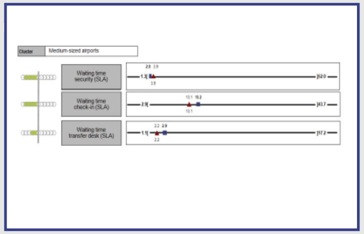
- All activities are consolidated to main activities and stated in the dashboard
- For each main activity, the calculated performance is made visible as a color

Cost Analysis
Detailed analysis of cost performance on various aggregation levels, using various drivers



- Comparison of the relative cost position per activity with comparable peers
- Performance gap calculated as the difference between operator's cost positions and the reference value

KPI Analysis
Comparison of key KPIs & cost structures per functional area



- Additional analysis done on structural cost analyses and KPI comparisons

Source: A.T. Kearney

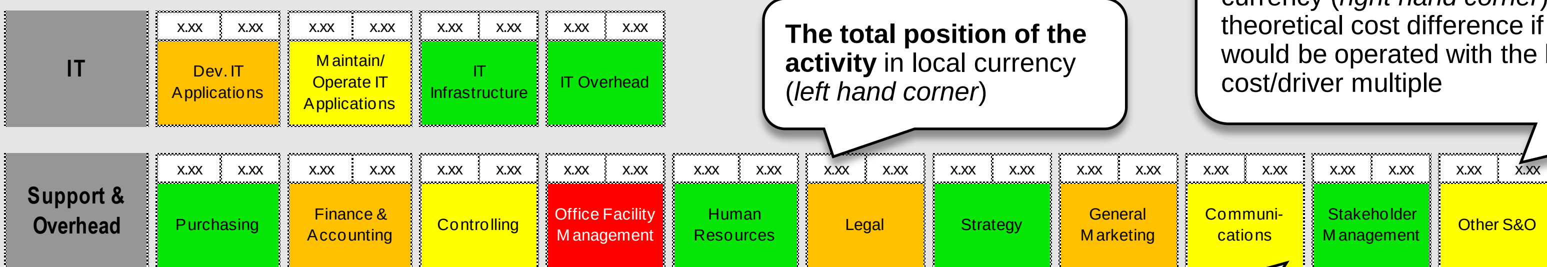
ATKearney

The "GCB Dashboard" provides a performance overview of the GCB airport activities

Introduction - GCB Dashboard Explanation

The total position of the activity in local currency (*left hand corner*)

The gap to the panel reference in local currency (*right hand corner*). The gap is the theoretical cost difference if the activity would be operated with the benchmark cost/driver multiple



Activity box stating the name and gap color of an activity. The gap is the theoretical cost difference if the activity would be operated with the benchmark cost/driver multiple

The meaning of the colors are the following:

- *Green: Airport* cost/driver < 1.05 x Panel cost/driver
- *Yellow:* 1.05 x Panel cost/driver < Airport cost/driver < 1.25 x Panel cost/driver
- *Orange:* 1.25 x Panel cost/driver < Airport cost/driver < 1.5 x Panel cost/driver
- *Red:* 1.5 x Panel cost/driver < Airport cost/driver

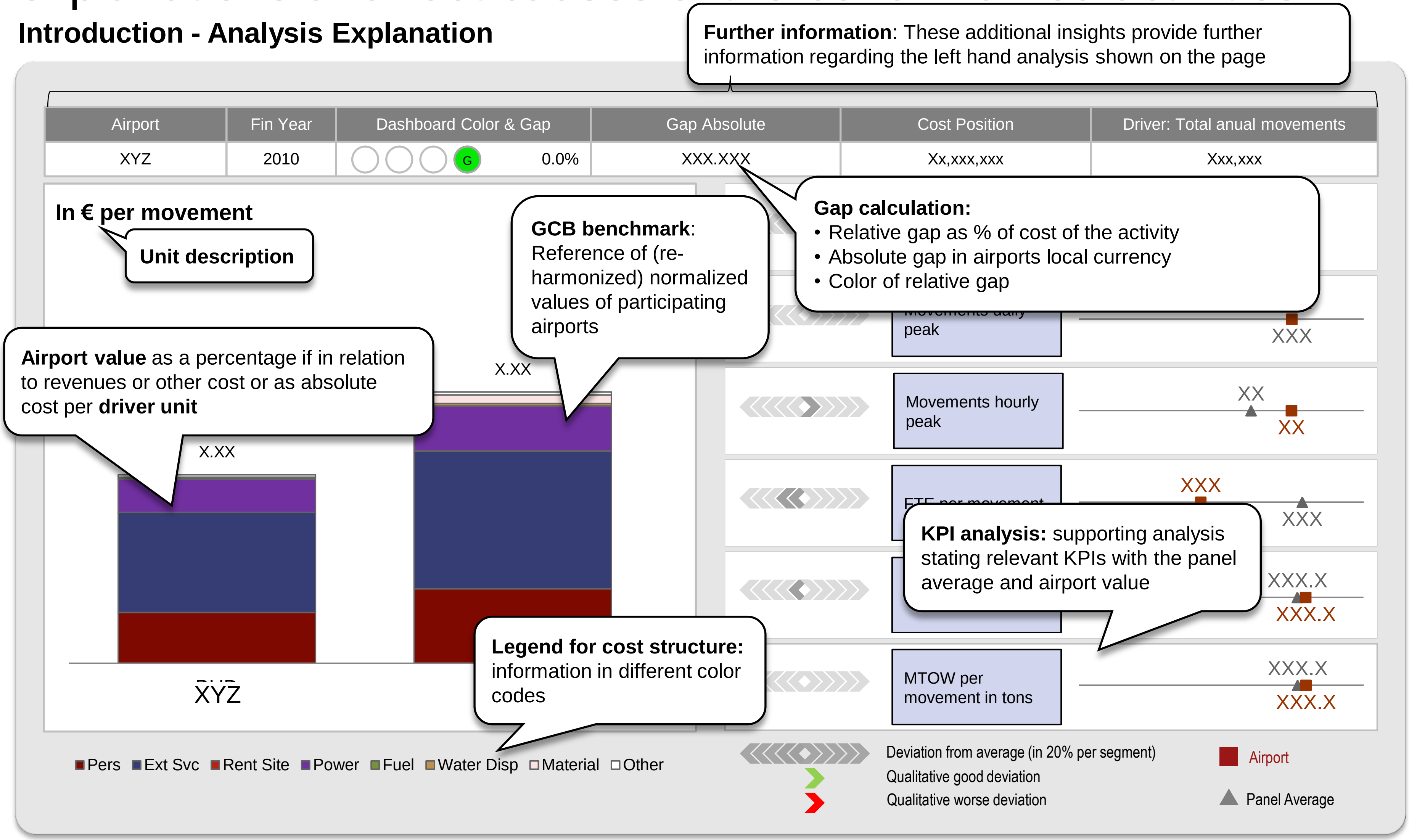
Rel. gap < 5% | Rel. gap between 5% and 25% | Rel. gap between 25% and 50% | Rel. gap > 50% | Limited comparability | Not benchmarked

Source: A.T. Kearney

ATKearney

The GCB in depth analysis supported by KPIs provide explanations and root causes of the benchmarked activities

Introduction - Analysis Explanation



Source: A.T. Kearney

ATKearney

Abbreviations are used to save space and enhance the reading experience

Introduction - List of Abbreviations used in the Report

Abbreviation	Explanation
A/P	Airport
Admin	Administration
Advert	Advertising
Airline reb	Airline rebates
Alloc	Allocation
Applic	Application
Av	Aviation
av	Average
Bank charg	Bank charges
Dep	Department
dep	departing
Dev	Development
Ext svc	External service
F&B	Food and beverages
Fac	Facilities
FTE	Full time employees
GAT	General aviation terminal
Infrastr	Infrastructure
LCC	Low cost carrier
LVM	License and vendor maintenance cost
Maint	Maintenance
Mgmt	Management

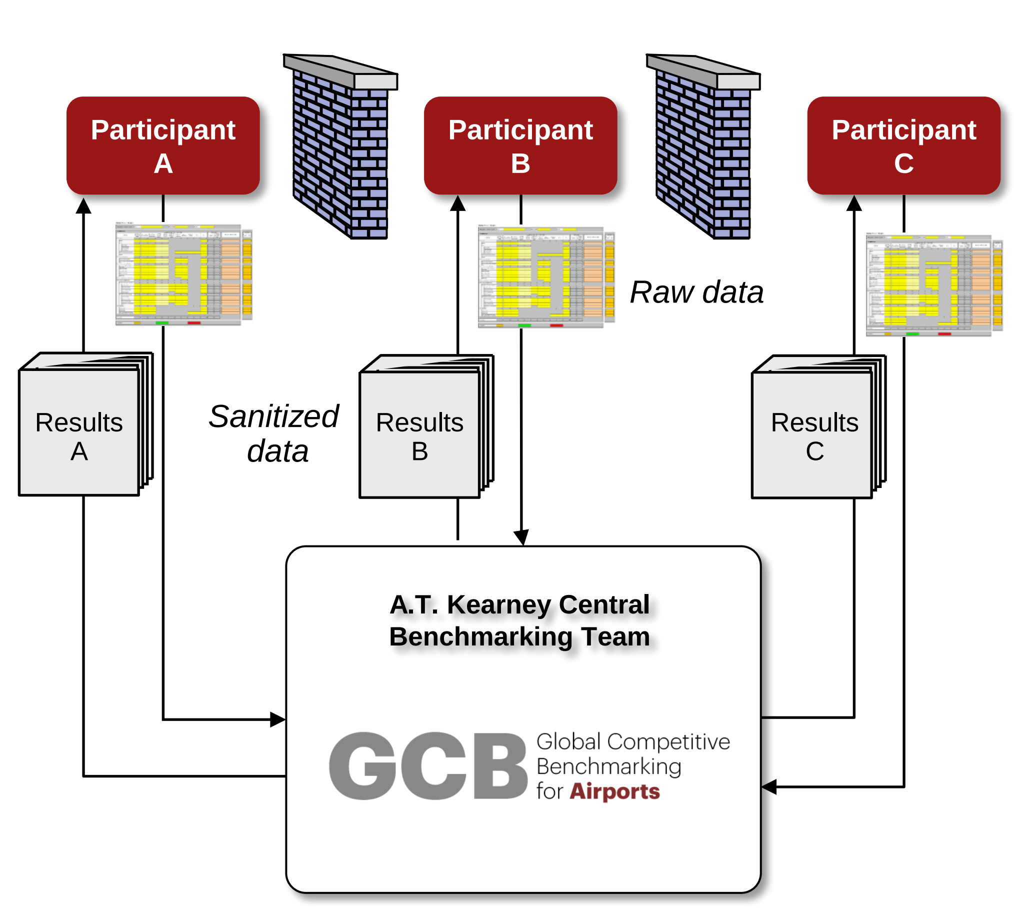
Abbreviation	Explanation
Mktg support	Marketing supplements
MTOW	Maximum take-off weight
Nav	Non-Aviation
Ops	Operations
P Avg	Panel average
PAX	Passenger
Pers	Personnel
PRM	Persons with reduced mobility
Rent site	Site and building rental
Rental eq	Equipment rental & lease
Rev	Revenues
S&O	Support and overhead
S&S	Safety and security
Sec	Security
Serv	Service
Sqm	Square meter
Superv	Supervision
Sys	System
Tel&Post	Telecommunication and postal charges
TU	Traffic unit = 1 PAX = 100 kg cargo
w/o	Without
Water disp	Water disposal

Source: A.T. Kearney

ATKearney

Tight processes were set up to assure absolute confidentiality between participating airports

Introduction - Data Confidentiality



- A.T. Kearney's treats all data and benchmarking results as strictly confidential
- All participants have to commit to A.T. Kearney to treat all benchmarking data and results as well as the final results presentation as strictly confidential
- In the results presentation only the respective client data will be disclosed
- Open-Book comparisons are possible, but on the basis of individual agreements only

Source: A.T. Kearney

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Executive Summary - Cost Dashboard (in mn GBP)

	Analyzed activity	Total cost	Total gap	Color rating
IT	Dev. IT Applications	121	-2.38	Green
IT	Maintain/ Operate IT Applications	4.01	-173	Green
IT	IT Infrastructure	9.56	-136	Green
IT	IT Overhead	144	0.04	Green
Support & Overhead	Purchasing	0.88	-0.35	Green
Support & Overhead	Finance & Accounting	2.96	-4.19	Green
Support & Overhead	Controlling	148	-0.06	Green
Support & Overhead	Office Facility Management	3.52	198	Red
Support & Overhead	Human Resources	4.31	-0.08	Green
Support & Overhead	Legal	114	-0.48	Green
Support & Overhead	Strategy	0.92	-0.86	Green
Support & Overhead	General Marketing	180	0.64	Orange
Support & Overhead	Communi-cations	2.33	-0.03	Green
Support & Overhead	Stakeholder Management	3.19	-190	Green
Support & Overhead	Other S&O	1174	-0.55	Green

Total cost | Total gap

Analyzed activity

Color rating of total gap

Thresholds by relative gap:

- Green: Rel. gap < 5%
- Yellow: Rel. gap between 5% and 25%
- Orange: Rel. gap between 25% and 50%
- Red: Rel. gap > 50%
- Hatched: Limited comparability
- White: Not benchmarked

Source: A.T. Kearney

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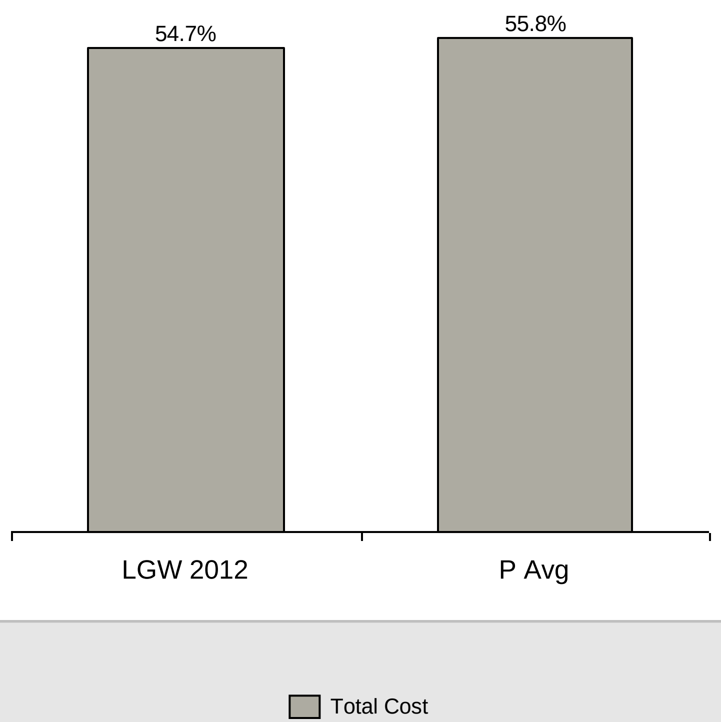
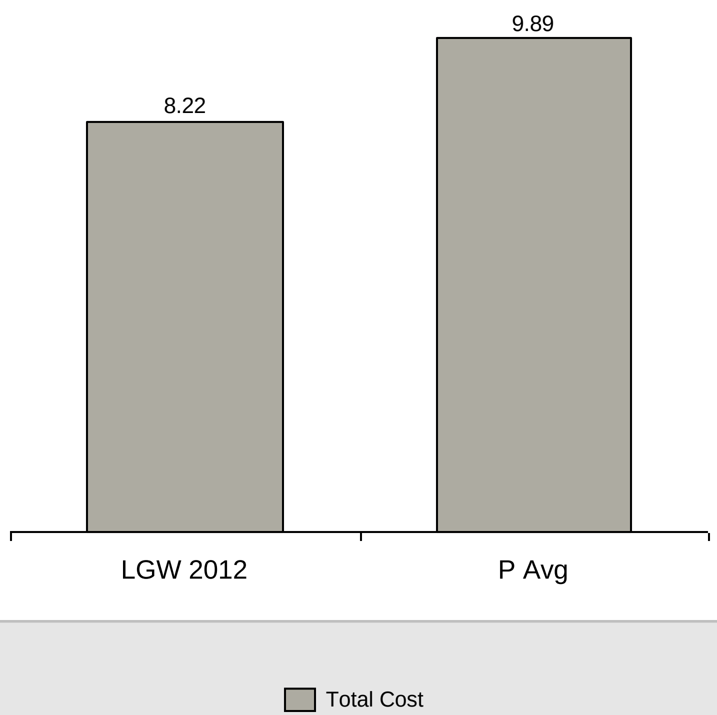
Summary - Total Cost Benchmark

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Airport revenues
LGW 2012	2012	G -2%	-6,280,592 GBP	290,332,441 GBP	531,122,190 GBP

Cost per airport revenue[1]



Cost in GBP per traffic unit[1]



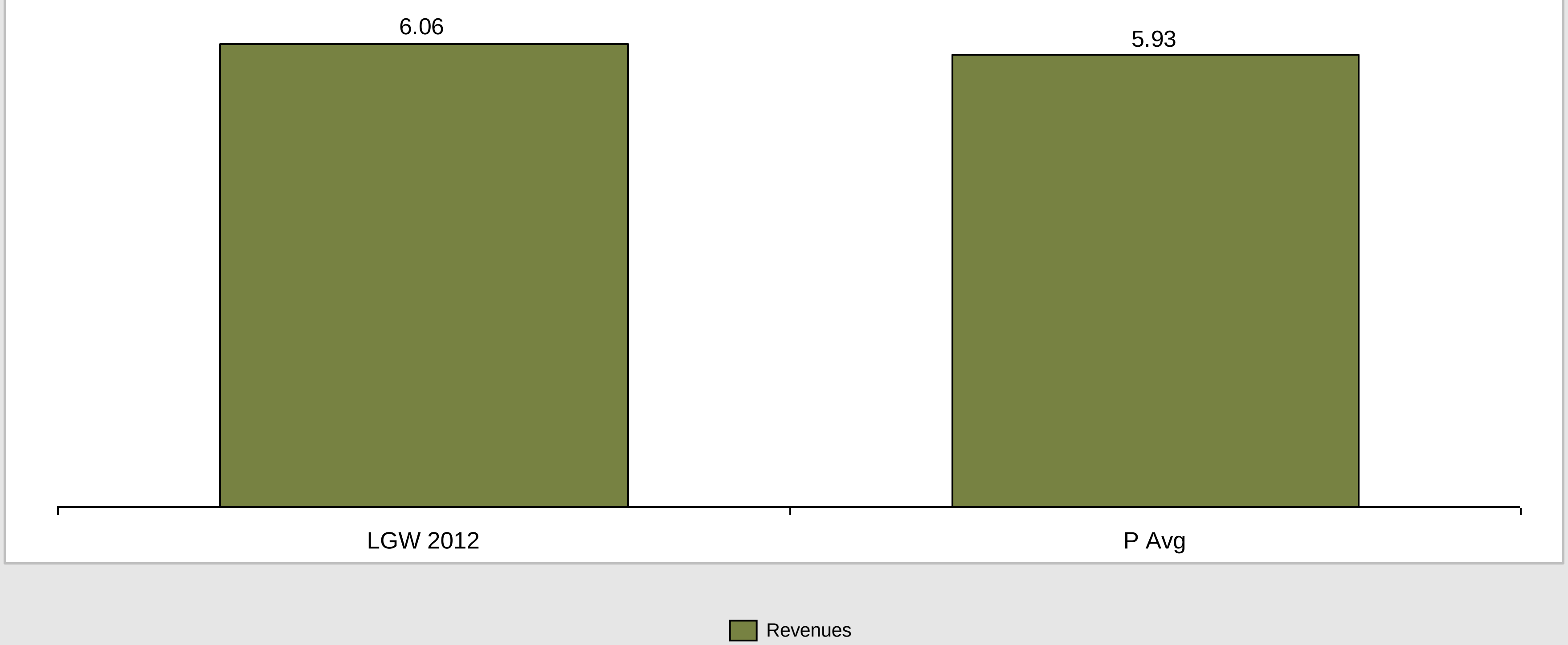
1. Without Ground Handling cost
Source: A.T. Kearney

ATKearney

Summary - Commercial Revenue Benchmark[1]

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Revenue position	Driver: PAX
LGW 2012	2012	G -2%	-4,156,794 GBP	207,839,717 GBP	34,272,262

Revenues in GBP per PAX



1. Includes Retail, Advertising, Car parking, Property, and Other concessions and licenses revenues
Source: A.T. Kearney

- Introduction
- Summary
- **IT Benchmark**
- S&O Benchmark

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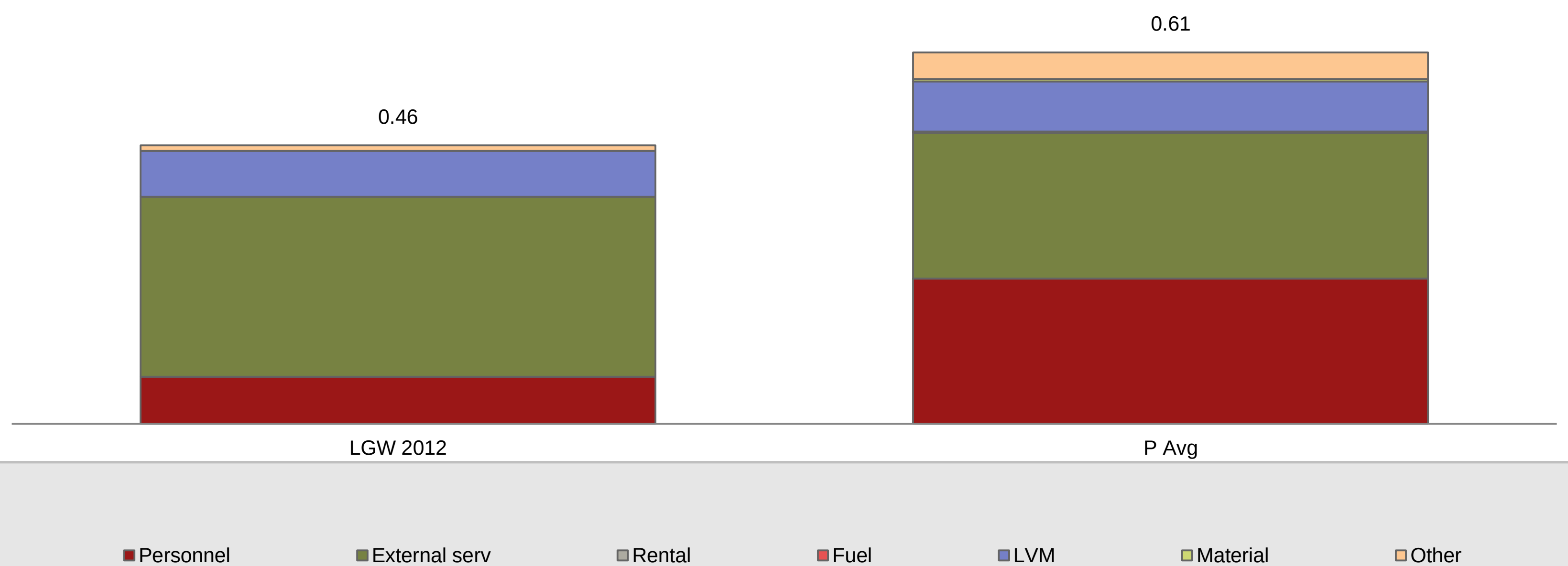
IT - Total Cost

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Traffic units
LGW 2012	2012	G -33%	-5,410,501 GBP	16,224,402 GBP	35,309,642

Cost in GBP per traffic unit[1]



1. Traffic unit = 1 PAX = 100 kg cargo
Source: A.T. Kearney

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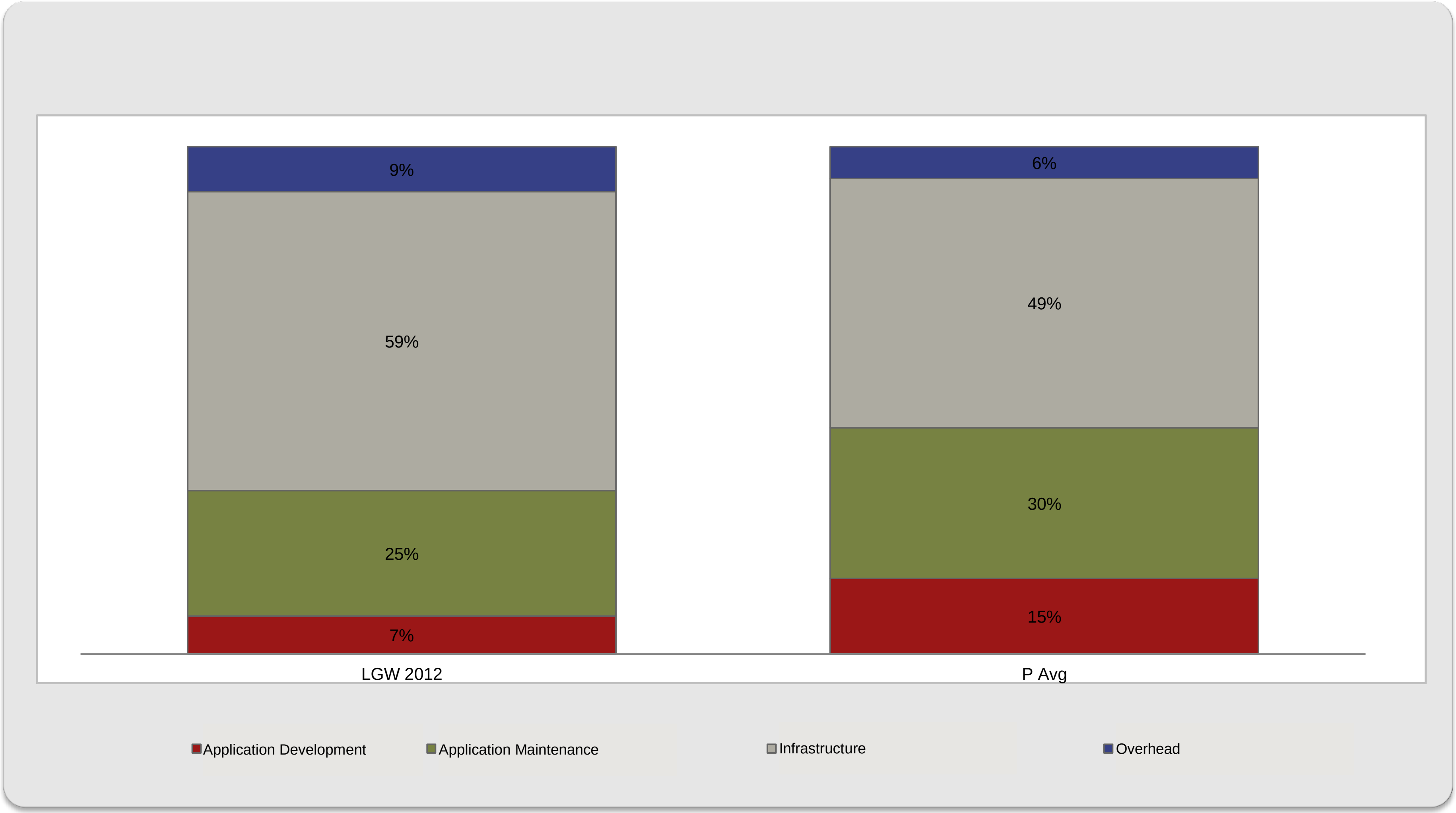
IT - Cost Share



Source: A.T. Kearney

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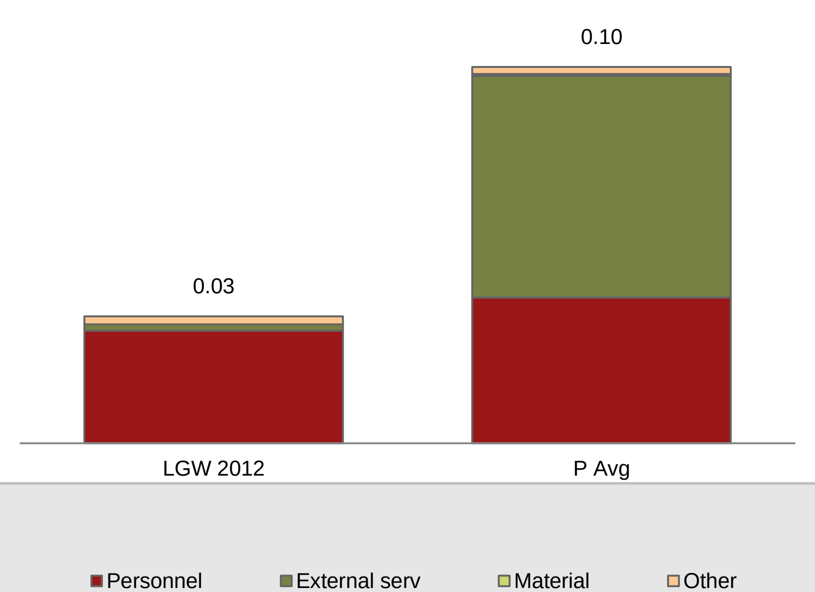
IT - Application Development Cost

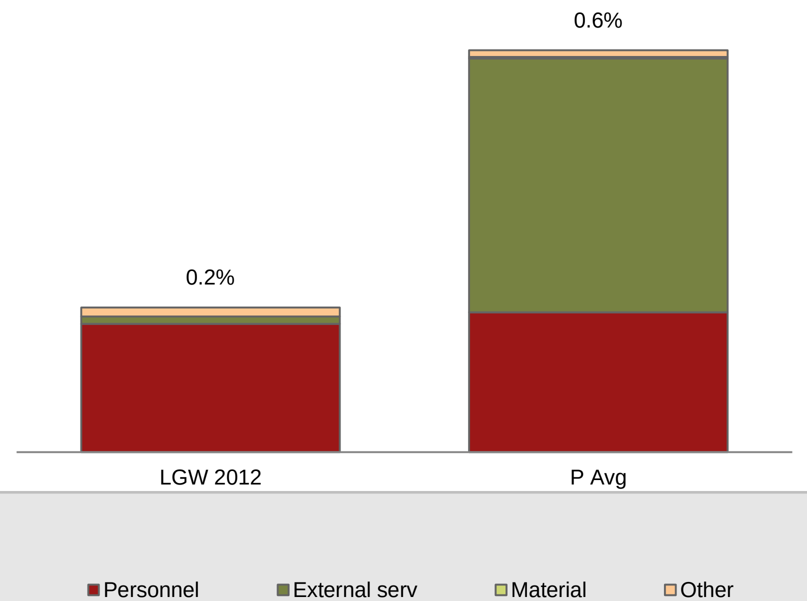
Main Analysis

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Traffic units
LGW 2012	2012	G -196%	-2,382,358 GBP	1,212,890 GBP	35,309,642

Cost in GBP per traffic unit



Cost in % of revenues



Source: A.T. Kearney

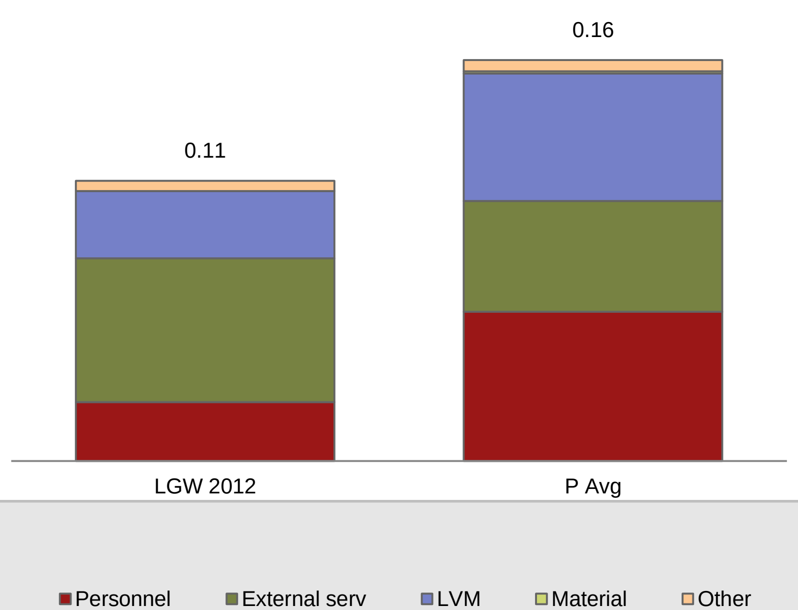
ATKearney

IT - Application Maintenance Cost

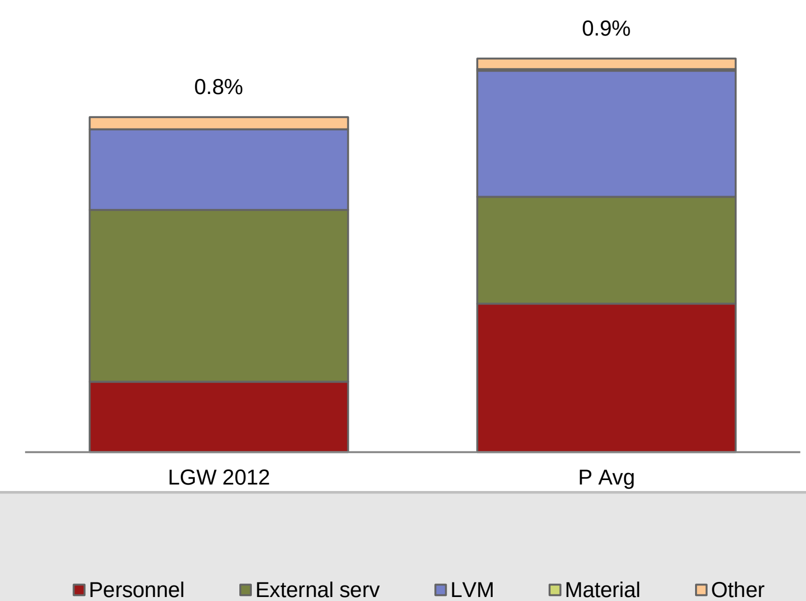
Main Analysis

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Traffic units
LGW 2012	2012	G -43%	-1,726,085 GBP	4,008,649 GBP	35,309,642

Cost in GBP per traffic unit

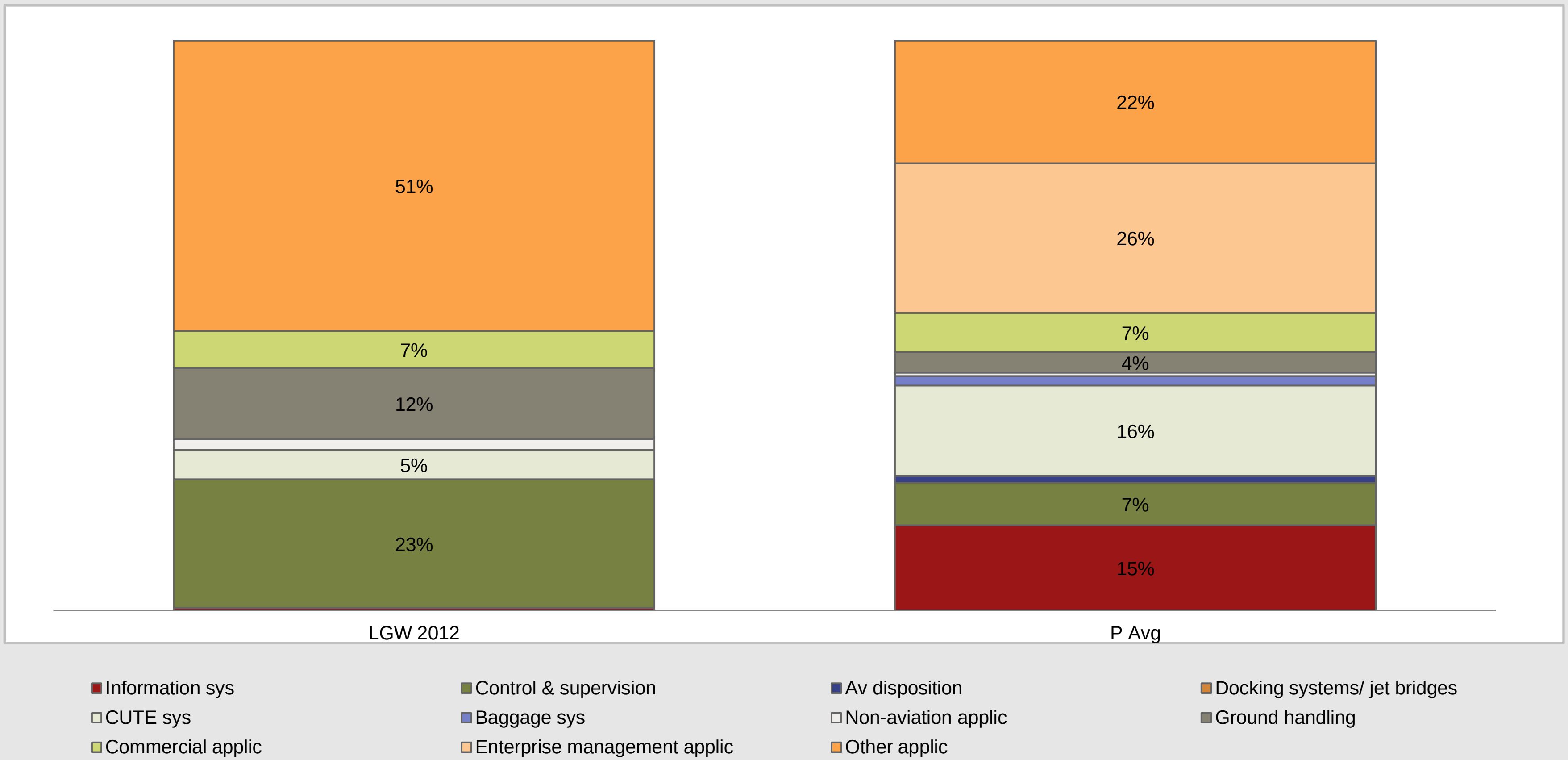


Cost in % of revenues



Source: A.T. Kearney

IT - Application Maintenance Cost Share



Source: A.T. Kearney

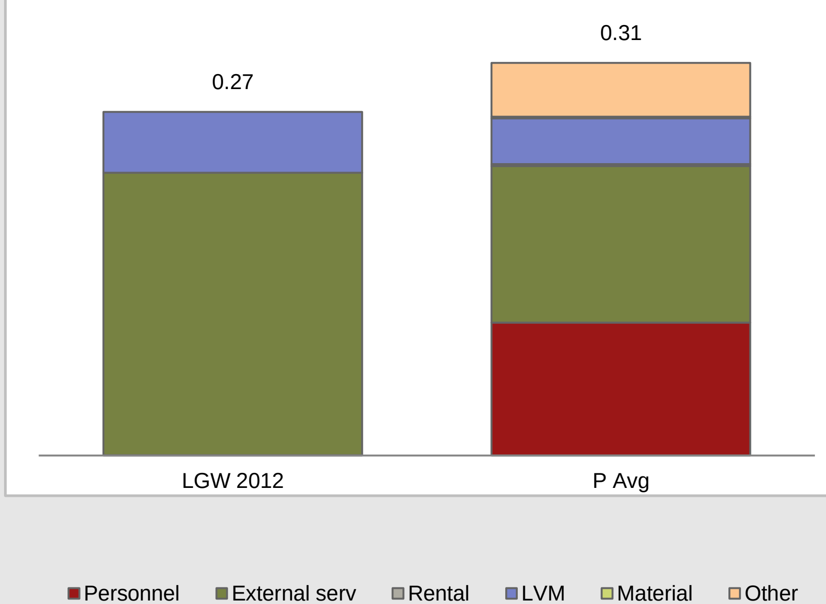
ATKearney

Main Analysis

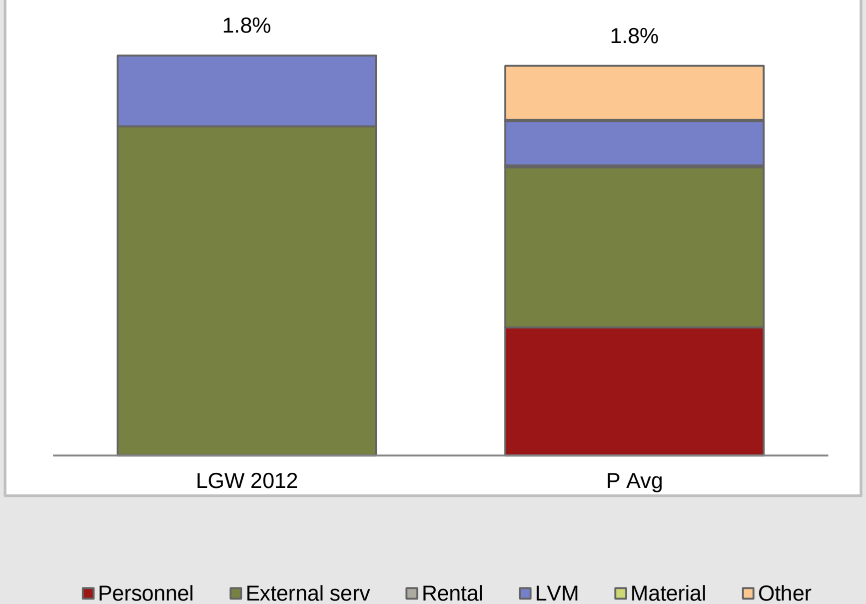
IT - Infrastructure Cost

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Traffic units
LGW 2012	2012	G -14%	-1,360,132 GBP	9,558,418 GBP	35,309,642

Cost in GBP per traffic unit



Cost in % of revenues



Source: A.T. Kearney

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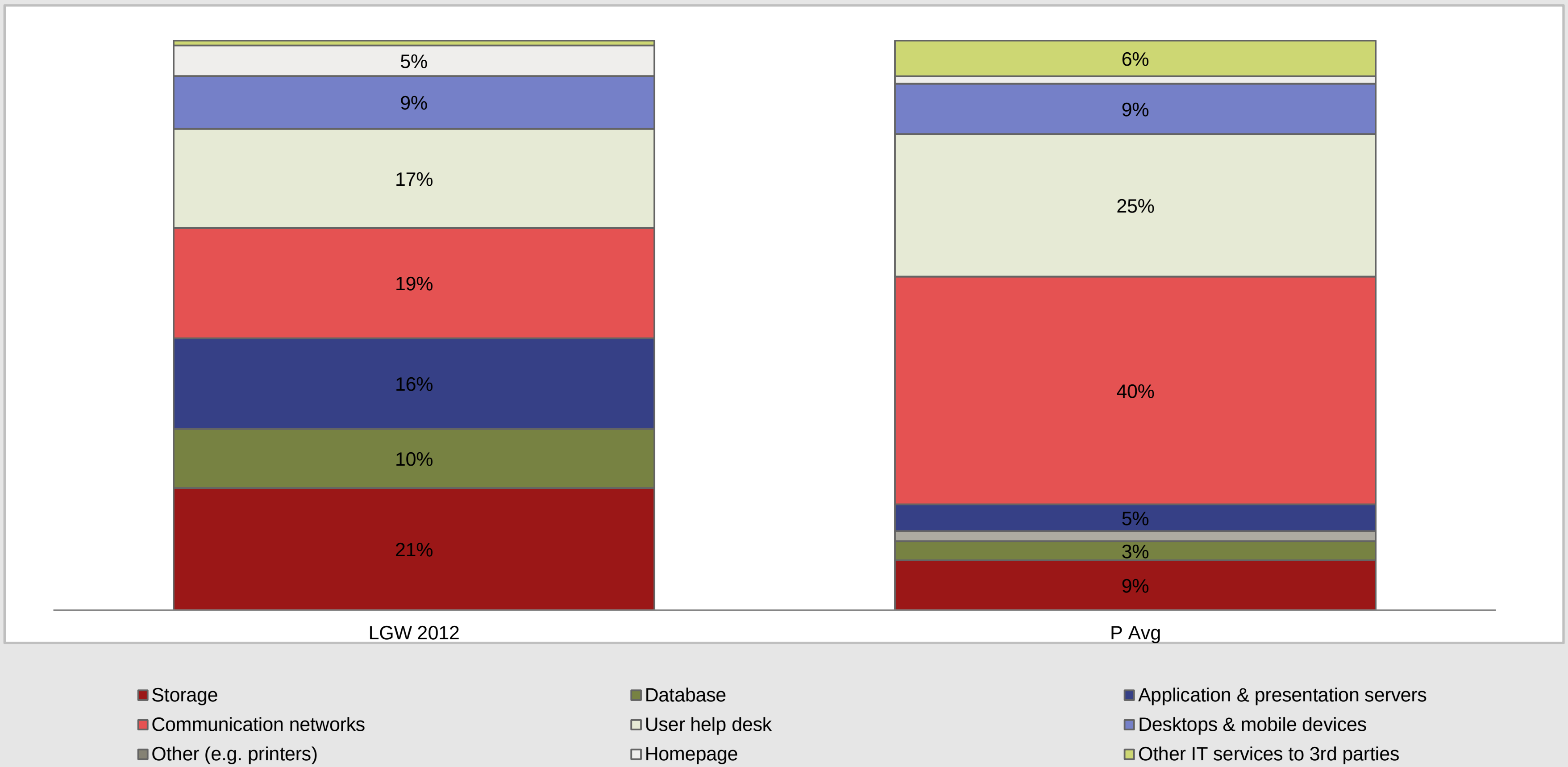
IT - Infrastructure Cost Share



Source: A.T. Kearney

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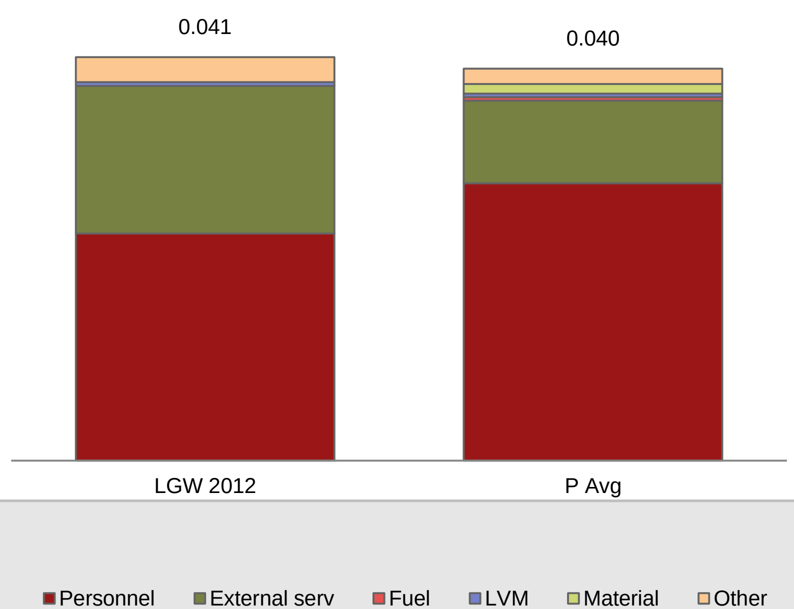
IT - Overhead Cost

Main Analysis

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Traffic units
LGW 2012	2012	G 3%	41,568 GBP	1,444,444 GBP	35,309,642

Cost in GBP per traffic unit



Indicator	Panel average	LGW 2012
Movements per IT FTE	2,889	3,424
Traffic units in mn per IT FTE	0.29	0.49
Airport rev in mn GBP per IT FTE	5.04	7.44

Deviation from average (in 20% per segment)
Qualitative good deviation
Qualitative worse deviation

LGW 2012
Panel average

Source: A.T. Kearney

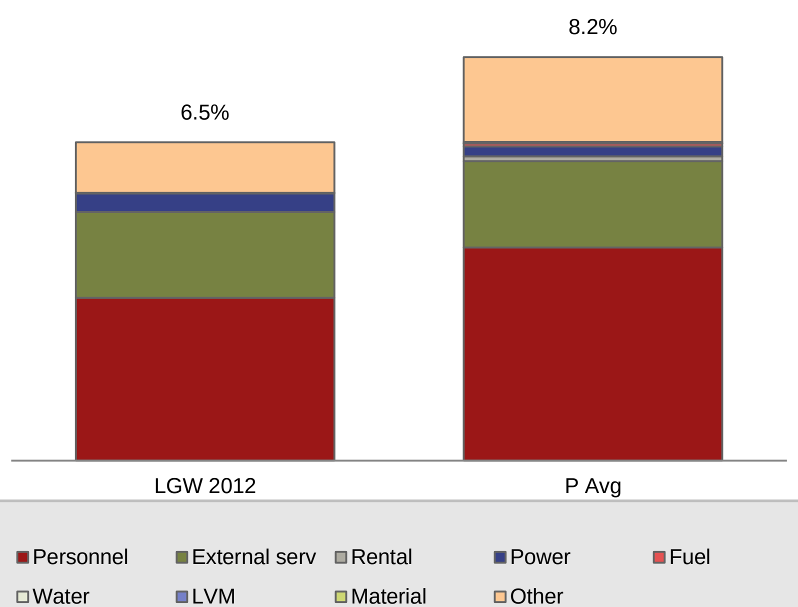
ATKearney

ATKearney

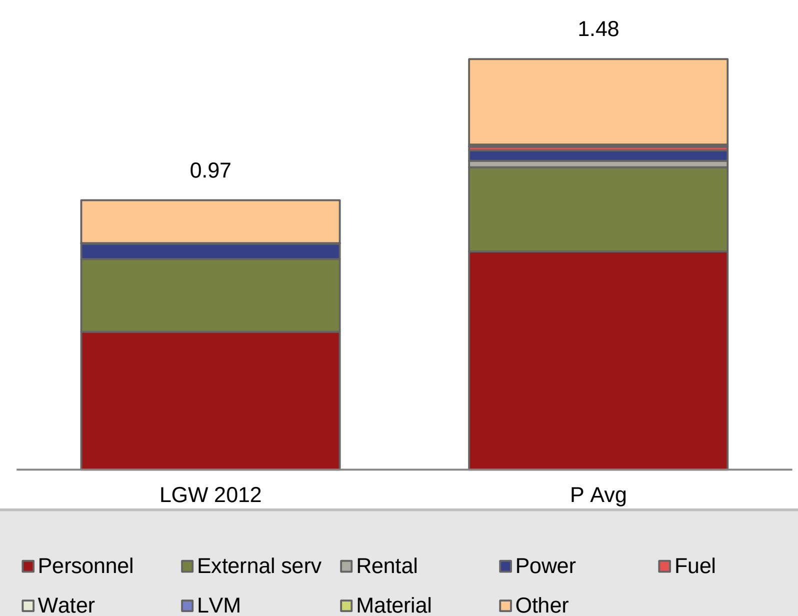
Support & Overhead - Total Cost

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Airport revenues
LGW 2012	2012	G -27%	-9,166,207 GBP	34,266,887 GBP	531,122,190 GBP

Cost in % of airport revenues



Cost in GBP per traffic unit



Source: A.T. Kearney

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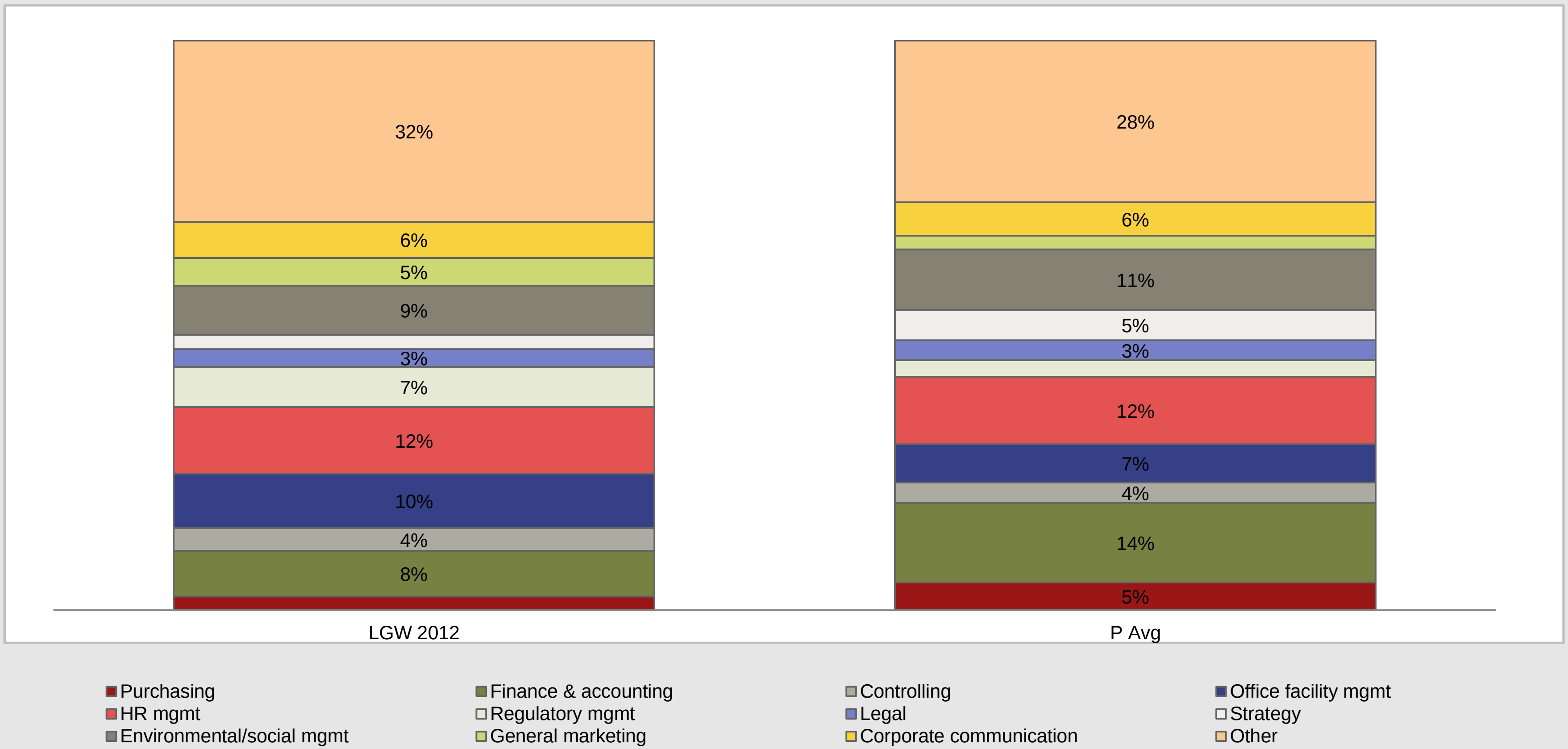
Support & Overhead - Total Cost Share



Source: A.T. Kearney

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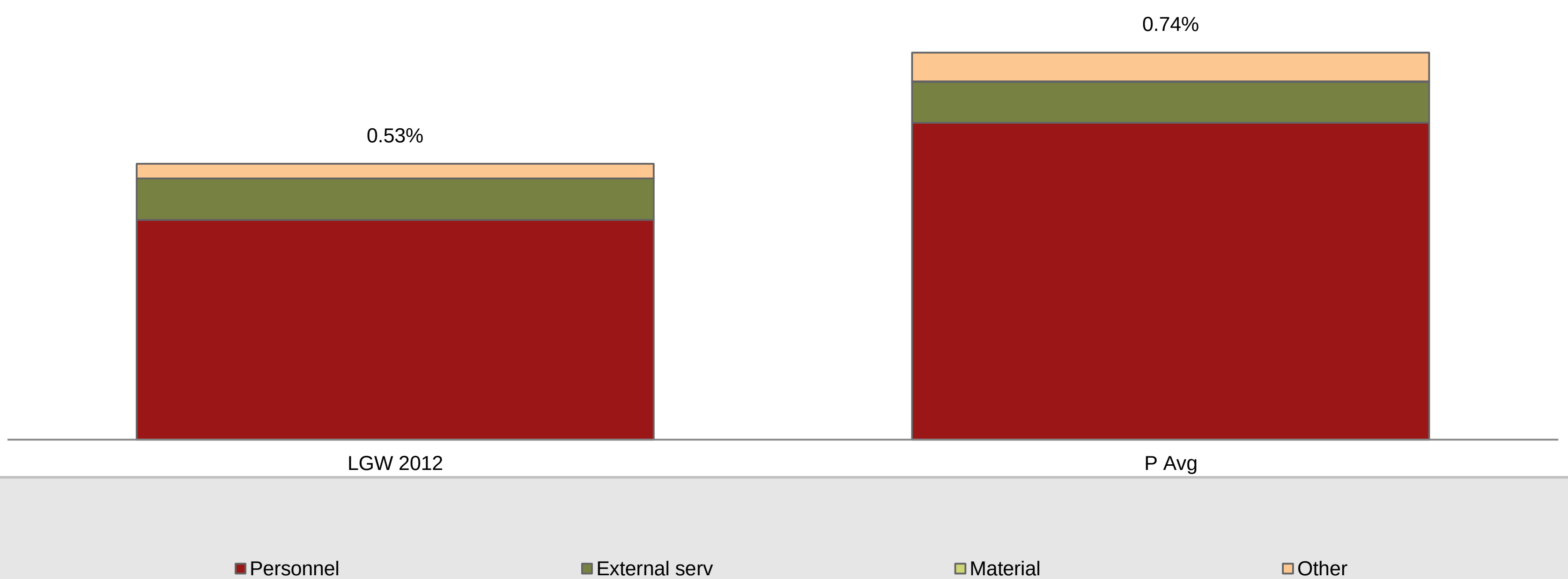
Main Analysis

Support & Overhead - Purchasing Cost

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Purchasing volume
LGW 2012	2012	G -40%	-354,397 GBP	880,708 GBP	165,822,640 GBP

Cost in % of purchasing volume



Source: A.T. Kearney

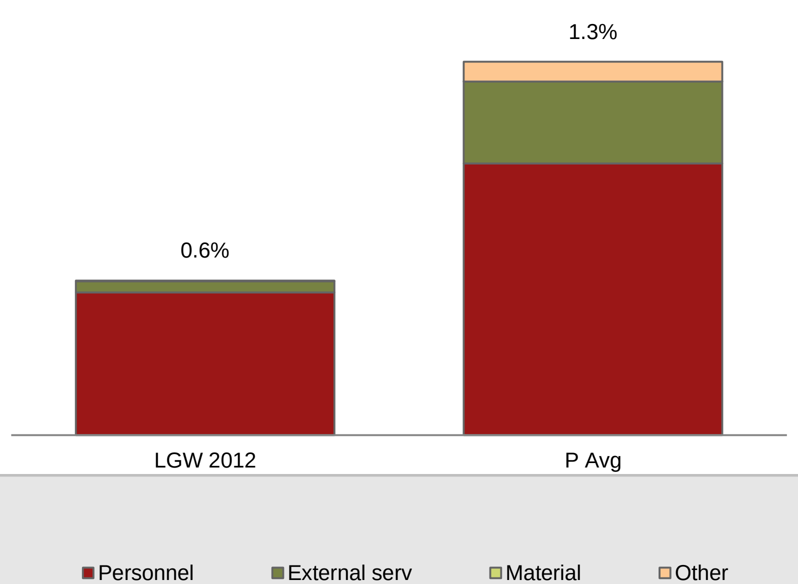
ATKearney

Main Analysis

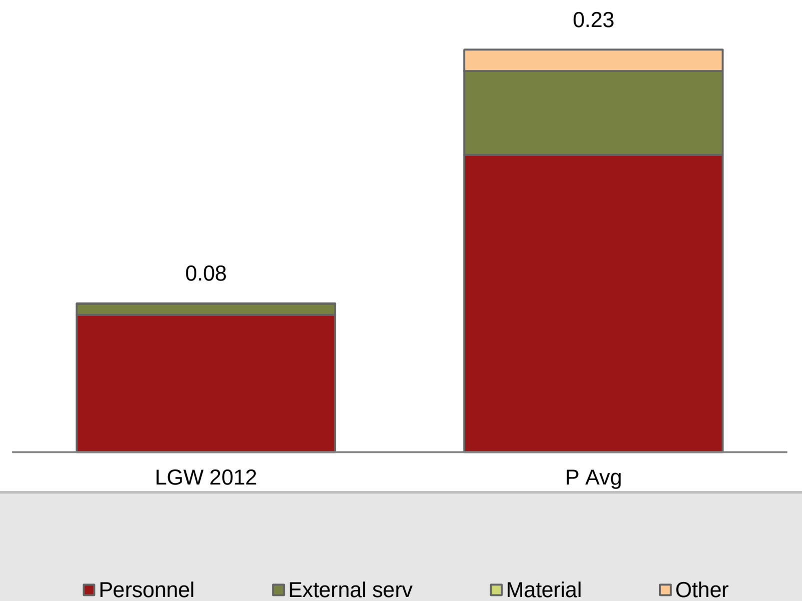
Support & Overhead - Finance & Accounting Cost

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Airport revenues
LGW 2012	2012	G -141%	-4,186,704 GBP	2,959,634 GBP	531,122,190 GBP

Cost in % of airport revenues



Cost in GBP per traffic unit



Source: A.T. Kearney

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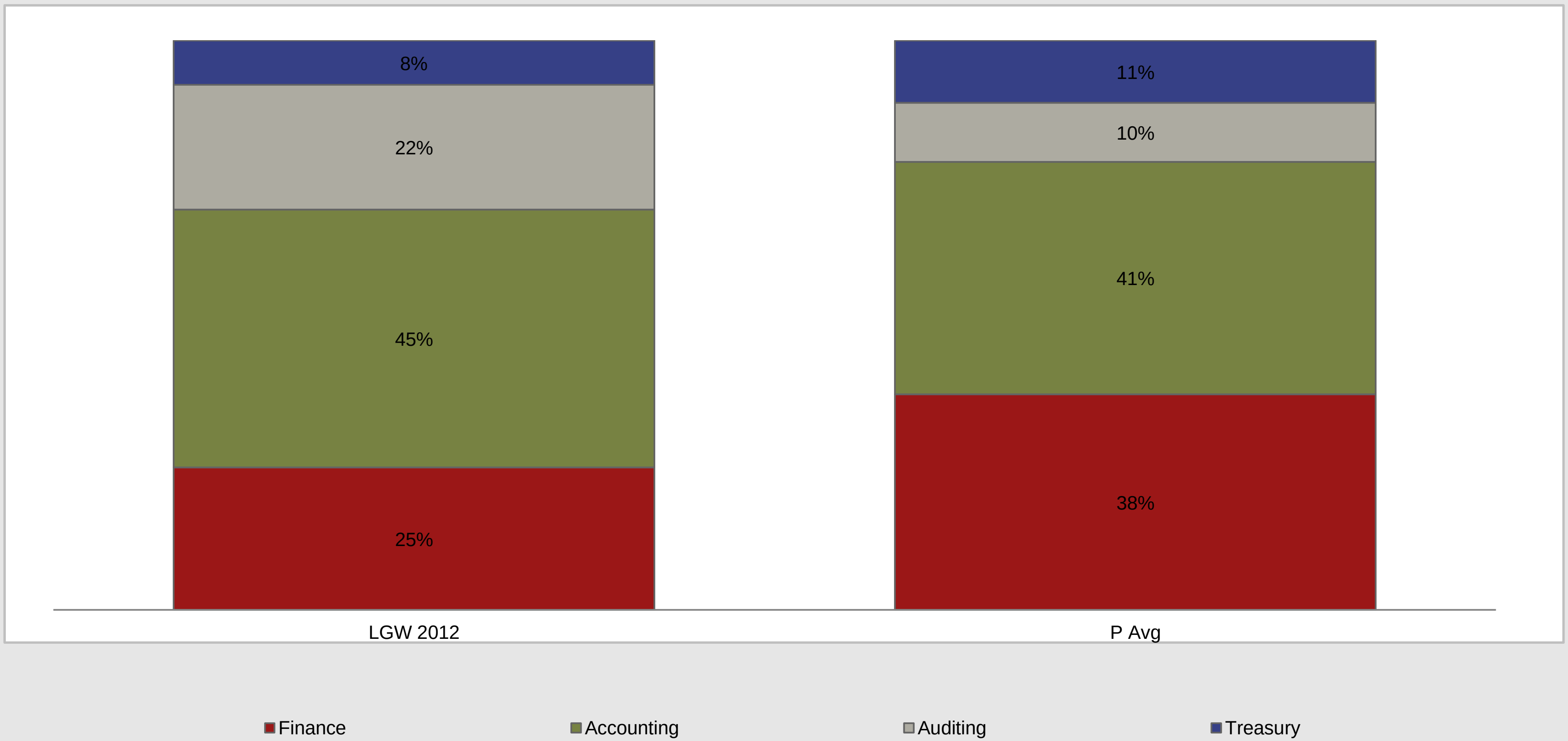
Support & Overhead - Finance & Accounting Cost Share



Source: A.T. Kearney

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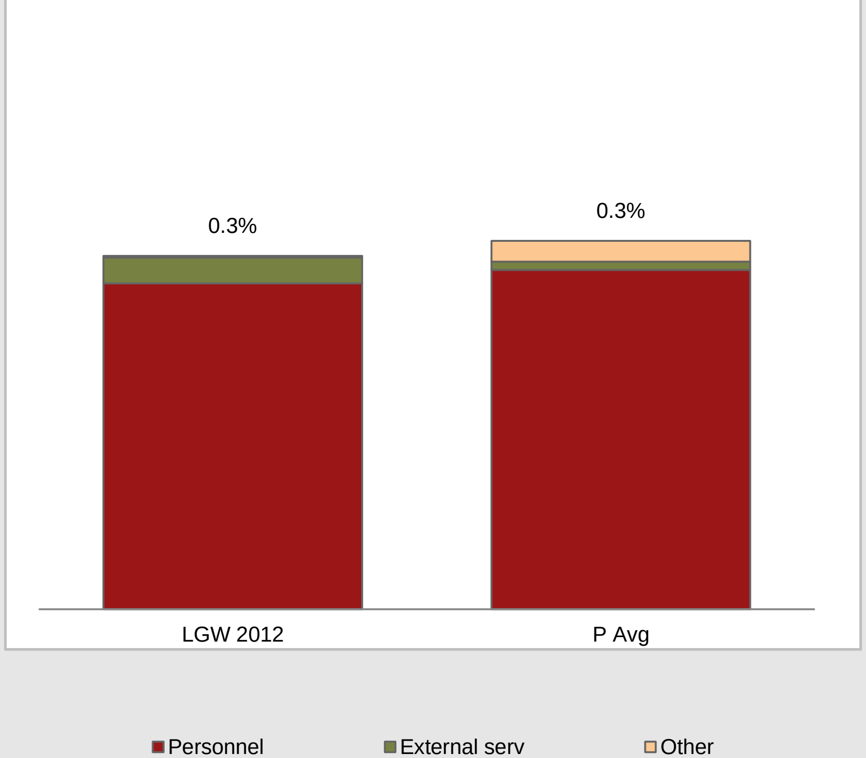
Main Analysis

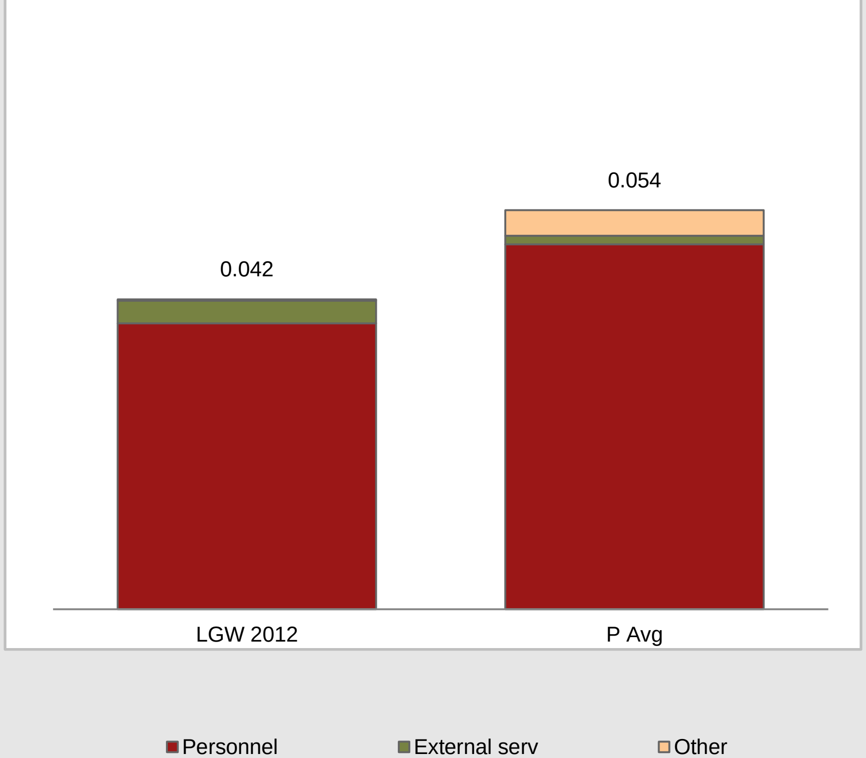
Support & Overhead - Controlling Cost

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Airport revenues
LGW 2012	2012	G -4%	-63,210 GBP	1,479,817 GBP	531,122,190 GBP

Cost in % of airport revenues



Cost in GBP per traffic unit



Source: A.T. Kearney

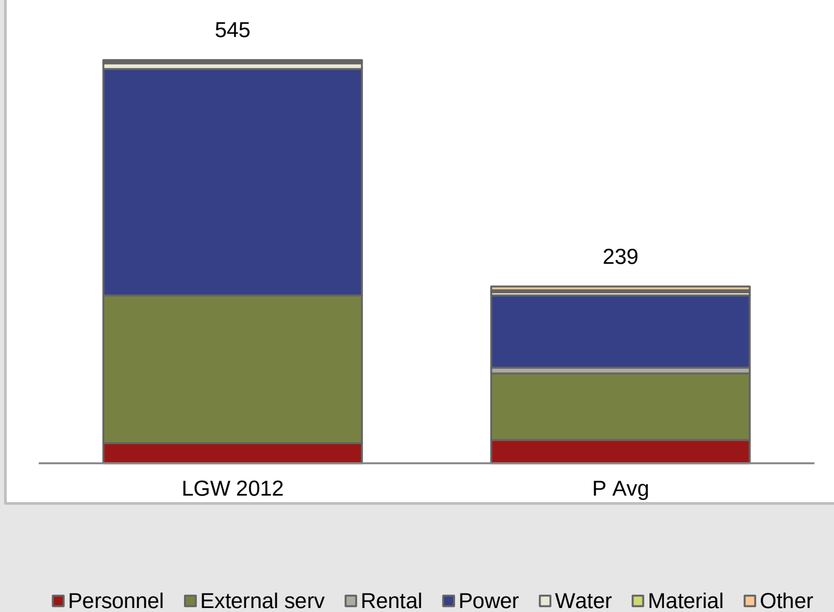
ATKearney

Support & Overhead - Office Facility Management Cost

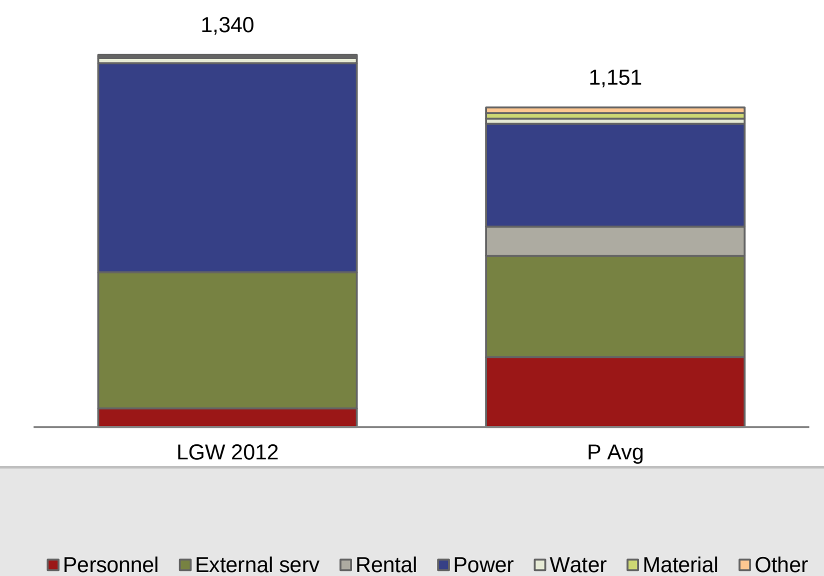
Main Analysis

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Office buildings area
LGW 2012	2012	R 56%	1,977,586 GBP	3,521,294 GBP	6,456

Cost in GBP per sqm office space



Cost in GBP per headcount of employees



Source: A.T. Kearney

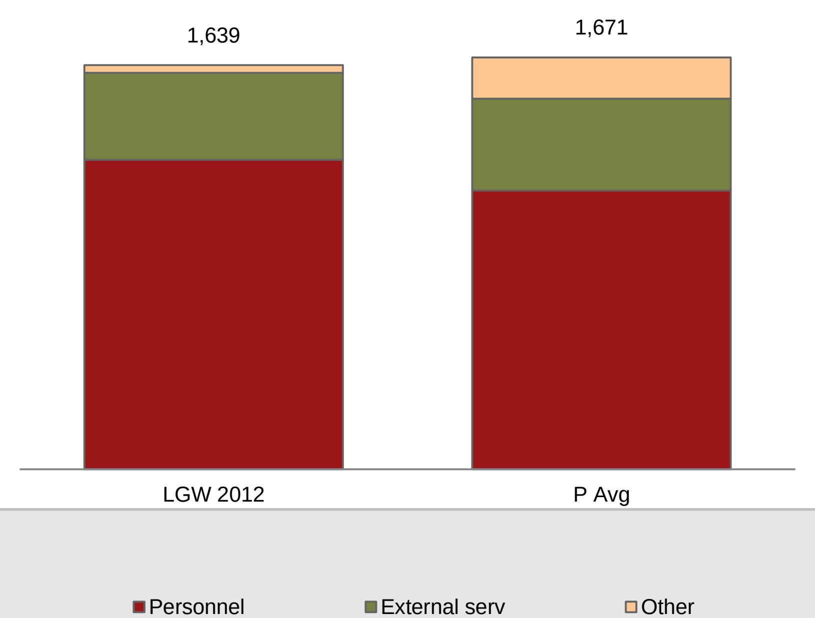
ATKearney

Support & Overhead - Human Resources Cost

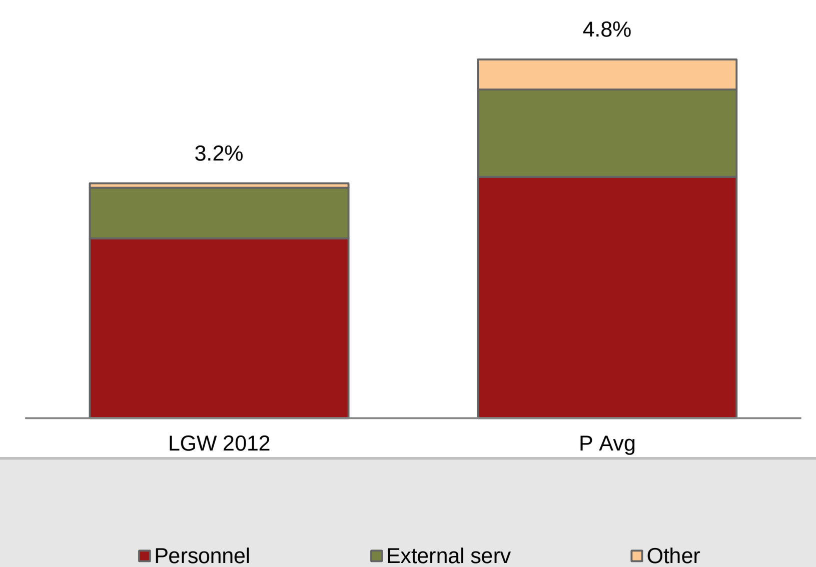
Main Analysis

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Headcount of employees
LGW 2012	2012	G -2%	-82,089 GBP	4,308,585 GBP	2,628

Cost in GBP per employee



Cost in % of personnel cost



Source: A.T. Kearney

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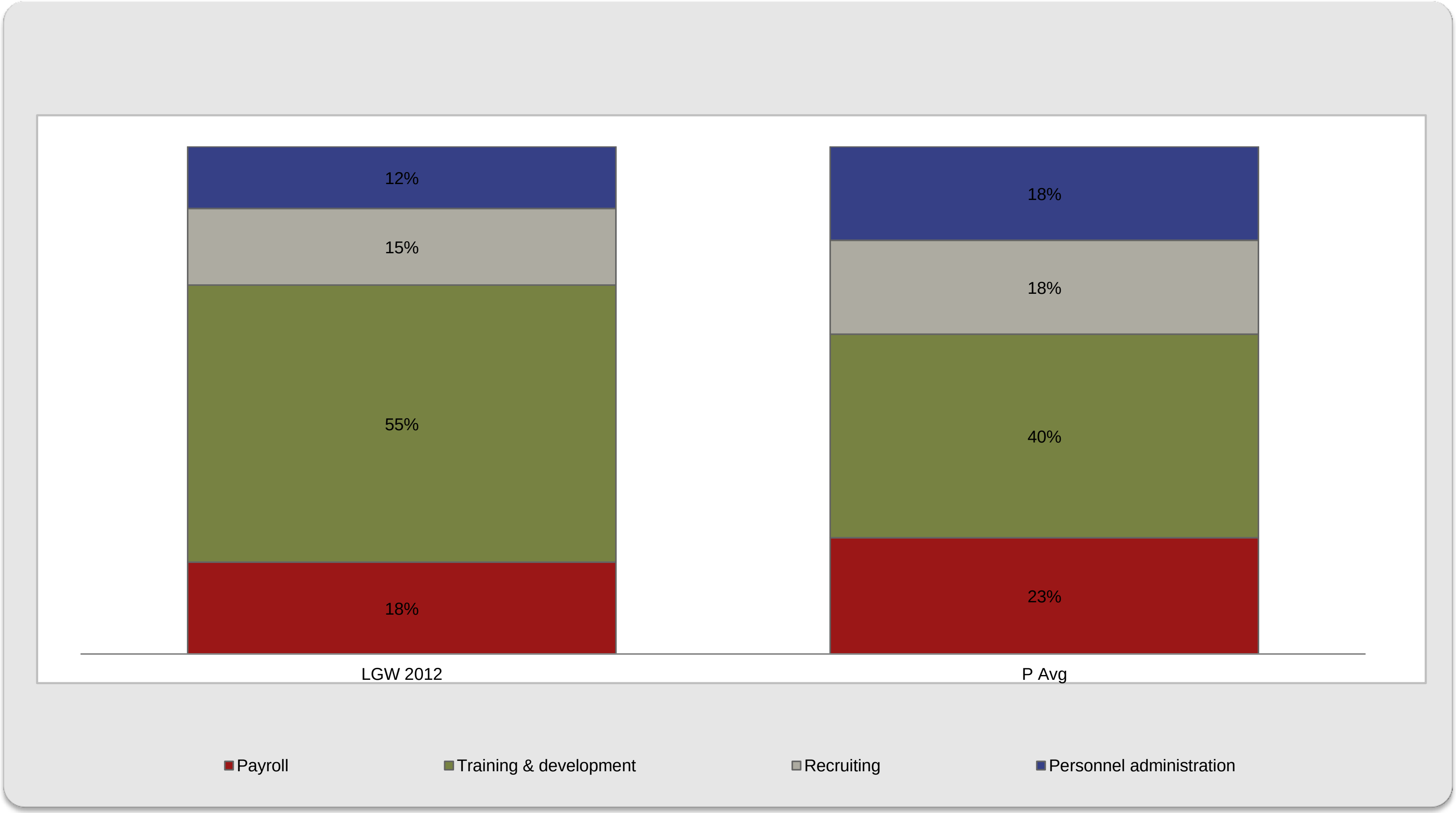
Support & Overhead - Human Resources Cost Share



Source: A.T. Kearney

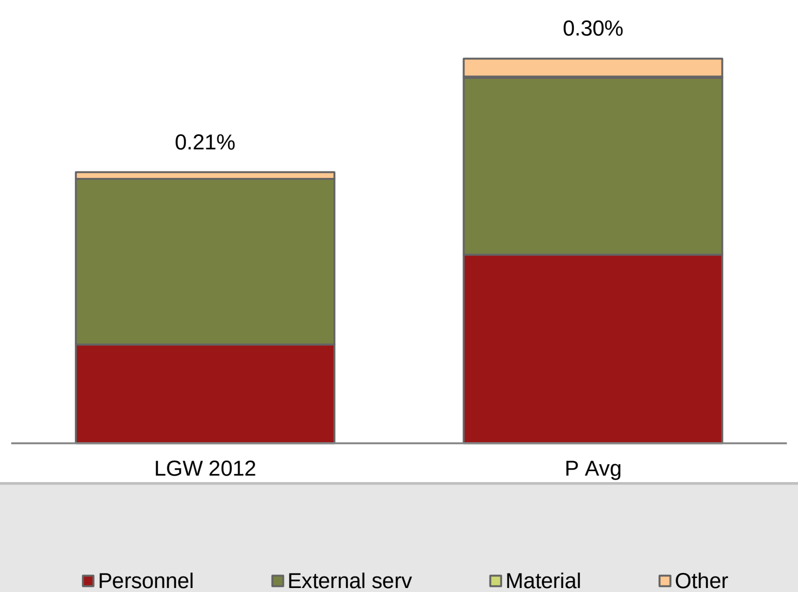
ATKearney

Main Analysis

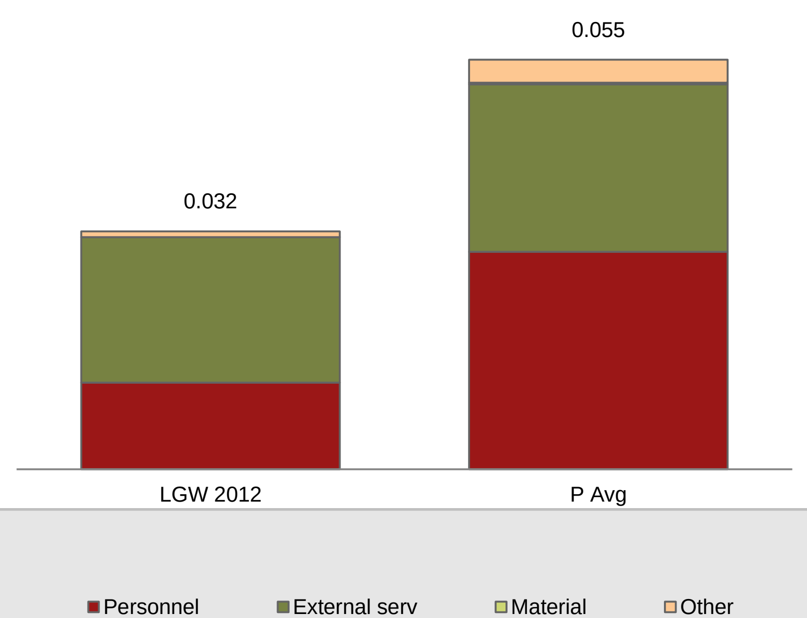
Support & Overhead - Legal Cost

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Airport revenues
LGW 2012	2012	G -42%	-475,566 GBP	1,136,230 GBP	531,122,190 GBP

Cost in % of airport revenues



Cost in GBP per traffic unit



Source: A.T. Kearney

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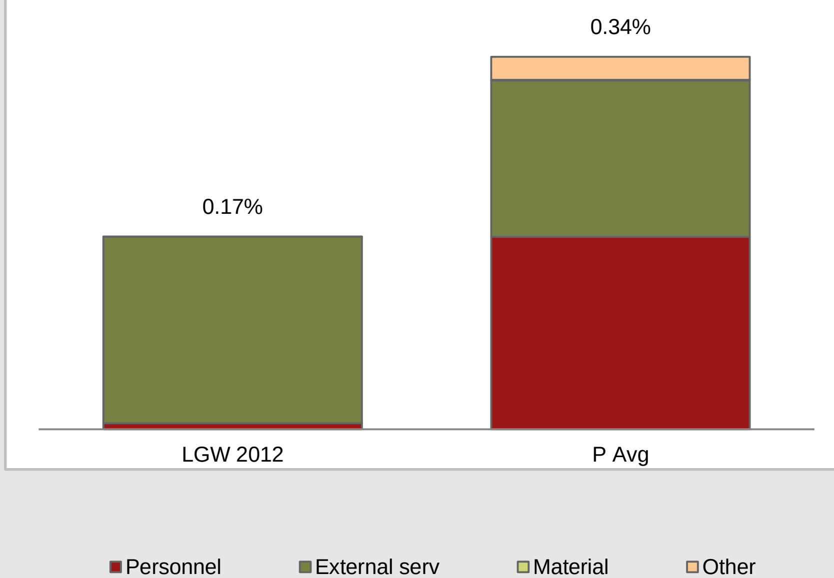
Main Analysis

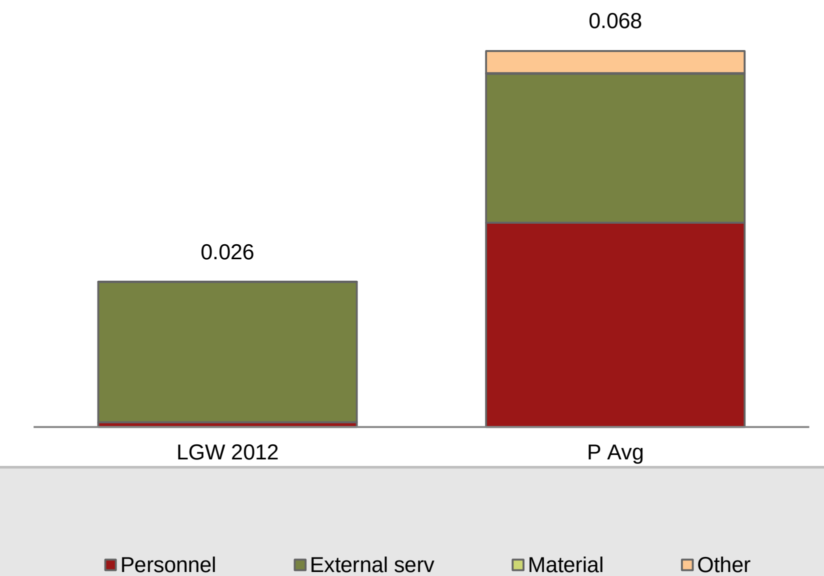
Support & Overhead - Strategy Cost[1]

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Airport revenues
LGW 2012	2012	G -93%	-861,277 GBP	921,808 GBP	531,122,190 GBP

Cost in % of airport revenues



Cost in GBP per traffic unit



1. At the moment it is very difficult to calculate internal strategy personnel cost for LGW because the activity in 2012 was executed by diverse functions and employees and a dedicated strategy team was only in the process of being formed
Source: A.T. Kearney

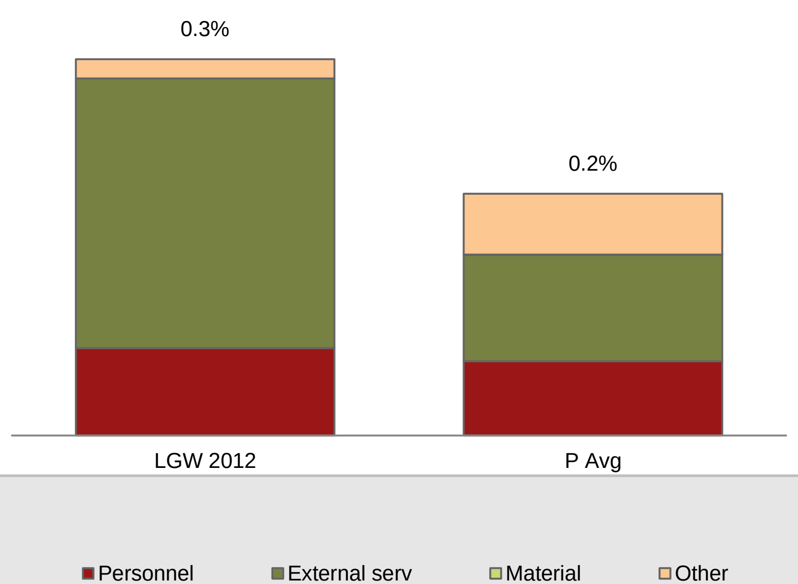
ATKearney

Main Analysis

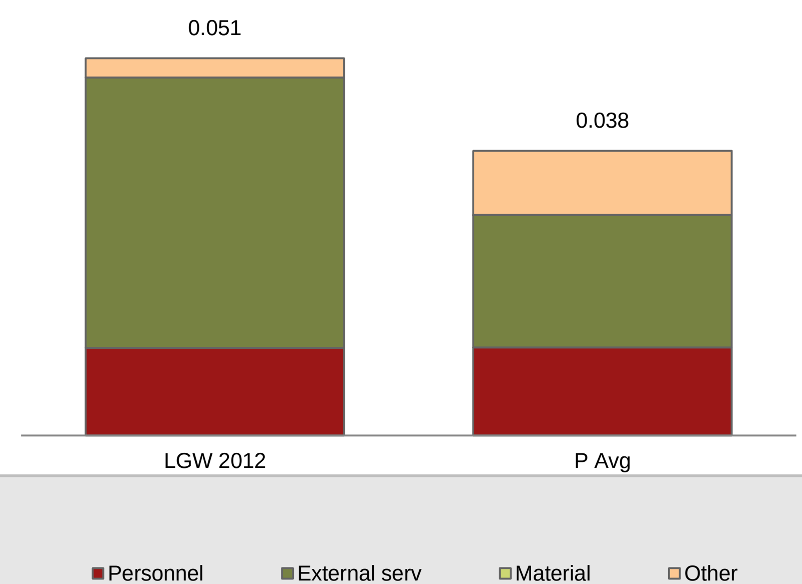
Support & Overhead - Marketing Cost

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Airport revenues
LGW 2012	2012	O 36%	642,355 GBP	1,798,931 GBP	531,122,190 GBP

Cost in % of airport revenues



Cost in GBP per traffic unit



Source: A.T. Kearney

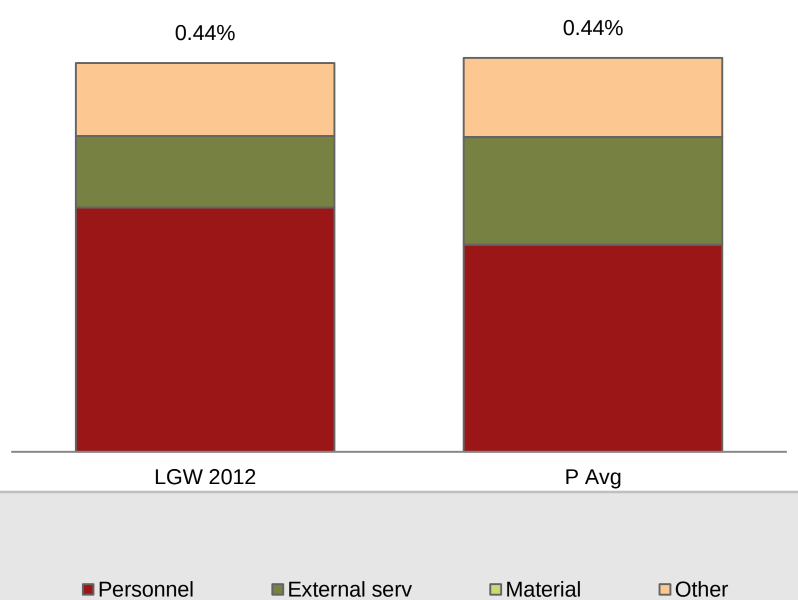
ATKearney

Main Analysis

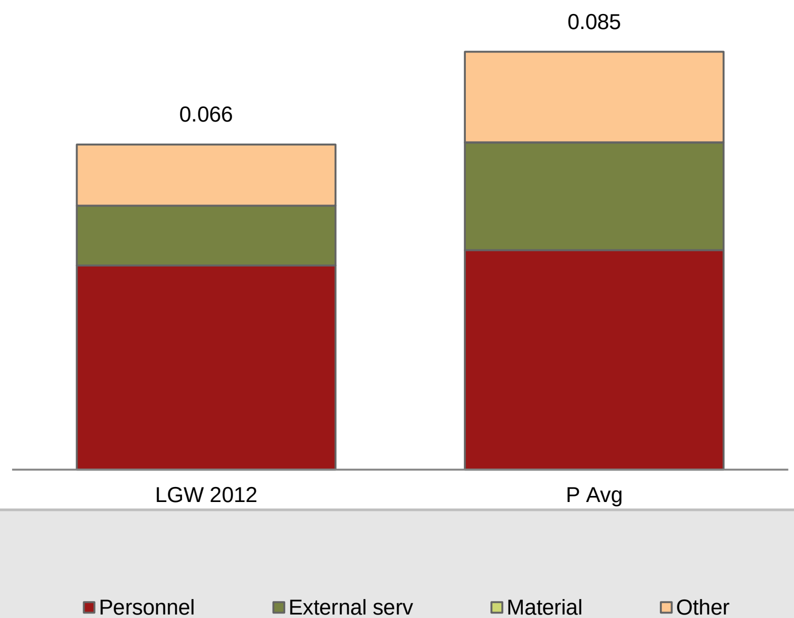
Support & Overhead - Corporate Communication Cost

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Airport revenues
LGW 2012	2012	G -1%	-31,835 GBP	2,326,823 GBP	531,122,190 GBP

Cost in % of airport revenues



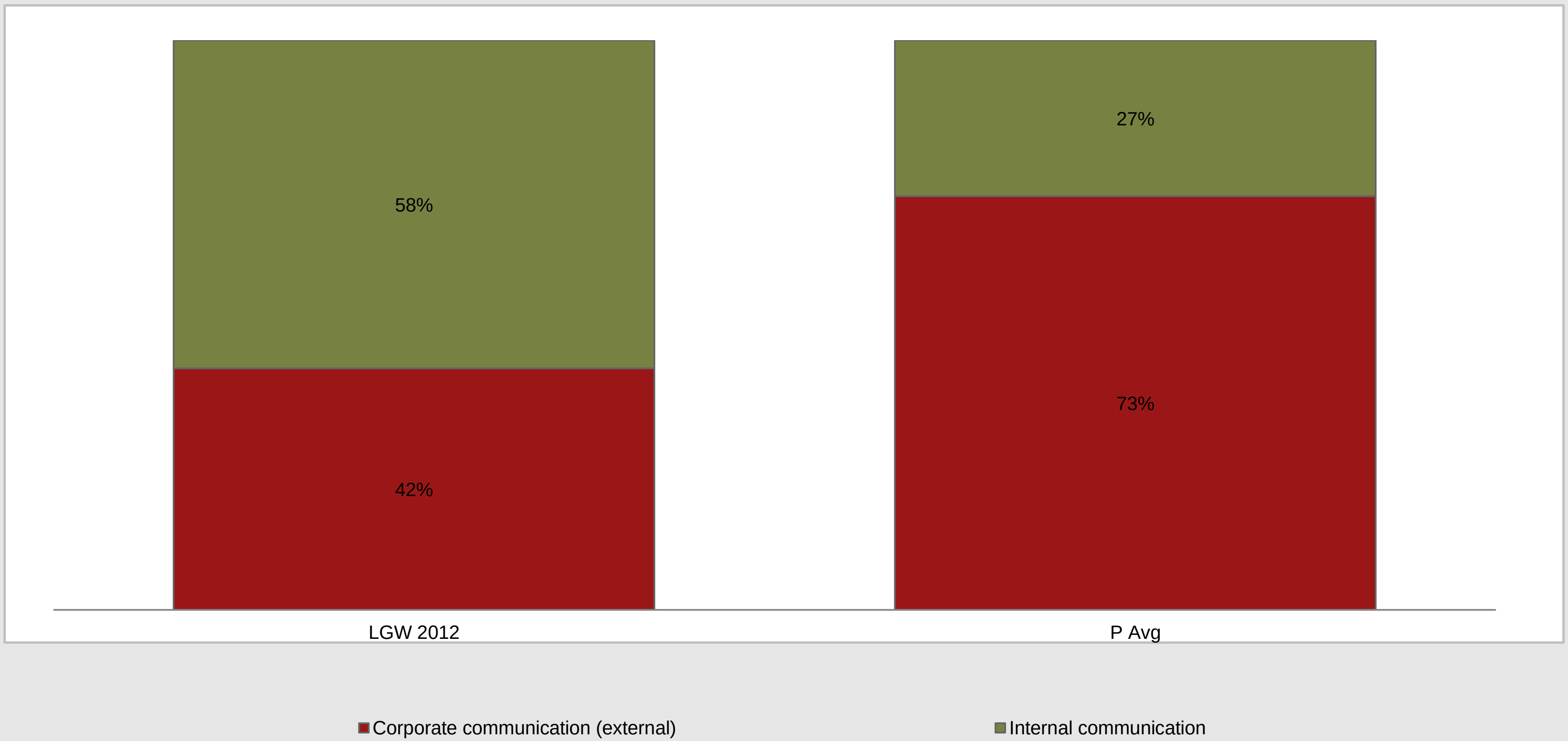
Cost in GBP per traffic unit



Source: A.T. Kearney

ATKearney

Support & Overhead - Corporate Communication Cost Share



Source: A.T. Kearney

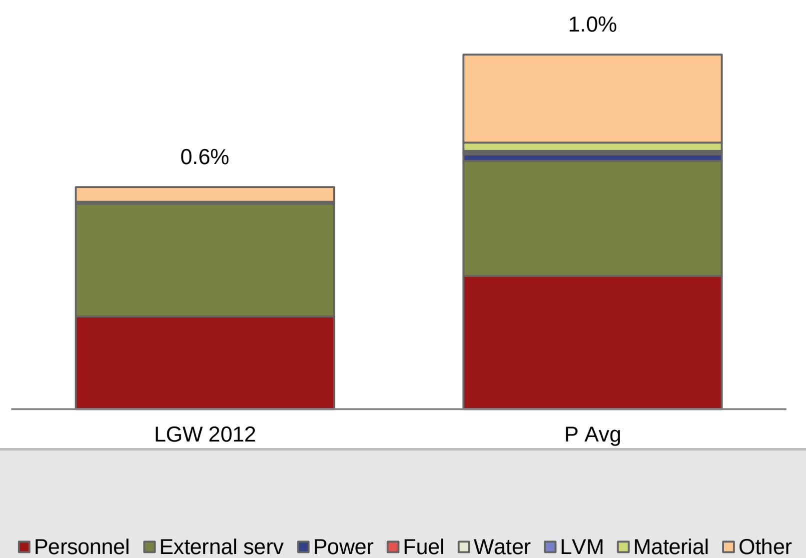
ATKearney

Support & Overhead - Stakeholder Management Cost

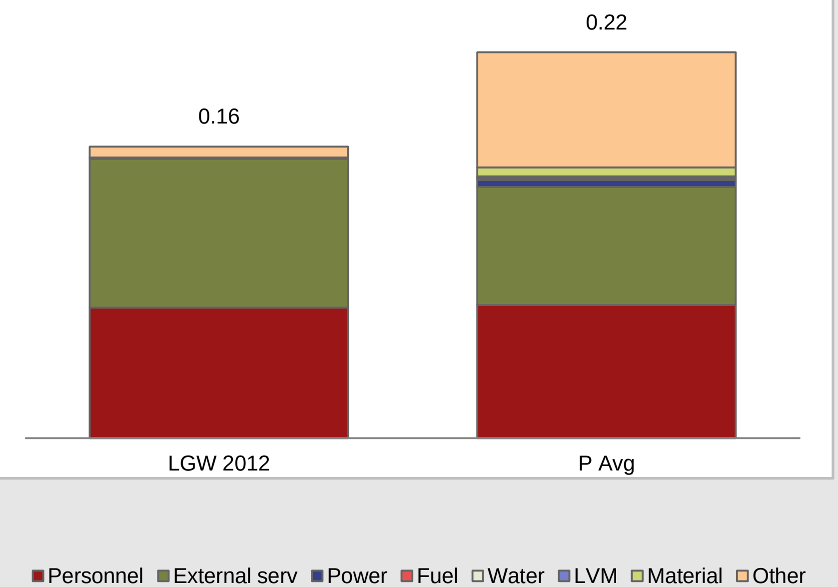
Main Analysis

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Airport revenues
LGW 2012	2012	G -59%	-1,897,637 GBP	3,190,119 GBP	531,122,190 GBP

Cost in % of airport revenues



Cost in GBP per traffic unit



Source: A.T. Kearney

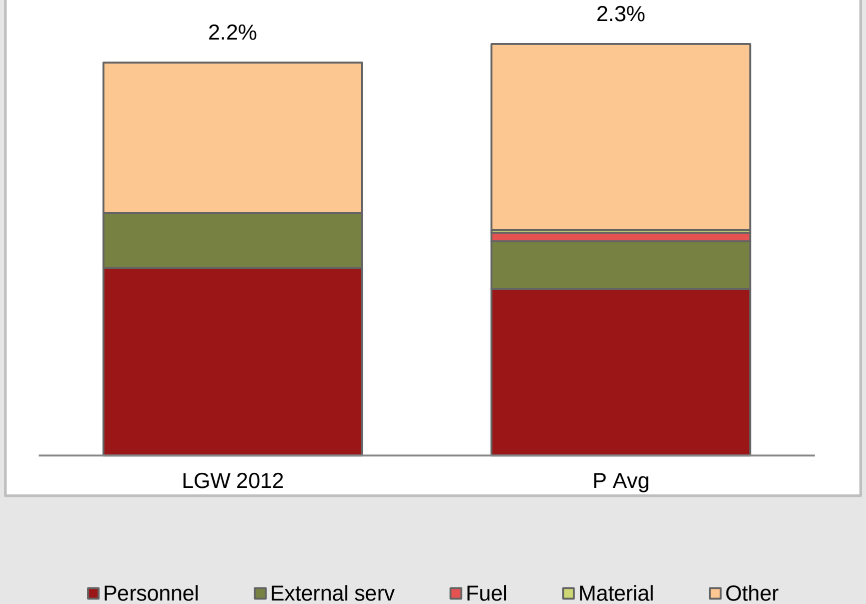
ATKearney

Main Analysis

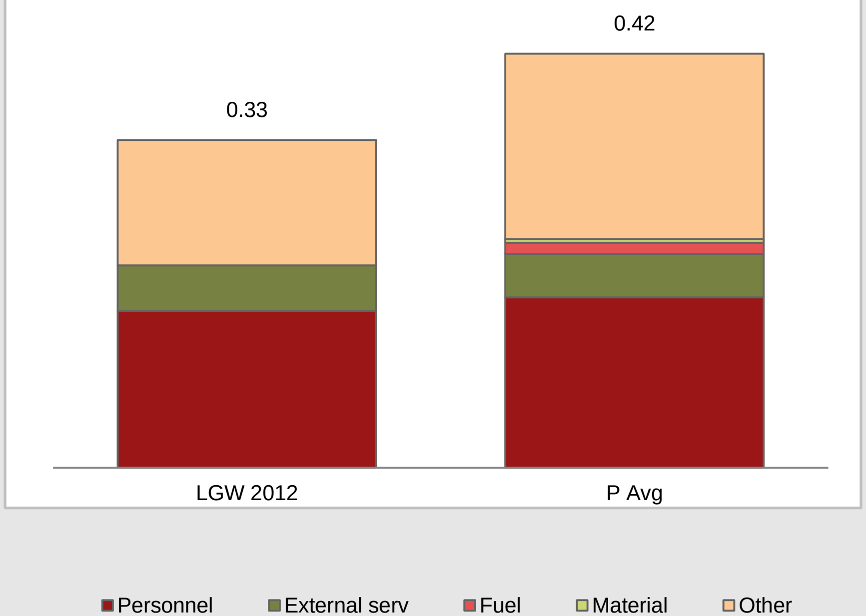
Support & Overhead - Other Overhead Cost

Airport	Fin year	Dashboard color & relative gap	Absolute gap	Cost position	Driver: Airport revenues
LGW 2012	2012	G -5%	-554,327 GBP	11,742,939 GBP	531,122,190 GBP

Cost in % of airport revenues



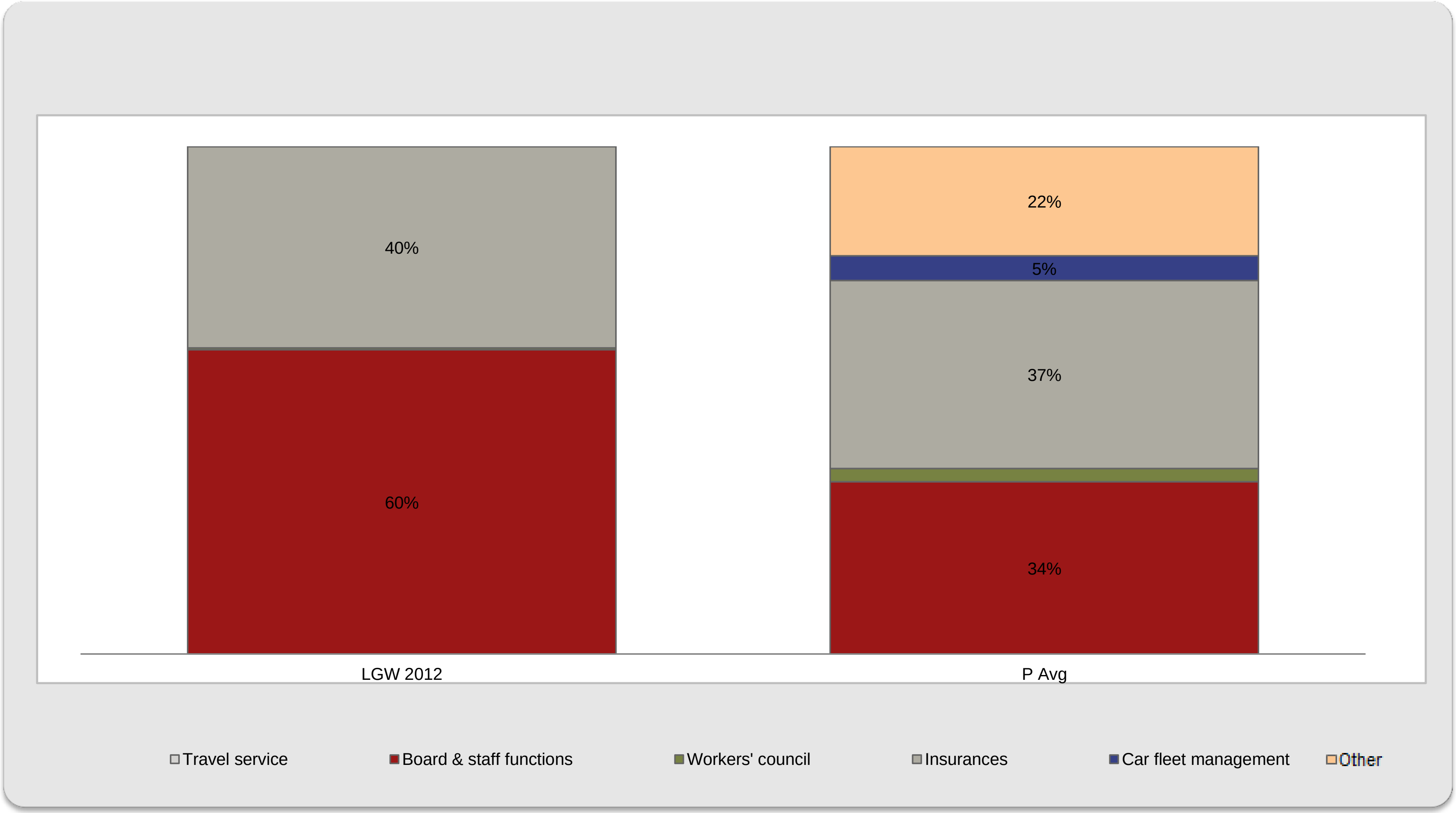
Cost in GBP per traffic unit



Source: A.T. Kearney

ATKearney

Support & Overhead - Other Cost Share



Source: A.T. Kearney

ATKearney

Support & Overhead - KPIs

KPI	LGW 2012	Panel average
Movements per support and overhead FTE	1,618	1,278
Traffic units per support and overhead FTE	233,588	128,847
Share of overhead FTE in airport FTE	6%	11%

Deviation from average (in 20% per segment)
Qualitative good deviation
Qualitative worse deviation

LGW 2012
Panel average

Source: A.T. Kearney

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Appendix 6: Gatwick comments on CEPA's top down cost benchmarking

Attached overleaf

Scope for efficiency gains at Gatwick

Note prepared for Gatwick Airport

June 7th 2013

1 Introduction

CEPA has analysed the scope for efficiency gains at Gatwick, Heathrow and Stansted airports, based on a number of productivity metrics.[1] It concludes that Gatwick should be able to achieve efficiency gains towards the top end of the range for real unit operating expenditure (RUOE).[2] This range is generated from estimates from price-regulated network industries, as well as other airports that CEPA considers to be close comparators for Gatwick. This conclusion is based on evidence that, in terms of the RUOE, Gatwick's performance has been below (less efficient than) that of other similar-sized airports and regulated network industries/utilities, while its labour productivity has fallen to date in Q5.[3]

However, a number of key factors that could significantly influence estimates of the scope for efficiency gains at Gatwick have not been considered in sufficient detail in the CEPA analysis or have not been considered at all in the final results, as summarised in Table 1.1 below.

[1] CEPA (2013), 'Scope for efficiency gains at Heathrow, Gatwick and Stansted airports', March.

[2] Ibid., p. xi.

[3] Ibid., p. 22.

Table 1.1 Overview of the main concerns with the analysis

Concern
RUOE
The rationale for the selection of the comparator airports is not clear
Key differences between Gatwick and other network sectors are not considered
Estimates have been derived over an inappropriate time period
No adjustments for the break-up of BAA
No adjustments for the increase in security costs, which are primarily outside Gatwick's control
Total factor productivity (TFP)
No adjustments for the break-up of BAA
The TFP analysis fails to capture changes in the economic climate
The TFP estimates fail to control for potential transaction costs or structural inefficiencies in the market
Labour, energy, materials and services (LEMS) cost measure
The LEMS analysis fails to capture changes in the economic climate
CAA/CC productivity measure
No adjustments for the break-up of BAA
No adjustments for the increase in security costs, which are primarily outside Gatwick's control
No adjustments for the decline in passenger numbers due to the financial crisis
Output price indices
The LEMS analysis fails to capture changes in the economic climate
Productivity estimates from the Airport Benchmarking Report Study (ATRS)
No adjustments for the break-up of BAA

	RUOE	TFP	LEMS	CAA/CC productivity measure	Output price indices	Productivity estimates from the ATRS
The rationale for the selection of the comparator airports is not clear	✓	–	–	–	–	–
Key differences between Gatwick and other network sectors are not considered	✓	–	–	–	–	–
Estimates have been derived over an inappropriate time period	✓	–	–	–	–	–
Estimates fail to control for possible transaction costs or structural inefficiencies	–	✓	–	–	–	–
Fails to capture changes in the economic climate	–	✓	✓	–	✓	–
No adjustments for:						
the increase in security costs, which are primarily outside Gatwick's control	✓	–	–	✓	–	–
the break-up of BAA	✓	✓	–	✓	–	✓
the decline in passenger numbers due to the financial crisis	–	–	–	✓	–	–

Source: Oxera analysis.

Oxera has explored these factors in more detail below.

2 Reliance on indirect approaches

The CAA's analysis underpinning its estimates in its Initial Proposals on Gatwick's scope for efficiency over Q6 is based on bottom-up estimates of Gatwick's efficiency, but also considers other studies, such as the CEPA report and other benchmarking studies, which are based on a top-down assessment of Gatwick's efficiency.[4] In particular, CEPA's report considers a number of indirect approaches to estimate top-down efficiency targets for Gatwick, including the RUOE, TFP, LEMS, productivity measures and output price indices.

However, the CAA itself has acknowledged the uncertainty inherent in top-down estimates of efficiency.

> The CAA is aware that benchmarking evidence cannot take into account all aspects of an airport operator's operation.[5]
>
> The fact that many of the benchmarks are derived from comparators that cannot completely take into account all aspects of Gatwick's operating environment meaning that the upper range of efficiencies may be over-estimated.[6]

The critique of CEPA's analysis of indirect approaches, presented in this note, highlights that there are a number of important factors that are not taken into account under the indirect approaches, as well as a number of uncertainties associated with reading across evidence from different sectors to airports, which could significantly influence the resulting estimates of efficiency.

The majority of regulators typically place greater weight on the results from direct comparisons within an industry or internationally, or from 'bottom-up' functional analysis of a company's main activities, with indirect approaches only typically being used as a cross-check on direct methods, rather than as a primary technique. For example, to set the price control for the water and sewerage companies, Ofwat typically assesses efficiency based on comparative efficiency econometrics models and an assumption about the scope for productivity improvements.[7] Where direct comparisons are unavailable—for example, in electricity and gas transmission—regulators have focused on bottom-up functional analysis of activities, and have used measures such as RUOE as a cross-check only.[8]

In particular, when estimating the scope for improvements in catch-up efficiencies (ie, the efficiency of an individual firm relative to the frontier for the industry), most regulators tend to rely on direct comparisons, to ensure that the comparisons are robust.[9] However, even when direct comparisons are made, regulators adjust for company-specific factors that need to be taken into account in assessing efficiency. In the water industry, for example, Ofwat adjusts

[4] CAA (2013), 'Economic regulation at Gatwick from April 2014: initial proposals', April p. 104.

[5] Ibid., p. 105.

[6] Ibid., p. 118.

[7] Ofwat (2009), 'PR09/39: Relative efficiency supporting information', December, available from http://www.ofwat.gov.uk/publications/pricereviewletters/ltr_pr0939_appendix2.pdf.

[8] Ofcom (2011), 'LLCC PPC Points of Handover pricing review: Final Statement on modification of SMP Conditions', September, available from http://stakeholders.ofcom.org.uk/binaries/consultations/revision-points-handover-pricing/statement/final-statement.pdf; and Ofgem (2013), 'Strategy Decisions for the RIIO-ED1 electricity distribution price control: Tools for cost assessment', March, available from http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/riio-ed1/consultations/Documents1/RIIOED1DecCostAssessment.pdf.

[9] Inefficiency can be broken down into two components: frontier shift and catch-up. Frontier shift refers to industry- or economy-wide developments in technology and best practice which allow efficient companies to improve. Catch-up refers to the inefficiency of an individual firm relative to the frontier for the industry.

for company-specific ‘special’ factors, which include any particular legal obligations on the industry that may have differing impacts on companies.[10]

There are a number of Gatwick-specific factors that CEPA should take into account in order to be consistent with regulatory and economic best practice in estimating the scope for efficiency gains. These factors include:

– the break-up of BAA and the change in ownership of Gatwick;
– key differences between Gatwick and regulated network sectors, including the degree of competition;
– the magnitude of security costs at Gatwick, and the increase in security costs, which is primarily outside of the airport’s control.

3 Concerns with the RUOE estimates

CEPA concludes that Gatwick should be able to achieve efficiency gains towards the top end of the range for the RUOE. However, before placing significant weight on the RUOE estimates to inform Gatwick’s scope for efficiency gains, a number of issues need to be investigated, as explored below.

3.1 The rationale for the selection of the comparator airports is not clear

The choice of comparators will depend on the purpose of the benchmarking study. For an efficiency study, the comparators should be selected such that they have similar cost drivers and outputs. Limited details are presented in CEPA’s analysis to describe how it chose the comparator airports. Although it acknowledges that airport size and passenger mix are key criteria in identifying comparator airports, other important criteria do not appear to have been considered in sufficient detail. These include, but are not limited to, the nature of regulation, the degree of automation (ie, the proportions of capital and labour input), the split between the airport’s aeronautical and commercial activities, the airport’s stage in its investment life cycle, the degree of capacity constraints, and the airport’s location.[11]

The factors relevant for selecting comparators vary according to the purpose of the study. Although Oxera’s previous work for Gatwick on benchmarking the regulatory regime is unlikely to align exactly with the comparators that are appropriate in this case, the selection of comparators is critical in order to ensure robust results from an efficiency benchmarking analysis.[12] In this regard, CEPA’s report lacks a comparable detailed analysis. Some of the factors that might drive differences in the results from an analysis of efficiency across different airports are described below.

3.1.1 The degree of regulation and the nature of the regulatory regime

There are some significant differences between Gatwick and the selected comparator airports in terms of the degree of regulation and the nature of their regulatory regimes (denoted ‘close comparators’ in Table 3.1). These factors can influence the strength of incentives for efficiency.

[10] Ofwat defines a special factor as any factor or operating expense that an appointed water company considers leads to it incurring capital maintenance costs or operating expenditure higher than those of other comparator companies. The same factor may apply to more than one company, but will have a company-specific effect. See Ofwat, ‘Glossary of terms’, p. 60, available from http://www.ofwat.gov.uk/aboutofwat/gud_pro_ofwatglossary.pdf.

[11] These factors are consistent with the criteria to identify comparator airports used in Oxera (2012), ‘Regulatory regimes at airports: an international comparison’, prepared for Gatwick Airport, December 21st. The 2012 report assessed the key features of the regulatory regime for airport comparators that are most similar to Gatwick Airport. For the purposes of assessing Gatwick’s efficiency, a couple of additional factors are considered in order to reflect the drivers of an airport’s efficiency.

[12] Oxera (2012), ‘Regulatory regimes at airports: an international comparison’, Prepared for Gatwick, December 21st.

The majority of the 'close' comparators for Gatwick—specifically, Manchester, Munich and Zurich—are not directly price-regulated, due to either a lack of market power in competitive assessments or a different national system. The remaining comparator (Copenhagen) has a looser regime, whereby charges are agreed bilaterally with the airlines, although subject to regulatory limits and subsequent approval. The main features of the regime for the set of close comparators is set out in further detail in Box 3.1.

Box 3.1 Overview of the regulatory regimes of the close comparators

An overview of the main features of the regulatory regime at the set of close comparators used by CEPA is provided below.

– **Manchester Airport**. Since April 1st 2009, Manchester Airport has been de-designated, and is therefore no longer subject to a price cap. However, the general level of charges set by the airport is subject to the European Directive on airport charges.

– **Copenhagen Airport**. Since December 2008, the airport has been subject to a new light-handed regulatory framework. The new regime is based on charges agreements being reached through commercial negotiation between airlines and the airport, with a set of statutory 'fall-back provisions' if agreement cannot be reached. The regulator agrees the charges on an ex ante basis.

– **Munich Airport**. The airport is regulated according to rate-of-return regulation.[1] Munich Airport is required to submit prices for (regulatory) approval by the federal authority subject to certain conditions. These conditions include that charges correspond to the forecast level of costs for the subsequent year (including a depreciation charge), plus an estimate of the return on capital.

– **Zurich Airport**. It is understood that it is intended that charges are agreed between the airport and its users on the basis of mutual agreement. In the event that mutual agreement cannot be achieved, the airport operator is required to submit a proposal to the Federal Office of Civil Aviation.[2]

Sources: [1] German Airport Performance (2008), 'Regulation of airport charges in Germany', Müller, F., König, C. and Müller, J., October 4th. [2] Zurich Airport (2012), 'Swiss Federal Council gives final approval for economic regulation of airport charges', May 10th.

Failure to control for differences in the extent of regulation is likely to make the evidence less reliable, as these airports face different constraints and incentives. For example, a non-regulated airport may be able to be more flexible with respect to its pricing decisions and the services provided to different airlines.

3.1.2 Capacity constraints

While CEPA acknowledges that capacity constraints will limit the scope for efficiency improvements, and that Gatwick is almost as constrained as Heathrow, the degree of capacity constraints does not appear to have been considered directly, either when selecting comparator airports or when drawing conclusions from the analysis:[13]

> Capacity at both Heathrow and Gatwick is highly utilised. Based on DfT forecasts, in 2010 Heathrow operated 94% of its total runway capacity, whilst Gatwick operated 90% of its capacity.[14]
>
> Demand exceeds capacity throughout the day.[15] The main capacity restriction is the runway although at peak times there are also terminal and stand capacity constraints.

[13] CEPA (2013), op. cit., p. 7.
[14] Ibid., p. vi.
[15] European Commission and Steer Davies Gleave (2011), 'Impact assessment of revisions to Regulation 95/93', March, p. 21.

The coordinator considers that runway capacity accounts for 90% of the capacity restriction at Gatwick.[16]

Capacity constraints at airports can act to increase unit costs as airports start to move beyond the maximum efficient scale, leading to volume growth not having the same beneficial effect on unit costs as it would at non-constrained airports[17]. If capacity constraints at Gatwick are appropriately taken into account this is likely to restrict its potential to achieve efficiency gains.

3.1.3 Overview

To ensure that RUOE comparisons are appropriate, the above factors should be taken into account before drawing conclusions on the scope for efficiency at Gatwick. Table 3.1 compares the key characteristics of Gatwick with the airports selected as comparators by CEPA for the efficiency analysis, on the basis of the overall size of the airport, the degree of regulation, and the degree of capacity constraints. 'Close comparators' denote those airports that are used directly by CEPA as comparators for Gatwick, while 'other comparators' denote those additional airports that CEPA also considers as comparators to the designated London airports. Table 3.1 also highlights whether information on security costs is easily available for each of the respective airports (for more details, see section 4.2).

Table 3.1 Overview of comparator airports

Airport	Passenger numbers (m)	Price-regulated	Capacity utilisation (%)	Security information available
Gatwick	**34**	✓	**90**	✓[1]
Close comparators				
Copenhagen[2]	23	x	47	x
Manchester	18	x	48	✓[1]
Munich	38	x	75	x
Zurich	23	x	67	✓
Other comparators				
Amsterdam	48	x	69	✓
Birmingham	9	x	45	✓[1]
Edinburgh	9	x	49	✓[1]
Glasgow	6	x	34	✓[1]
Heathrow	69	✓	94	✓[1]
Hong Kong	52	x[3]	75	x
Luton	9	x	80	✓[1]
Stansted	17	✓	55	✓[1]

Note: Capacity constraints are defined relative to the maximum number of airport traffic movements.[1] It is understood that the UK Civil Aviation Authority (CAA) collates data on security costs at UK airports. [2] Until 2008, charges at Copenhagen Airport were subject to a CPI ± X cap, as set by the Danish CAA. In December 2008, the Danish CAA announced that the airport would be subject to a light-handed regulatory framework. [3] Hong Kong Airport is operated by the statutory airport authority.
Source: Oxera analysis, based on various regulatory documents, annual reports and press releases.

[16] Ibid., p. 39.

[17] Capacity constraints may also limit the airport's ability to respond efficiently to exogenous events such as weather events and economic shocks.

As set out above, the factors identified are likely to influence an airport's relative efficiency. As CEPA provides little justification in its report for the selection of the comparator airports, it is not clear how robust the results of the analysis are. The analysis appears to be sensitive to the choice of comparators—for example, including Amsterdam would change the lower bound of the ten-year post-privatisation RUOE range for Gatwick from –0.5% to –3.6%, implying less potential for Gatwick to achieve efficiency gains. This underlines the importance of the appropriate selection of comparators.

The airports used as comparators to Gatwick need to be carefully selected. Small changes in the selection can lead to significant changes in the RUOE estimates.

3.2 Key differences between Gatwick and network sectors are not considered

In addition to comparator airports, Gatwick is compared directly to a number of regulated network utilities, on the basis that these are also 'large scale customer facing regulated industries'.[18] However, this comparison is not appropriate as there are two key structural differences between airports and the network utility comparators:

– the comparators from the energy sector (namely the electricity distribution network operators) are not directly customer-facing in the same way an airport is;

– many of the comparators do not operate in the South East of England, which faces different cost pressures to other parts of the country.

These two factors highlight that there is little similarity between the key characteristics of the designated airports and the regulated utility networks. The only similarity would appear to be the historical type of regulation.

Price regulation is designed to give firms the incentive to reduce costs as much as possible in order to lower prices to consumers. However, Gatwick competes with other airports not just on price but also on quality of service (such as queue lengths, availability of staff and passenger experience). When competing on such factors, the optimal cost level is likely to be above that of an entity competing purely on price.

Other regulators have made use of evidence of local cost pressures for some time. For example, Ofwat uses the regional construction output price index (COPI) and regional wage indices,[19] or the widespread application of adjustments for purchasing power parity (PPP) when making cost comparisons. CEPA's report does not appear to use PPP conversions when comparing estimates across airports based in a variety of countries, nor does it offer any regional adjustment dimension.

Although CEPA acknowledges that airports, as a group, perform poorly relative to regulated networks, the drivers behind these perceived differences are not taken into account or investigated:

> It shows that, of all the industries considered, the three UK designated airports (taken together) have experienced the lowest RUOE performance [...] It is not entirely clear why airports perform relatively poorly.[20]

[18] CEPA (2013), op. cit., p. iv.
[19] See http://www.ofwat.gov.uk/regulating/prs_in1108copi.pdf.
[20] CEPA (2013), op. cit., p. 27.

The significant differences between Gatwick and the regulated sectors suggest that there is likely to be large variation in terms of economies of scale, and the long-term effects of past investment on current efficiency levels. As such, given the dissimilarities on the quantitative and qualitative dimensions, it is not appropriate to use these sectors to estimate Gatwick's scope for efficiency.

In addition, unlike regulated utility networks, Gatwick is not a natural monopoly; rather it competes on price and quality for airlines and passengers. Such competition makes the comparison with regulated utilities that are typically subject to a fixed price and quality offering less relevant, as Gatwick will also need to consider service quality, and therefore will have less freedom to minimise costs.

> Airports used to be considered as something akin to natural monopolies. But airports must now compete with each other for passengers and airlines which have significantly more choice than in the past. Airports themselves have become more commercially focused. The result is a more competitive and dynamic airport market.[21]

> Most of Gatwick's passengers appear to have a real choice between different London airports, with 76 per cent of short haul routes served from Gatwick also being served from other London airports.[22]

In contrast to the more predictable demand for services provided by the regulated utility networks, the sensitivity of demand to price and income is far higher for airports.[23] Indeed, the sensitivity of airport demand is highlighted by CEPA, alongside statements by the CAA:

> The last five years has seen a fall in passenger numbers, which is likely to be related to depressed global economic conditions. During the period 2007 to 2010 passenger numbers fell [...] by 11% at Gatwick.[24]

> The results of passenger modelling [...] suggest that there is a relatively high degree of responsiveness to changes in airport charges.[25]

> Overall, the cost of switching airports for many passengers using Gatwick are unlikely to be large, given the number of alternative large airports in the London area and smaller airports in the wider south east, and the large degree of route overlap on short-haul routes between Gatwick and other London airports.[26]

As a result, airports are exposed to much less predictable demand because airlines can switch their operations between airports, reflecting the increased flexibility of airlines' business models.[27] Further evidence of competition for volumes comes from airports increasingly marketing themselves to airlines. Estimates suggest that 96% of all European airports are actively marketing their airport to airlines.[28]

It is not appropriate to benchmark Gatwick's efficiency estimates with reference to other regulated

[21] Copenhagen Economics (2012), 'Airport Competition in Europe', p. 12.

[22] CAA (2012), 'Gatwick - Market Power Assessments', February, p. 101.

[23] For further details, see CAA (2005), 'Demand for Outbound Leisure Air Travel and its Key Drivers', December. Gillen, D., Morrison, W.G. and Stewart, C. (2002), 'Air Travel Demand Elasticities: Concepts, Issues and Measurement'; Waddams, C. and Clayton, K. (2010), 'Consumer Choice in the Water Sector', Centre for Competition Policy and University of East Anglia. Olmstead, S.M. and Stavins, R.N. (2007), 'Managing Water Demand', A Pioneer Institute White Paper, Public Policy Research, July; and Reiss, P.C. and White, M.W. (2002), 'Household Electricity Demand Re-visited', Stanford University, June 14th. Liu, G. (2004), 'Estimating Energy Demand Elasticities for OECD Countries, A Dynamic Panel Data Approach', Statistics Norway Research Department, Discussion Papers No. 373, March.

[24] CEPA (2013), op. cit., p. vi.

[25] CAA (2012), 'Gatwick - Market Power Assessments', February, p.86.

[26] Ibid., p. 86.

[27] Copenhagen Economics (2012), op. cit., p. 5.

[28] Ibid., p. 80.

sectors, as network utility comparators are not subject to the same competitive pressures. Based on CEPA's results, if network utility comparators are not taken into account, this would tend to lead to lower estimates of the scope for efficiency gains.

3.3 Estimates have been derived over an inappropriate time period

CEPA considers estimates of the RUOE over two main periods: more than ten years after the privatisation of the particular industry; and more than 15 years after the privatisation of the particular industry. However, estimates of the RUOE can vary substantially within each of these periods. Owing to the price control process, it would be more insightful to assess how estimates of the RUOE change between five-year periods. Under a five-year price control, the regulated firm's spending is monitored/limited across the whole period. Therefore, there are likely to be a number of biases within the period, such as front-loading of cost-reducing investments. Overall, it is most effective to divide the data in a way that aligns with the firm's medium-term efficiency incentives, which may be closely related to the five-year cycle of price controls.

Furthermore, the use of ten- and 15-year periods since privatisation masks the improvements in efficiency made by Gatwick since the sale of the airport by focusing predominantly on years as part of BAA. Indeed, as acknowledged by CEPA: 'Gatwick's OPEX fell by almost 30% between 2009/10 and 2010/11'.[29] However, the significant cost reduction seems to be ignored in the conclusions, where CEPA concludes that Gatwick can achieve the same efficiency improvement in the future as its competitors in the South East.

If recent changes at Gatwick are appropriately taken into account, such as the significant increase in performance since the sale of the airport, this would lead to a reduction in estimates of the potential for future efficiency savings at Gatwick.

4 Impact of external drivers on airports

4.1 No adjustments for the break-up of BAA

CEPA acknowledges that, as a result of the separation of ownership, less weight should be placed on evidence from the period before the sale of Gatwick Airport. However, CEPA does not incorporate any specific adjustments into its estimates of the RUOE or the estimates of labour productivity to take into account the impact of the sale.[30] For example, it acknowledges that 'Gatwick's OPEX fell by almost 30% between 2009/10 and 2010/11', which is likely to be related to the sale of the airport in 2009, but this does not appear to be taken into account when arriving at the conclusions from the RUOE analysis.

As acknowledged by CEPA, the Airport Benchmarking Study also does not take into account the sale of the airport, which is likely to influence Gatwick's productivity:

> As a final caveat, we note that the ATRS benchmarking analysis, although published in 2011, is based on data up to and including 2009, and so does not take into account changes in productivity since then. This issue is likely to be most pertinent for Gatwick, given that its sale in 2009 may have prompted changes in productivity.[31]

[29] CEPA (2013), op. cit., p. 36.

[30] Although, in its conclusion relating to the ATRS, CEPA acknowledges that less weight should be given to the results from this study, since the data primarily relates to the period prior to Gatwick's sale, no specific adjustments are applied to estimates from the other approaches (although Gatwick's higher 'other' costs are noted). For further details, see CEPA (2013), op. cit., p. 36.

[31] CEPA (2013), op. cit., p. 66.

Although CEPA acknowledges the limitations of a study that fails to consider Gatwick's sale, estimates of TFP are based on the period up to and including 2006 only. Although sensitivities are undertaken, these do not capture the impact of the change in ownership because this occurred after the period covered by the majority of CEPA's data and because the effects of the sale are likely to have arisen after 2009. In general, Oxera would consider the most recent data to be the *most* important in assessing efficiency.[32]

The failure to control for Gatwick's sale in the analysis of the RUOE and labour productivity estimates is likely to overestimate the scope for efficiency gains at Gatwick. As the ATRS and the TFP analysis are based on earlier periods, and therefore do not capture Gatwick's sale, this is likely to bias estimates of Gatwick's efficiency from either of these methods.

4.2 No adjustments for the increase in security costs, which are primarily outside Gatwick's control

CEPA acknowledges that security costs are driven by exogenous shocks, which are primarily outside an airport's direct control.[33]

> An increase in security staff requirements (eg, for the opening of Terminal 5 at Heathrow, for changing government requirements, or to ensure safety during the London 2012 Olympics) will increase the level of employment, and therefore costs. [...] security costs have historically been treated by [the] CAA as only partially controllable and therefore not all changes in security costs will relate to changes in productivity.[34]

Despite this, and the scale of security costs, CEPA does not control for the impact of the increase in security costs, caused by incidents such as the liquid bomb threat, on estimates of the RUOE. It attributes its failure to control for this to a lack of consistent data on security costs:

> We were unable to find sufficient consistent data on security costs in order to remove these [...] However, we note that the increased security requirements for airports, which are predominantly outside their control, could have led to the lower and negative growth in the RUOE for the airports.[35]

Where possible, high-level cross-checks should be undertaken for those airports where data is available, in order to ascertain the impact of controlling for security costs. From an initial review of airports' annual reports, data on security costs appears to be available for a number of airports (see Table 3.1) to at least enable some high-level sensitivities to be undertaken for security costs.[36]

As security costs represent around 20% of Gatwick's total OPEX base, with security staff costs comprising around 50% of total staff costs, [37] the failure to control for the rise in these external costs in estimates of the RUOE and the CAA/CC productivity measure is likely to invalidate the resulting estimates. However, this does not appear to have been taken into

[32] Ibid., p. 45.
[33] Ibid., p. 7.
[34] Ibid., p. 15.
[35] Ibid., p. 41.
[36] Further information on airport security costs is available through reports such as Frost & Sullivan's review and forecasts for the airport security market, and in previous cost benchmarking exercises, such as the Incomes Data Services (IDS) report for the CAA on employment costs. See Frost & Sullivan (2012), 'Global Airport Security Market Assessment', May; and IDS, CAA (2013), Benchmarking employment costs: A research report for the CAA', January.
[37] Based on information provided by Gatwick.

account by CEPA in its conclusions; rather, CEPA concludes that 'Gatwick has experienced negative productivity.'[38]

Furthermore, CEPA go on to state that an increase in security costs would lead to a reduction in productivity if there is no increase in passenger numbers.

> Although an increase in security costs might cause labour productivity to fall (if passenger numbers do not increase by the same amount), these changes can be outside the airport's control.[39]

However, an increase in security standards would be likely to lead to a reduction at all levels of passenger throughput.

The failure to control for the rise in security costs is likely to overestimate the potential for Gatwick to achieve efficiency gains. This will bias the estimates of the RUOE and the CAA/CC productivity measure.

4.3 No adjustments for the decline in passenger numbers due to the financial crisis

As acknowledged by CEPA:

> The last five years has seen a fall in passenger numbers, which is likely to be related to depressed global economic conditions. During the period 2007 to 2010, passenger numbers fell by 22% at Stansted, 11% at Gatwick and 3% at Heathrow.[40]

In its analysis of productivity measures, CEPA acknowledges that there has been a significant fall in productivity in Q5 to date, which it attributes to the reduction in passenger numbers since 2007/08:[41]

However, in its overall conclusions, this is not taken into account. In a unionised environment, costs cannot be reduced as quickly in response to a reduction in passenger volumes. In reality, Gatwick will have to balance cost reduction with the threat of industrial action, which will harm its competitive position and customers.

The failure to account sufficiently for the decline in passenger numbers since the onset of the financial crisis will overestimate the productivity measures.

5 The TFP, LEMS and output price indices analysis fails to capture changes in the economic climate

Business cycle effects can cause problems for productivity measures, as the particular point where a country is in the business cycle will affect the level of productivity. Improvements in efficiency may be easier or harder to achieve during particular periods of the business cycle.

The current consensus in the academic literature is that productivity is *pro-cyclical*, at least in the short term. This means that productivity will grow more quickly in periods of economic

[38] CEPA (2013), op. cit., p. 22.
[39] Ibid., p. 7.
[40] Ibid., p. vi.
[41] Ibid., p. 17.

expansion (growth) and, similarly, deteriorate more quickly in periods of economic contraction (decreasing demand).[42]

CEPA bases its analysis of TFP, LEMS and output price indices on the period between 1997 and 2006 (with an end point of 2007 for the purposes of the output price indices analysis). It does this on the basis that this represents the most recent full business cycle in the UK. However, the literature suggests that the rates of productivity achieved in a period of relatively high economic growth may not be replicable in periods of lower economic growth. CEPA fails to consider whether, in light of the financial crisis, it is still reasonable to assume that companies can achieve the assumed efficiency gains in the current and prospective economic climate of low expected economic growth.

The impact of the current macroeconomic environment on whether it is feasible to achieve the estimates derived from the TFP, LEMS and output price indices analysis needs to be considered. Productivity growth will tend to be lower during recessionary periods (as companies tend not to reduce labour immediately in order to maintain capacity at the expense of reductions in productivity, for example) and the benefits of volume growth are limited by macroeconomic factors.

6 The TFP estimates fail to control for possible transaction costs or structural inefficiencies

CEPA's estimates of economy wide productivity are likely to include a significant amount of catch-up efficiency as well as pure frontier-shift and hence need to be adjusted before being used to estimate a frontier shift target.

In its analysis of TFP, CEPA notes that:

> Most of the comparator sectors that we use are non-regulated industries with sufficient competition to ensure that the gains from catch-up have already been made. However, we include 'electricity, gas and water' supply which is a regulated sector as well as post and telecommunications and transport, parts of which are still regulated. Efficiency changes within these sectors may be brought about by both catch-up and frontier shift. Since the overall weight of these sectors is not very large in the construction of our composite index we expect there to be little 'catch-up' captured in the TFP results and as such do not make any adjustment for this.[43]

Although estimates are supposed to be derived from firms operating in a competitive environment (ie, where the comparators' performance represents that of an efficient firm, and as such does not include any catch-up), this assumes that all firms are operating efficiently. In reality, there may be transition costs and structural inefficiencies that may influence this estimate.[44]

A more conservative view, based on academic evidence, is that around 75% of economy-wide productivity gains are the result of pure frontier shift, with the remaining 25% arising from companies making structural changes to catch-up to best practice.[45] This assumption

[42] See, for example, Boisso, D., Grosskopf, S. and Hayes, K. (2000), 'Productivity and efficiency in the US: effects of business cycles and public capital', *Regional Science and Urban Economics*, **30**:6, December, pp. 663–81.

[43] CEPA (2013), op. cit., p. 54.

[44] For further details, see OECD (2001), 'Measuring Productivity: Measurement of Aggregate and Industry-level Productivity Growth'.

[45] Färe, R., Grosskopf, S., Norris, M. and Zhang, Z. (1994), 'Productivity Growth, Technical Progress, and Efficiency Change in Industrialized Countries', *The American Economic Review*, **84**:1, March, pp. 66–83.

was previously adopted by the Office of Rail Regulation (ORR) and the Competition Commission.[46]

Although CEPA acknowledges that significant weight is not placed on the regulated sectors—electricity, gas, water, postal services, telecommunications and transport—the analysis that it presents suggests that the exclusion of these sectors would lead to a significant reduction in estimates of TFP.

In addition, there are some concerns around the choice of the comparator sectors to the components of OPEX for UK airports. In particular:

– the comparator for rent and rates appears to be 'renting of machinery and equipment and other business activities'; a more appropriate comparison would be an industry that requires large tracts of land, with office and industrial space;

– as it is understood that the majority of intercompany costs relate to IT and other consultancy services, the selection of 'renting of machinery and equipment and other business activities' does not appear to be appropriate.

The approach adopted by CEPA may overestimate the potential for TFP gains as a result of the failure to control for any adjustment costs or inefficiencies and is sensitive to the choice of comparators.

7 Frontier-shift estimates are not towards the bottom end of the regulatory precedents

CEPA concludes that a gross frontier shift of 1–1.2% for each of the three airports appears reasonable, and that this is 'slightly towards the bottom end of the range, but is consistent with recent regulatory precedents'.[47] However, a review of regulatory precedents suggests that this assumption is not towards the bottom end of recent assumptions. Indeed, in the most recent price control reviews, regulators have adopted estimates of frontier shift of around 1% per annum, on average, before accounting for input price growth differentials (industry-specific input price growth that is not captured by the RPI/COPI) (see Table 7.1). However, the assumption used by the CAR reflects both frontier-shift and catch-up efficiencies and Ofcom's assumption reflects the technological nature of developments in the telecoms sector. If these are excluded, the average assumption for frontier shift is 0.7%, significantly below CEPA's estimate.

[46] Oxera (2008), 'What is Network Rail's likely scope for frontier shift in enhancement expenditure over CP4?', report prepared for ORR, p. 25; and Competition Commission (2010), 'Bristol Water plc: A reference under section 12(3)(a) of the Water Industry Act 1991', Appendix K, para 51 (which refers to Oxera (2008), op. cit.), para 109 (which makes a net adjustment, implying at least a 10% adjustment for catch-up) and para 112.

[47] CEPA (2013), op. cit., p. 69.

Table 7.1 Recent precedents on frontier shift

Regulator	Assumption	Commentary
CAA airports	1% p.a. on OPEX	
CAR airports	2.5% p.a. on TOTEX	Reflects both frontier-shift and catch-up efficiencies
CAA NATS	1.25%	
ORR	1% p.a.	
Ofgem electricity DNOs	1% p.a.	
Ofgem gas distribution	1% p.a. for OPEX	
Ofgem transmission	1% p.a. for OPEX	
Ofwat 2009 price review	0.25% for base OPEX	Represents net frontier shift
Ofcom telecoms	2% p.a. for OPEX	
Postcomm	0% p.a.	
Water Industry Commission for Scotland	0% p.a.	
Average[1]	**1.0 p.a.**	
Average excluding assumptions by the CAR and Ofcom	**0.7 p.a.**	The CAR's assumption reflects both frontier-shift and catch-up efficiencies. Ofcom's assumption may reflect the technological nature of developments in the telecoms industry

Note: [1] A simple average is calculated across the regulatory precedents shown in the table.
Sources: CEPA (2013), op. cit, p. 14; Water Industry Commission for Scotland (2009), 'The Strategic Review of Charges 2010–15: The Final Determination', November; and Postcomm (2005) 'Royal Mail Price and Service Quality Review: Final Proposals for Consultation'.

As shown by the analysis of regulatory precedents, CEPA's assumption of 1–1.2% is not towards the low end of the range—indeed, it is above the average of recent regulatory precedents, with no evidence being provided to explain the reasons for this, particularly as this is to be applied over a period when economic growth is expected to be lower than previous periods.

8 Conclusions

The concerns highlighted in this note significantly affect the conclusions that can be drawn from the various CEPA analyses undertaken to date.

– The RUOE estimates are based on inappropriate comparators, and fail to control appropriately for key changes in the airports market in the South East, such as the break-up of BAA, as well as the higher costs as a result of additional security requirements.

– The labour productivity measures also fail to control sufficiently for key factors such as the costs associated with the break-up of BAA, the increase in security costs, and the decline in passenger numbers due to the financial crisis.

– As acknowledged by CEPA, there are a number of limitations associated with the ATRS, including the failure to capture the impact on costs of the sale of Gatwick.

These concerns suggest that the scope for catch-up efficiency at Gatwick derived from the above measures is likely to be overestimated.

In addition, this note has highlighted concerns with estimates of the scope for ongoing efficiency:

- the TFP estimates have failed to account of the break-up of BAA, the deterioration in macroeconomic conditions, and the possible transaction costs or structural inefficiencies experienced by some comparator companies which if accounted for are likely to lower the estimate of frontier shift;

- the LEMS cost measure and output price indices fail to capture the change in the economic climate.

These factors suggest that it would not be appropriate to rely on these estimates without further analysis of the impact of the issues raised in this note on the results from the approaches outlined above.

Appendix 7: Gatwick comments on IDS' employment cost assessment

Introduction

This appendix provides Gatwick's comments on the reward benchmarking and rostering analysis within the IDS report.

Detailed comments on the IDS employee reward benchmarking

IDS' general overview:

- **Relevance of analysis period given change of ownership:** The report seems to focus for the main on movement of salaries from the period 2006 – 12. There also seems to be little recognition of the fact that much of the increased costs in the period of the report happened before the current owners bought the organisation; and during the last round of pay increases for negotiated grades (5%, 2010/11 and 4.82%, 2011/12) a decision was taken to generate a degree of confidence in the new owners by retaining the existing policy of linking salary increases directly to the Retail Price Index.

IDS' executive summary:

- **Misunderstanding of Gatwick's grade structure:** The Evidence of Grade Drift section 2.2.2 does not understand the fundamental shift in grading that was introduced into Gatwick for our Engineering Technician personnel; previously TEL and TMEs reflected two different disciplines – those disciplines have now been combined and TEL now holds Team Leader Technicians and TMEs a mix of Technicians Electrical and Technicians Mechanical ; Team Leaders were previously paid with a supplementary allowance which has subsequently been rolled into base pay;

- **Wrong comparison of staff to benchmarks:** We contend that Airport Security Officers should not be compared directly to Security Officers as is the case in the Executive Summary;

- **Failure to recognise need for operational resilience:** While we acknowledge that there is a trade-off between overtime and absolute number of FTEs, an operational environment requires operational resilience, so that service levels and the SQR are met. We cannot rely on using overtime to manage this resilience (i.e. planning to fail). IDS should have recognised this reality and need for FTEs;

- **Absenteeism:** IDS should have recognised that the methods of absence recording employed at the airport have been improved which also accounts for higher recorded absence.

IDS' methodology:

- **Change in staff numbers:** The change in staff numbers section on page 42 does not address the significant redistribution of security personnel after the introduction of checks on liquids in 2007. Nor does it make any significant mention of the those parts of the organisation which essentially did not exist at point of sale – including IT and Development, which were previously centralised functions under BAA; other functions – such as Human Resources – would operate as satellites with centralised functions – such as payroll – being handled centrally. Gatwick's inter-company recharges from BAA were also falling. All of this should be taken into context of the change in headcount, and also in grade shift, as much management was again centralised under BAA. (Page 45).

- **Airport Security Officer FTE growth:** Increases in ASO FTE identified by IDS were partly a result of leading performance on service metrics, queue times and new government lead legislation around safety measures.

IDS' conclusion:

- **Recognition of change of ownership:** The report does not put into context any of the union arrangements inherited at point of sale, nor does it address the complexities of existing pay procedures inherited at point of sale. It does not really identify the complexities of undoing these arrangements, and indeed the only line in the conclusion – paragraph 4 – "*potential changes to pay may not easily be introduced*" seems almost dismissive.

Detailed comments on IDS roster analysis (Section 7 Pages 81 to 104)

IDS' introduction:
The roster analysis report delivered by IDS reviewed Gatwick's approach to staffing for internal security, which is the largest workforce employed by Gatwick. IDS reviewed current roster patterns and measured how successful they were at meeting demand requirements. Effective and flexible roster systems mitigate the requirement for high staff levels, reduces waste and the requirement for overtime. All three factors drive cost management, efficient operations and counter the issues with inherently high staff costs from BAA ownership.

Roster system:
IDS reviewed the current rosters in use at Gatwick and their opening comment states *"A more flexible roster system was recently implemented … driving business and administrative efficiencies and improving employee engagement" (IDS Gatwick 7.1.1)*. Throughout the report, IDS continue the theme of flexibility and efficiency.

Another example is the Premier roster, *"effectively a blank sheet and staff are rostered in a very flexible way … (applying) the most appropriate cover for the operation" (IDS Gatwick Page 81)*. The Premier roster "*gives a mechanism for addressing the significant fluctuations in demand between winter and summer" (IDS Gatwick Page 7.1.5)*.

The number of departing passengers in August 2012 (1.93m) was 92% higher than in January 2013 (1.00m). The fluctuations in demand from winter to summer have meant that Gatwick has had to developed effective, flexible rosters that drive efficient use of staff since the change in ownership from BAA.

IDS state that up to 30% of Gatwick staff are employed on a flexible roster. *"This gives a good* *mechanism for coping with variations in demand between terminals, seasons and daily fluctuations" (IDS Gatwick 7.1.2).*

Aside from the financial implications from flexible, efficient rosters, Gatwick have also aligned team leaders with their direct reports. *"Over 90 per cent of ASOs (Security Officers) have the same roster as their team leader … Through this alignment, all frontline staff now receive regular performance reviews, personal development plans and regular meetings with their line managers." (IDS Gatwick 7.1.7).* This alignment was one of the key factors that supported Gatwick in achieving the award of Investors in People ("IiP") in 2013.

Observations:
IDS undertook a variety of analytical activities on the data provided commentary and observations on the roster system Gatwick has developed and established.

Gatwick leads the way in terms of flexibility and efficiency. IDS states that "*there is a close match between actual staffing levels and demand" (IDS Gatwick 7.4.9)*. The analysis IDS undertook shows that Gatwick achieves an RSQ of between 93% and 95%. This measure shows demand and supply, and hence, the effectiveness and efficiency of Gatwick's roster staff, are extremely close despite "*large differences between Summer and Winter demand" (IDS Gatwick 7.4.6).*

During consultation, Gatwick requested a significant proportion of the detail to be excluded. An efficient and flexible workforce delivers a competitive advantage in terms of both cost and staff required. No other airport has developed a roster system that delivers such a dynamic workforce.

For example, at Heathrow, "*all rosters are fixed throughout the year" (IDS Heathrow report 8.4.5)*. Heathrow has an excessive requirement on overtime, "*average for the year ranges from 7.12% in Terminal 4 to 8.89% in Terminal 5." (IDS Heathrow 8.4.8)*. Gatwick "*averages out at less than 4% of planned work" (IDS Gatwick 7.4.14)*.

IDS also recommend Heathrow to *"use some form of flexible rostering or annualised hours, in which typically, overtime is substantially reduced and working hours better match the annual workload" (IDS Heathrow 8.4.12)*. This perfectly describes the Roster system developed at Gatwick, hence the request for detail to be excluded on the grounds of competitive advantage. "*The low level of overtime is due to the flexible start times … and the fully flexible shifts" (IDS 7.4.14).*

Conclusions on roster analysis:
Overall, the IDS section on roster analysis, demonstrates Gatwick's resolve to drive efficient and effective operations. The IDS report references continuously the flexibility that Gatwick has succeeded in developing within its roster system. With almost 30% of security staff on a flexible roster, compared to zero at Heathrow, Gatwick has the most progressive suite of rosters at an airport. This allows Gatwick to closely match supply against demand, reducing waste and drive efficiency. A result of this is the reduction in overtime down to less than 4% at Gatwick, compared to Heathrow's 8%, which delivers a significant cost saving and provides a competitive advantage against those other airports that are now looking at improving their own roster systems.

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Appendix 8: Gatwick comments on Helios' central support cost assessment (interim report)

Introduction

This appendix contains Gatwick's final comments on the final draft of Helios' central support cost assessment report. We submitted a response to Helios' draft final report in April 2013. Many of the comments in this response continue from that time; some points have not been changed between Helios' draft and final reports.

Overall comments

We continue to have serious concerns with the report:

- The CAA did not follow the "*Process of Airport Benchmarking*" as set out in its own report "*The Use of Benchmarking in the Airport Reviews – Consultation Paper – December 2000*". The process followed by the CAA in commissioning the consultancy reports has not provided enough guidance or time to allow the consultants to undertake a comprehensive collaborative benchmarking exercise;

- Given the time and scope it has not been possible for Helios to normalise the data to ensure that its analysis compares like with like. Therefore, the results produced by Helios are unsuitable for identifying areas where scope for improvement exist, because it is not clear whether the differences are due to measurement errors or real underlying efficiency differences;

- Helios failed to find appropriate comparators, and as such have failed to take into account differences between Gatwick and the comparators used. There is limited data from perceived comparator airports that restricts the meaningfulness and robustness of any conclusions derived from it;

- Helios did not provide the CAA with an understanding of the relationship between the services and quality offered by Gatwick and the costs to deliver these outputs, as only costs have been considered in this report; and

- Likewise, Helios did not assess the achieveability of its proposals, as required in the CAA's terms of reference. While Helios offered plenty of suggested methods by which Gatwick could reduce costs (potentially at the cost of quality of service), the consultants did not offer an assessment of whether such methods could be achieved, or in fact, the cost of achieving such efficiencies.

Working method

Helios stated that the IDS pay benchmarking study did not explicitly cover the back office function and roles. This statement is incorrect: the IDS report assessed all of Gatwick's staff costs. By including staff cost efficiencies in its report, Helios has double counting the staff efficiencies that IDS proposed.

Approach and methodology

The project's terms of reference require an "*evidenced assessment*". We recognise Helios' efforts to secure a wider evidence base. However, there are still many places in the report where Helios derives conclusions without sufficient (or sometimes any) evidence, or places where the conclusions are not derived from the evidence. This is despite the terms of reference requiring "*findings should be supported by a clear evidence base*".

In its cost categorisation and assessment metrics, Helios commented that Gatwick's finance function includes payroll. In Gatwick, payroll is not in finance, it is an outsourced cost within the HR function. As a consequence, any benchmarking in relation to finance cannot be relied on to be comparable.

Helios has used data from annual reports to compare typical senior manager costs at airports in Europe. However it did not compare this with data from Gatwick's Report and Financial statements.

Helios has not ensured for the benchmarking exercise that the airports / airlines are similar in terms of size and organisational structure.

The external benchmarks used by Helios are not bespoke reports that have been adapted for a specific user or purpose.

Publically available external benchmarks taken from the public domain should not be used in this report, as these sources of data are not comparable with Gatwick. These reports are promotional material showing what could be achieved as part of a collaborative benchmarking exercise.

Helios should provide a process definition for the Gartner transportation benchmark similar to those provided for The Hackett Group HR and Finance.

Helios has stated that the report does not rely on the peers being in the same industry. It would be unwise to compare Gatwick to non-regulated businesses that are not in the aviation industry.

Helios noted that previous price control studies have taken the same approach. This is factually incorrect as the KPMG Benchmarking of the finance and facilities management costs of BAA Plc. – Benchmarking Report was completed in two phases: a scoping phase and a benchmarking phase. The scoping phase understood the functions, identified what could and should be benchmarked, agreed what benchmark measures would be used and decided who the comparator groups should be. The benchmarking phase reviewed and analysed the work stream datasets, providing a series of findings against the previously agreed comparator groups. The Helios approach is not similar to the previous detailed study undertaken by KPMG and this is backed up by comments made in this report by Helios.

The suitability of the bespoke peer group does not include any reference to organisational structure. The reports states "*We have accepted airport functional cost definition at face value. We have not been able to validate functional boundaries with benchmark definitions in the scope of this study, nor with comparators*". We are surprised that no attempt has been made by Helios to ensure that the organisational structures of the data sets are comparable.

Helios states "*A detailed collaborative benchmarking study which would review each function in depth* *has not been undertaken for this work*". This would indicate that the benchmarking undertaken is not comprehensive enough to provide comparable data.

Helios states "*Any 'arm's length' external benchmark references can be challenged as not being a substitute for a full collaborative benchmark which is beyond the remit of our study. Such a full collaborative benchmark would be done in detail, working with an airport to provide genuine diagnostic analysis, using agreed data definitions to ensure a like-for-like comparison*". This would again indicate that the benchmarking undertaken is not comprehensive enough to provide comparable data.

Helios states "*…and further have used tailored peer group benchmarks in HR and finance*". This contradicts the comments made where Helios has stated that a detailed collaborative benchmarking study has not been undertaken, and also where Helios has not been able to validate functional boundaries with benchmark definitions in the scope of their study. Therefore, how could any tailored peer group benchmarks have been produced?

Helios forecast the number of FTE employees by growing the number of employees in 2011/12 by the growth in man-years. Gatwick has not been provided with the calculations Helios used to create the FTE data within this report. As a result, Gatwick cannot validate any results within this report that use FTE as a metric.

Central support costs review

Helios re-states that "*As discussed in Section 4, there will be some variation in the definitions of functions, as we have not been able to validate functional boundaries with the airport and comparators, and have taken functional submissions at face value*". This indicates clearly that the data used throughout the report is not based on comparable organisational boundaries.

The analysis for cost per central support staff on page 30 (item 5.10.3) observed a gap of £30k - £40k, which is a clear indication that the data sets within this report are not comparable, as one would expect given that this exercise was not a collaborative process.

Finance

Helios used two PwC reports "*Putting your business on the front foot – Finance effectiveness benchmark study 2012, PwC*" and "*Drifting or driving? Finance effectiveness benchmark study 2011, PwC*" as external benchmarks. These reports are promotional material showing what PwC could provide from its benchmarking expertise, in which the consultants would spend time to normalise the data to appropriate comparators. Such generic promotional matter is inappropriate and produces benchmarks which are non-comparable to Gatwick, and hence any reference to these reports should be removed.

On page 35 (item 6.4.2), the finance benchmarks (median) point in 2011/12 has moved since the draft final report, yet the reports used for this data have not changed.

Helios stated on page 35 (item 6.4.2) "*…Gatwick's finance function is efficient in 2011/12, and its finance cost moves towards the top of the quartile by the end of the review period on current data*". Therefore, Helios should identify the finance function as efficient and remove all references to efficiency savings.

Helios calculated a finance manager/non manager ratio (page 37 item 6.4.5). Gatwick does not agree with the figure calculated by Helios in table 6-3. We require Helios to provide the workings to support the ratio in this table for the Gatwick value.

On page 38 (item 6.5), Helios stated that they have not been able to undertake a detailed analysis of Gatwick's insurance for this report and that they have not received information on specific key drivers behind the planned insurance costs. Gatwick arranged a conference call with Helios on 13th March regarding "Insurance - Helios Central costs review". During this call, the subject matter experts answered questions around the drivers for each type of insurance and therefore the changes, what the premiums are based on, the limits of liability and the process behind this and the changes over time. It was our understanding that the subject matter experts had answered all of the questions which were raised. Helios subsequently requested explanations for changes in specific years, we informed Helios at the time that the subject matter experts were un-available at the time as they had been working on completing the insurance renewal process, and we were unable to discuss the questions raised by Helios in detail. Gatwick requested that Helios confirm the level of detail they were expecting to see in the analysis required, but Gatwick did not receive a reply. This comment by Helios is disingenuous and should be removed.

Helios have included a new statement in the report (page 38 - item 6.5) "We have consulted an insurance expert who has advised that the current insurance market in terrorism is such that insurance is relatively easy to obtain and reasonably priced compared to previous years. There appears to be no reason for an annual increment of the level proposed by Gatwick". The term of reference for this report includes "*An evidenced assessment of the scale of efficiencies that might be achievable over Q6*". We would therefore expect to see evidence to support this statement if none is available then this statement and any efficiencies based upon it should be removed from the report.

On page 39 (item 6.5) Helios make the comment "*We have not yet been supplied with data sufficient to enable us to investigate whether an increased asset value or capex is driving the insurance increase during Q6*", please see the response for insurance above.

Helios question the validity of the provision for unexpected events, this was explained in the conference call on the 13th March 13 (page 39 item 6.5), and please also see the response for insurance above.

Helios have added a new comment (page 39 item 6.5) "*We see that while Gatwick's insurance cost as a percentage of revenue is on an upwards trend from 2011/12, the comparator's costs as a percentage of revenue sees an on-going downward trend in future years*". There does not appear to be any evidence to back up this statement. Helios should include data and / or a graph to support their point or remove the comment from the report.

Helios observes (page 39 - item 6.5), "*The year on year increases for all types of insurance appear* *unjustified and have not been adequately explained by Gatwick despite repeated requests*", please see the response for insurance above.

Helios commented (page 39 item 6.5) "*The airport has provided an overview of the main types of insurance and factors that affect the costs of insurance. We have requested information on specific drivers for changes in insurance. Further analysis will be undertaken on insurance costs when data and a justification for insurance costs increases is made available by Gatwick*", please see the response for insurance above.

On page 40 (item 6.6) Helios stated "*Gatwick's finance function is therefore efficient when compared to benchmarks in 2011/12*" and "*Gatwick's finance costs as a percentage of revenue improve further by Q6 and are expected to be around 0.7% during the first few years of Q6 and reach 0.6% in 2018/19. Gatwick's finance function throughout Q6 is efficient compared to current benchmarks*". Therefore Helios should identify the finance function as efficient and remove all references to efficiency savings.

Helios stated again (page 40 - item 6.6) "*Our view is therefore that although Gatwick has an efficient finance function, as shown by the finance cost as a percentage of revenue...*". Therefore, Helios should identify the finance function as efficient and remove all references to efficiency savings.

Any efficiencies identified by Helios in relation to insurance (page 40 item 6.6) should be removed as Helios have not provided any evidenced assessment as to why they feel that Gatwick is inefficient.

Human resources

According to Helios, the Bespoke Hackett Group Benchmarking Data (page 45 - item 7.4) is based on a bespoke peer group of organisations of similar scale to Gatwick. This report may be bespoke in terms of the request Helios made but it was not created via a collaborative process and as such it cannot be considered valid.

The report "*Hackett Shared Services and Outsourcing Network (SSON) 2009*" used by Helios is generic and out of date and "*HR excellence*" is a generic publicly available document and as such cannot be used as a comparator to Gatwick because it is not tailored to a company of Gatwick's size. Any reports taken from the public domain should not be used in this report as these sources of data are not comparable with Gatwick.

In the HR spend per employee, a new metric (page 46 item 7.4.1 - figure 7-3) has appeared "*Gatwick peer group median*" no explanation is provided as to what this metric is or how it is relevant to this report. This metric should be explained or removed.

Helios stated (page 48 item 7.4.3) "*We have not been able to look at the change in manager and non-manager ratios over time as the airport has only provided a snapshot and is not able to provide forward-looking information on staffing ratios*", Helios then stated in the same paragraph "*We are concerned that the ratio of managers to non-managers increases in the period before 2014/15*". These two statements appear to be contradictory. Helios should clarify, amend or remove the comments accordingly.

Helios has not taken into consideration the fact that, although approximately 15 security trainers have been transferred from HR to Operations, the management of these FTEs has remained in HR. Therefore in order to obtain a true manager / non-manager ratio Helios would need to add back the 15 FTEs transferred out of HR (page 48, item 7.4.3).

Helios stated "*This shows that Gatwick's HR function is expected to remain efficient throughout Q6*" (page 48, item 7.4.3). Therefore, Helios should identify the HR function as efficient and remove all references to efficiency savings.

IT

Neither of the Gartner IT Spending and Staffing Reports for 2011 and 2012 (page 52 item 8.4.1) used as external benchmarks are bespoke reports, and any reports taken from the public domain should not be used in this report as these sources of data are not comparable with Gatwick.

Helios adjusted benchmarks from a generic publicly available document that has not been tailored to the specific requirements of this process (page 53, item 8.4.1). Airport and airline benchmark data has been changed by Helios without any input from these entities, therefore the results cannot be relied upon to be actual representation of the true costs of the data sets.

On page 54 (item 8.4.2) in figure 8-3 the colour coding in the legend for airport 3 not consistent with other graphs. Please amend so all colours between graphs are consistent.

Helios made the statement "*…although Gatwick's IT cost as a percentage of revenue is expected to fall during Q6, it is unlikely to perform better than benchmark averages*" (page 54 item 8.4.2). Helios do not provided any evidence to support this statement or clarified in whose opinion is it "*unlikely*". When Helios comment "*unlikely*", it should also quantify this statement or remove it from the report.

The statement is made by Helios "*However, previous price control studies have used transport benchmarks*" (page 55 item 8.4.3). Previous price controls may have used transport benchmarks - however it may not have been the correct thing to do, as is the case in the current review. Just because it was done previously does not mean that it was or is the correct thing to do.

Helios stated "*We note that in annual surveys of organisations and their IT costs, cloud computing is becoming more prevalent and is not specific to Gatwick*" (page 56, item 8.4.4). Helios should reference which "*annual surveys*" provide the evidence for this statement and, if this cannot be done, the comment should be removed.

The comment made by Helios "*We also do not think that this is sufficient justification for higher unit staff costs*" (Page 56 item 8.4.4). There is no evidence provided to support this statement. Helios should provide more detailed findings as to how they reached this observation. If this cannot be done the comment should be removed.

Helios should make reference to the fact that by the end of BQ5 Gatwick's IT cost as a percentage is below all benchmarks with the exception of the NCC median (transport). It is notable that no airline or airport comparators are used in this metric (page 58, item 8.4.6).

On page 58 (item 8.4.6), Helios do not make any reference to where the data for the ratio of manager to non-manager ratios has been derived from. If it is based on the snapshot of data provided by Gatwick in Jan 13, Helios do not take into consideration that the Gatwick IT function is in a transitional period and any ratios created at a point in time now for IT will not be the same going forward.

Helios stated "*The Gartner transportation benchmark is based on an industry sample which includes airlines, airport operations and air traffic control enterprises. This sample therefore seems well matched to comparison with Gatwick*" (page 59, item 8.5). While this benchmark study is likely to include airlines, airport operations and air traffic control enterprises, Gatwick have been unable to confirm if this statement is correct. Helios need to reference where they sourced this information from, provided a breakdown of all categories and the volumes included in this sample. If Helios cannot provide this supporting evidence, then the comment and all references, observations and conclusions in relation to this particular benchmark should be removed from the report.

Helios should reference where the Gartner transportation has been the standard used in previous price control exercises (page 59, item 8.5).

Recognition is provided by Helios that the sample enterprises used for Gartner's benchmark have significantly larger average staff sizes and therefore might benefit from greater economies of scale than Gatwick (page 59, item 8.5). This may reduce some of the scope for efficiency. This identifies that the benchmarks used are not fit for purpose as the companies within these benchmarks are not comparable with Gatwick.

The value differential when looking at the IT costs per IT staff, and assessment of efficiencies that could be made, clearly indicate that the benchmarking data and that of Gatwick are not like for like and thus not comparable (page 59, item 8.5). Any scope for efficiency savings derived from this analysis should be removed from the report.

Helios acknowledge that IT FTE is in line with their benchmark, but conclude that the manager to non-manager ratio is too low (page 59 item 8.5). This ratio is based on a snapshot in time and therefore is not representative of the IT function through Q6. In addition Helios suggest staff costs reduce by an average of £16k to bring Gatwick in line with the airline comparator, how did Helios reach this conclusion? A more relevant comparator would be another airport but even then it would be difficult to compare on a like for like basis as there are different strategies and different stages of the life cycle in relation to IT - something that Helios do not take into consideration in their report.

On page 57 (item 8.6) Helios notes that IT spend is falling as a result of a programme change. Achieving this programme change has required external assistance from consultants. Helios has identified this consultancy cost for removal. However, it has ignored the effect of removing this cost, which would have been to take away the overall IT cost reduction.

Legal

Helios need to state that the reason no legal costs were included prior to 2009/10 is that the function did not exist as it was prior to separation (page 61 item 9.2).

On page 63 (item 9.4), Helios continued to ignore Gatwick's reservations around the spurious legal benchmarking used within the report. Helios should remove all of the legal benchmarks used in this report as there is no evidenced assessment of how this data is comparable to Gatwick.

Helios have ignored Gatwick's previous comments in relation to external legal fees, made dismissive comments, and shown no appreciation for the issues and costs faced in relation to the Ryanair case and the impact that this will have on the number of subsequent legal challenges Gatwick will now face going forward.

Communications

All graphs point to a steady state communications function performance over the period. Gatwick is in line with most comparators in the 3 years where data is available and going forward minimal increases year on year. Again it is clear that the comparable airports have a structure that is not consistent with Gatwick.

Helios did not comment on how Gatwick's communications costs compare with comparators to assess the scope for efficiency (page 70, item 10.5). Helios are not using the comparators data available to them all graphs and references to them should be removed.

No evidenced assessment is provided in the scope for efficiencies which are based on the Helios conclusion that there are unjustified cost increase in real terms (page 70, item 10.5).

Strategy and regulation

Revenue is not a driver of regulatory costs (page 74, item 11.4.1). These costs are driven by the intensity of the regulatory regime that is faced by the company. This means that a smaller entity (such as Gatwick) directly suffers a scale disadvantage against a larger entity, which could require similar regulatory activity.

Helios has not undertaken any detailed analysis to ensure that Gatwick and its comparators have the same structure and remit in this function (page 75, item 11.5). Helios should provide evidence as to how they have reached the conclusion that they are comparing like for like in their analysis. If this cannot been done then the scope for efficiency should be removed.

Helios makes comments about the proportion of managers within the function. However no evidenced is provided to support these observations (page 75, item 11.5).

Airport management

Helios only secured two main benchmarks (Page 78, item 12.4) - one airport and one airline. Against the airport, Gatwick is more efficient, per revenue, and more efficient than the airline for average salaries. We note that there are only two benchmarks, which is not particular informative, given the narrowness of the comparison. Further, we note the incongruity in the analysis. We do not believe that anything can be derived from these comparisons.

Helios benchmarked 2011 costs against publicly available information for other grouped and non-grouped airports (page 78, item 12.4). We note that Gatwick's 2011/12 airport management costs were just short of double the projected annual cost for the period beyond Q5. This was because of changes to personnel. We request Helios to remove comparisons which involve non-typical one-off costs.

Helios made observations on data that is clearly not comparable in table 12-3 a fact which Helios acknowledged (page 80, item 12.5). If Helios were to take data from Gatwick's statutory accounts and compare this with the statutory accounts data from other airports as presented in table 12-3 there would not be any scope for efficiencies. Helios therefore should remove efficiency savings in relation to Airport Management, as their evidenced assessment is fundamentally flawed.

Conclusions

Airlines expressed concern that pay for central support staff was above the market average. The IDS study has taken account of staff cost efficiencies and, by including staff cost efficiencies in their report, Helios are imposing a double count in terms of staff cost savings on Gatwick for the support functions. Helios should remove any staff cost efficiency targets from their report (page 82).

Gatwick provided a snapshot of their organisational structure as at 25th March 2013 and we highlighted to Helios that this snapshot could not be used to analyse the Revised Business Plan as they are from different points in time and some functions (e.g. IT) will change over the period in question. Efficiencies derived from changing the mix are not able to be substantiated (page 82).

On page 82, Helios made the statement "*…we were unable to review insurance in detail and had no information on specific drivers*" is factually incorrect and should be removed. Gatwick arranged a conference call with Helios on 13 March regarding "*Insurance - Helios Central costs review*". During this call, the subject matter experts answered questions around the drivers for each type of insurance and therefore the changes, what the premiums are based on, the limits of liability and the process behind this and the changes over time. It was our understanding that subject matter experts had answered all of the questions which covered. Helios subsequently requested explanations for changes in specific years. However we did inform Helios at the time that the subject matter experts were un-available at the time as they had been working on completing the insurance renewal process and as such we were unable to discuss the questions Helios raise in detail. We did ask Helios to confirm the level of detail they were expecting to see in the analysis required to which we did not receive a reply. This comment should be removed. Helios has not incorporated any of the responses in relation to insurance that they received directly from the subject matter experts.

Helios should provide evidence for the statement that there was a high use of consultants without a benefits impact, and remove the comment completely if this cannot be done (page 82).

On page 83 Helios stated "*Increasing central support costs in line with revenue appears wholly unjustified*". However, Helios failed to mention that as per table 5-7 on page 28 in the first year of BQ5, the support costs as a percentage of revenue drops by 1.1% and then remain constant. Table 5-

1 on page 24 shows that there is only £0.1m increase in support functions costs between 2013/14 and 2018/19.

Helios have ignored the additional costs of £2m (nominal) in both 2017/18 and 2018/19 which, if excluded from the analysis, would change the conclusions Helios make in terms of scope for efficiencies when looking at percentage of revenue, spend per employee and staff cost per central support staff (page 83).

Helios state "*Gatwick's finance function is efficient…*". Therefore, Helios should remove all scope for efficiency savings that relate to Finance. Helios should not recommend scope for efficiencies in the staff costs for finance as, in doing so, they are double counting as the IDS study has already taken into consideration staff cost efficiencies for the whole of Gatwick (page 83).

Helios cannot make any recommendations in relation to insurance as they have taken no account of the information provided to them in relation to drivers for each type of insurance and therefore the changes, what the premiums are based on, the limits of liability and the process behind this and the changes over time. Unless the information provided to them is assessed as evidence in their assessment of scope for efficiencies, Helios should remove any savings they have identified for insurance (page 83).

Helios comment that HR "*Towards Q6, Gatwick is operating nearer to the World Class figure*" this combined with the statement from page 48 "*This shows that Gatwick's HR function is expected to remain efficient throughout Q6*" should mean that the HR function is classified as efficient and any references to efficiency savings should be removed (page 83).

IT Helios do not have any bespoke benchmark reports for IT, and have also independently manually adjusted the data for these reasons, any analysis cannot be relied upon to base any efficiency savings. Helios have based the scope for their efficiencies in relation to IT in terms of it being "unlikely" but they do not state in whose opinion it is unlikely, and they also provide no evidence to support this view.

Previous price and annual studies are mentioned by Helios, yet no reference is provided to any such studies. Therefore conclusions cannot be justified without sufficient evidence. Helios "do not think" that there is sufficient justification for higher staff costs, however they again do not provide any evidence to support this conclusion. Helios have not credited Gatwick with reducing IT costs which is clearly demonstrated not only in the costs themselves but in the 3 graphs produced to support the metrics used by Helios (page 84).

On page 85 in table 13-1, scope for efficiencies shows significant differences from the draft report yet sources of data, evidence and conclusions have not. Why have such significant changes to the efficiencies occurred?

The scope for efficiencies identified by Helios start immediately in year 1. There is no allowance for a more realistic phased approach.

Reducing costs will not itself guarantee efficiency. Helios need consider the fact that different comparators will have different processes and procedures and unless best practice is shared efficiencies may not be achievable. It is unlikely, given the competitive environment that Gatwick now operates in, that competitors or comparators are likely to share what is essentially a competitive advantage.

Helios has said that one-off costs are not relevant to the analysis. This is a factually incorrect statement as, if Gatwick are being asked reduce staff, then while staff costs will go down we would incur costs during BQ5 in relation to redundancy. In the next paragraph Helios contradicts its earlier statement by saying that redundancy costs would need to be taken into account. Their second comment is correct as these costs clearly need to be taken into consideration when calculating scope for efficiencies (page 85).

Helios provided no evidenced assessment of how they reached the conclusions around how quickly staff reductions could be achieved. Helios provided 2 timescales, within a year and between one to three years, but do not clarify why there are 2 and which should be used and when. Helios also assumed that work can be transferred between staff and also using more technology and / or outsourcing which will add costs back into the business. Helios did not provide any explanation or evidence of how they arrived at an estimate of twice the annual staff cost for lost staff or how to reduce consultants and general expenses immediately (page 85).

In what currency are the revenue figures in C.2 Finance Peer Group table (page 95)?

On pages 96 to 98 at what rate have Helios converted the $ values to £ to then use the £ value in the main report?

Gatwick know that they are not inefficient across all support functions and although Helios refer to certain functions being efficient yet efficiency savings are still applied. The issue faced by Gatwick is that in order to defend our position we need to identify and explain factors for not only our deviation from the upper quartile but also those of comparators. This exercise has not made it possible for this element of the benchmarking process to take place.

Benchmarking may still have a role to play in regulation, but the CAA should recognise that the scope for efficiencies in this case largely measures the extent to which Helios have failed to explain costs, and not the extent to which Gatwick are inefficient.

Appendix 9: Gatwick comments on SDG's assessment of other operating costs

Introduction

Our major concerns with this report are:

- **Problems with benchmarking:** We still have a number of major concerns about SDG's benchmarking, particularly in the areas of cleaning and police costs.

    - **Limitations with external benchmarks:** Without detailed normalisation, we believe that external benchmarking can be of only limited use in understanding the ability of a business to achieve targeted levels of cost.

    - **Limited number of comparators:** We are not convinced that any firm conclusions can be drawn from just three comparators, as an example in police costs (although we note SDG have identified an additional comparator in cleaning). We would encourage SDG to find a significant number of additional suitable comparable airports or to recognise clearly the significant statistical limitations of the analysis it is undertaking;

    - **Lack of benchmarking transparency:** The CAA's terms of reference require SDG to "*clearly identify which benchmarks are most relevant and why, the source of any potential data and any constraints on its use*". SDG does not identify its comparators. This lack of transparency leaves a question mark about their suitability. If stakeholders cannot assess the suitability of the comparators then the credibility of any benchmarking exercise is seriously in doubt; and

    - **Validity of comparators:** In particular, if the comparators have limited overall scale, in a location without high South Eastern salary levels or are not regulated, with all of the requirements/ constraints that this brings, then there are serious doubts about whether the benchmarking is informative. Stakeholders need to have transparency over the comparators to test this comparability;

    As a result of these flaws the benchmarking exhibited in the Draft Final Report is of little use. Unless it is improved and made more transparent the CAA can attach little weight to its results.

- **Lack of evidence:** Similarly, the terms of reference require an "*evidenced assessment*". There are many places in the report where SDG derives conclusions without sufficient evidence. This is despite the terms of reference requiring "*Findings should be supported by a clear evidence base*". In many cases highlighted below, SDG continues to base its potential efficiencies on insufficient evidence.

- **Achievable efficiencies:** Again, the terms of reference require an assessment of "*efficiencies that might be achievable*". We are very concerned that SDG have made little attempt to understand the effect of the implied efficiencies on the business and whether they are achievable (let alone realistic). We believe that such an assessment is required and in its absence SDG's conclusions lack credibility;

- **Level of efficiency targeted:** We believe that it is unreasonable to expect that the efficiency of all of Gatwick's functions should match the toughest possible external source found. Even the most efficient organisations will find areas where improvements can be made, not least as what constitutes efficiency constantly evolves. The SDG approach is likely to lead to unrealistic efficiency targets;

- **Unbalanced assessment:** SDG purport to find efficiencies in each of the cost items –despite its own workings showing mixed efficiency verdicts for areas such as cleaning and police costs. Where there is a mixed picture derived in the workings, no evidence-based reasons are given for opting for the conclusion of inefficiency. This leads us to conclude that the assessment is unbalanced –which may have been promoted by the requirement written into the CAA's terms of reference to find "*an evidenced assessment of the scale of efficiencies*", rather than 'an evidenced assessment of efficiency'. However, that does not excuse the lack of balance in the findings, nor avoid the need for SDG to better balance the conclusions offered;

The following sections respond to specific points raised within the rates, rents, utility, police, Air Navigation Services ("ANS"), cleaning, and PRM sections, many of which bear out the general points made above about lack of balance.

Rates

We are uncomfortable with two particular points in SDG's final report.

First, SDG suggests in paragraph 3.8 that the reason for outperformance of the Q5 settlement is partly due to an exclusion of efficiency assumptions in the Q5 settlement. SDG is correct in their assumption that no efficiency overlay was applied to BAA's rates projection for Gatwick1, but this is not the reason for outperformance. In fact, an earlier set of points under 3.6 fully captures the reasons why Gatwick's rates cost were below the Q5 settlement: it was the result of a significant restructure of the property portfolio in Q5 (e.g. the demolition of Hangar 5, and the leasing of Longbridge House and Norfolk House to hotel operators). As well as this, there have been changes in the scope and phasing of the capital programme and some one-off exceptional items. We therefore ask SDG to correct this point.

Second, SDG consider it reasonable to increase the Uniform Business Rate (UBR) multiplier using the inflation assumptions from the Office of Budget Responsibility (OBR) instead of Gatwick's view of 3.5% per annum. The UBR rate is driven by September RPI of the preceding year and also adjusts for various rate reliefs. Gatwick has sought external expert advice on this matter and their assessment has been reflected in our plan. The Economic and Fiscal Outlook report produced by the OBR provides a long term projection of average RPI, and does not take into account the intricacies of rate reliefs associated with rolling forward the UBR rate.

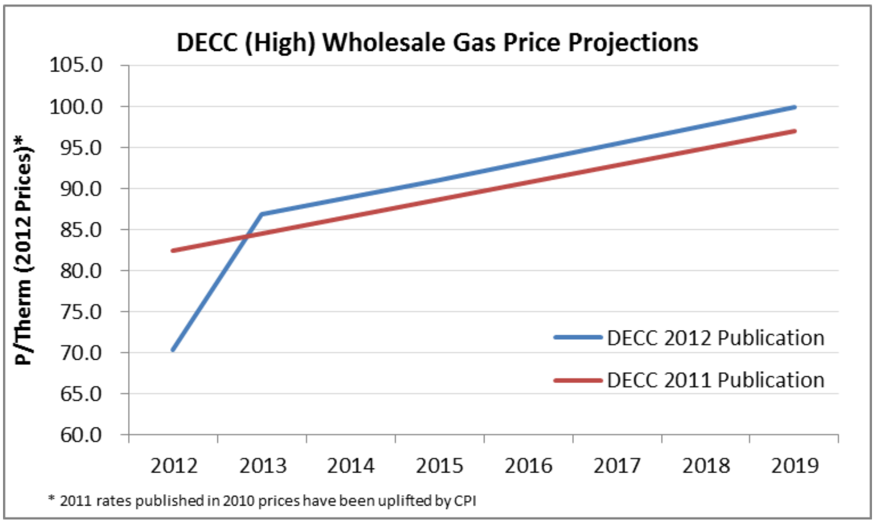
Further, it is unclear to Gatwick how SDG have applied the OBR inflation "while making explicit allowance" for the application of the Contractor's-test method of valuation after the 2017 revaluation. We request further detail on how this allowance has been calculated.
Rents

We note that SDG agree that there is currently no opportunity to consolidate rented accommodation.

Utilities

We would like to raise some concerns regarding some comments in SDG's Final Report.

First, SDG suggest in paragraph 3.55 that an incorrect gas unit rate was used for 2013/14. Gatwick has simply updated its view on the unit rate based on more recent market information. The assumption in the Revised Business Plan (RBP) was correct at the time.
Second, SDG state that Gatwick is unable to attach a probability to its different scenarios of gas rate projections. For this reason, SDG have recommended and adopted the central DECC gas rate forecast. We do not believe this is sufficient justification for using this rate not least as DECC's forecast scenarios do not contain such probabilities either, likely due to the highly volatile nature of gas prices. Gatwick has also noted that forward gas prices have recently risen between DECC forecast iterations and we believe this trend is set to continue (see chart below).



Gatwick has also stated that global supply and demand of gas needs to be considered in relation to price forecasts, which introduces yet more complexity and uncertainty. The approach used by Gatwick is that where there is more certainty in the market in the near term, we have reflected this in lower gas prices. Where there is greater unpredictability and risk in the longer term, Gatwick has reflected this in higher prices. From this point of view, we believe a fairer and more realistic challenge would be to moderate gas rates to the DECC high projection.

Third, we do not believe Gatwick's Revised Business Plan (RBP) numbers have been correctly reflected in Table 4.2: Utilities costs –potential savings. Currently it still shows the Initial Business Plan.

Police

We note that SDG does not propose further cost savings based on comparisons with unit police costs at other UK airports. We believe that SDG is correct in this view, as there is no conclusive evidence to support efficiencies on that basis.

Our remaining concern remains the arbitrary SDG assumption to limit post-2016 police costs based on below inflation pay increases of between -1.3% and -1.7% for the remainder of the 5 year period beyond Q5 (real terms; 2% increase per year in nominal terms). Following an average pay freeze between 2010 and 2016, which would have reduced average wages by up to 13% in real terms, we remain of the view that below inflation pay settlements after 2016 are not a prudent or credible assumption.

We note that SDG did not provide evidence as to why the real terms decreases in police officer salaries will continue post 2016. Without such evidence there needs to be a more prudent assumption of reverting to modest real terms increases in line with long term trends. This is particularly relevant given the Police deployed into the airports are expected to have specialist skills (e.g. firearms, anti-terrorism, dog handling) that the recent Police pay review has identified as meriting a skill/role based incremental allowance as compared to other Police roles. These skills are highly in demand in areas (such as central London) immediately adjacent to the area covered by the Sussex Constabulary.

ANS

We note that SDG's benchmarking exercise did not provide evidence of inefficient service provision at Gatwick. Further, following the CAA's conclusion that ANS tower services is not a contestable market, we note SDG's statement that "*given the CAA's recent contestability review that the airport is not in a particularly strong position to negotiate hard on price*". Therefore, we are somewhat bemused that SDG's conclusions attempt to enforce a "*no real terms increase from future tendering*", without any evidence to support such a claim.

Instead, SDG appears to cast doubt over the achievability of its own conclusion: "*this may be a challenging target*".

Further, SDG's drafting appears to dismiss the significant amount of NSL cost risk described in our response to the Interim Report, which included:

1) **Scope risk:** The potential for higher costs driven by the operational requirements of European RP2 regulation and the CAA's Future Airspace Strategy, which are particularly relevant to Gatwick as the busiest single runway operation in the World; and

2) **Wage cost risk:** In the ten years before the end of Q5, NATS ATCOs did receive real annual wage and pension increases. Therefore, given the strong ATCO unions, we do not see any evidence for concluding that ATCO costs would hold steady in real terms.

SDG note that Gatwick (the busiest single runway airport in the world) is also focused on getting best commercial value from our service provider, which is not purely focused on cost but also looks at improved performance and greater capabilities over time. The strategic importance of this appears to have been ignored by SDG in arriving at a cost-based view.

These are serious issues which will be a barrier to a reduction in our ANS cost projection.

Cleaning

We note that SDG have dismissed passenger numbers as a relevant driver of cleaning costs. We disagree with this statement and believe it is illogical to assume additional passengers will not drive additional facility usage and consequently additional cleaning. SDG justify their statement on the basis that no relationship exists between historical total cleaning costs and total passengers. Such an analysis would need to strip out noise from changes in cleaning practices, level of building work, changes in area and normalise for cleaning quality using our QSM survey data. We therefore believe SDG's analysis is too simplistic and does not warrant a complete dismissal of this cost driver.

This has led SDG to focus on terminal area as the key driver and we note its benchmarking results in figure 3.10, which shows Gatwick to be lower than Benchmark A, on par with benchmark B and C, and higher than Benchmark D. As an aside, we note that for Benchmark C the data for 2012/13 is not included in Figure 3.10 but is in Figure 3.11 and is suggesting an upward trend in costs. This appears to be an oversight and should be rectified. This benchmarking exercise is fraught with issues:

1) We note an additional benchmark airport has been added since the interim report but no rationale for its inclusion has been provided. We are unsure if this is due to changing the benchmark criteria or whether this is simply new information;

2) There remains an unbalanced assessment of the positioning of Gatwick relative to the other airports. The report fails to understand the reasons why cleaning costs differ between airports and separate actual efficiency from practices aided by a better structural backdrop. For example, managing and coordinating teams over 2 terminals is more problematic than managing teams over one larger terminal;

3) Transparency of the benchmarked airports has not been provided and therefore comparability and suitability of the airports cannot be evaluated e.g. age of infrastructure, geographical location, passenger numbers of the benchmarked airports;

4) We asked SDG to provide further evidence that the metric of 'cleaning cost per square metre of terminal area' is being calculated consistently and on a like-for-like basis between all comparator airports. We have noted SDG's definition of terminal area, but we believe this is open to ambiguity and does not capture a sufficient level of granularity. For example, office space can be vacant or occupied, which drives different cleaning requirements. Also, the responsibility of cleaning office areas cans vary between Gatwick and tenant. An additional consideration is the recovery of a service charge for the cleaning of communal tenanted areas

which is captured under our property revenue. We are unsure if this reduction to cleaning costs has been considered by SDG;

5) A cost benchmark in isolation does not take into account other aspects of value such as cleaning quality and coverage, which is measured by our QSM surveys. This is further evidence of an unbalanced assessment; and

6) The report does not attempt to assess the viability of reducing cost per square metre to the same level as benchmark D. Gatwick has a good understanding of its 'floor' on cleaning costs, which was demonstrated in 2010/11 when such costs were lowered to a level that adversely impacted quality and service levels. Further, since SDG has recognised the effectiveness of our procurement process, it is not clear how it expects us to secure a cheaper cost for cleaning.

While SDG state a strong relationship between cleaning costs and area, we do not then observe any assessment of the impact of the various new capital projects. In particular, we expect the NT IDL project and pier service to deliver significant additional footprint.

We further note SDG's analysis which shows that we may have under provisioned for underlying pension cost increases over the 5 years beyond Q5. Given the re-tendering process that is currently on-going, we note the risk to the projections in the plan. SDG also comment that wage costs should follow a rate of growth consistent with the minimum wage.

We have significant concerns over this assumption for the following reasons:

1) The minimum wage is only published a year in advance by the Department for Business, Innovation and Skills. This government body does not give longer term projections due to the level of economic uncertainty and lack of robust forecasts on which to base future rates;

2) We do not believe historical minimum wage inflation is an adequate justification for future rates, as suggested by SDG. Putting this aside, Q5 saw both sub-RPI increases as well as plus-RPI rises, which again indicates the volatility of minimum wage. If Q4 was considered then this rate would change to be closer to RPI +2%; and

3) Finally, this rate does not take into account the high customer service levels expected of our business partners. All front line personnel need to endorse Gatwick's philosophies, values and passenger charter; in particular 'we'll treat you as our guest'. We are also challenging our business partner to meet a broader and tougher set of KPIs, and increase their scope of work. Additionally, our wage assumption allows for a higher mix of unsocial hours so that cleaning can be carried out at times least disruptive to our passengers.

PRM

SDG state in paragraph 3.195 that PRM growth is likely to taper off at a faster rate than Gatwick's forecast. We would welcome any evidence to support this statement. Gatwick has seen double digit growth over the last two years, and we have assumed the rate of growth to slow to 6% per annum in the period beyond Q5. We believe this is an entirely realistic assumption based on population demographics and greater awareness of this service. Therefore, supporting evidence for their demand assumptions is required for these to be credible.

SDG take a view that wage inflation should reduce to RPI-0.9%. Gatwick does not believe this is appropriate and contradicts Gatwick's strategy of attracting and retaining good quality front line staff. We expect high customer service standards from our external business partners and, just as we have done with our concierge team, we are keen for them to have a salary bandwidth to employ specialist staff e.g. where someone may have a second language. Also, we are concerned that SDG's assumption of sub inflation wage growth has been applied to the entire PRM cost in table 4.6. Although labour rates are a significant part of PRM costs, this cost line also includes equipment and other sundry costs that should rise in line with inflation.

Lastly, we note that any increase or decrease in PRM cost does not have a bearing on the calculation of aeronautical price, due to the cost recovery principles in setting PRM charges (revenue). Any adjustment in this area would require an equal and opposite adjustment in non-aeronautical revenue.

Appendix 10: Gatwick comments on SDG's assessment of maintenance and renewal costs

Introduction

This appendix sets out our response to Steer Davies Gleave's final report on Assessment of maintenance and renewals costs at Gatwick Airport. Like any competitive company we welcome constructive criticism that challenges us to perform better. We are however concerned and disappointed with many aspects of this report commissioned by the CAA. Many of the comments we include in this Appendix have been raised with SDG and the CAA, but have not been addressed and remain valid.

Overall, we are very concerned that the report has given little credence to our best practice and externally certified asset stewardship process. Further, the efficiencies called for are based upon benchmarks that have no credibility or sound evidence.

Factual accuracy

We are concerned that despite engagement this report still contains comments which do not accurately reflect the information gathered by the CAA's consultants. In particular SDG comment in paragraph 5.21:

- 'Legislative changes that have occurred throughout the life of the asset can also mean the operation of the asset becomes uneconomic. We would expect an organisation that has good asset management practices in place to be fully aware of these strategic changes and have incorporated them into their long term strategy.'

This comment is inaccurate: our asset stewardship procedures look at all aspects, including legislative change which we keep fully abreast of. The comment is aimed entirely at the HBS requirement for 2018 (which is then further expanded at paragraph 5.64) and our rationale for that sitting beyond 2019 was explained. As part of our regular asset stewardship reviews this is now being reviewed to establish whether the HBS requirements need to be brought forward to BQ5, reflecting recent views from the DFT.

Sufficiency of the evidence

Further, we note that there are a number of areas where SDG appear to draw ambitious conclusions either without outlining what the basis for the conclusions are, or basing them on information insufficient to substantiate them.

SDG comment in par 4.20:

- 'High level benchmarking of unit cost metrics against other UK airports and foreign airports.'

No information is provided as to which "other UK airports" are benchmarked; without this, it is impossible to know whether or not the benchmarks are valid.

SDG comment in paragraph 4.19:

- '*While we recognise the successful control of costs during Q5+1…… we have relied largely on benchmarks to assess the cost projections for Q6.*'

SDG comment in paragraph 4.30:

- '*Cost comparisons between airports are difficult to obtain……and also the comparison can itself be limited…..*'

SDG comment in paragraph 4.31:

- '*While no airports are identical to Gatwick, and the UK airports…..are necessarily smaller….*'

SDG comment in paragraph 4.47:

- '*…..although those airports do all have simpler operations than Gatwick.*'

We are surprised by this trail of comments given the concerns that we raised about benchmarking in our response to the interim report. The conclusions drawn in terms of efficiency, when based solely on this benchmarking exercise, continue to lack sufficient credible evidence and do not make sense. No comparison of infrastructure has been referenced and, for example, it is not clear whether the European airports are regulated. Comparison on this basis is more likely than not to be spurious.

SDG comment in paragraph 4.29:

- 'The implication is that while Gatwick is planning to control costs at about the level of BEAMA increases, it is anticipating labour cost growth significantly above average wage growth. Given strong procurement processes, we believe it should be possible to contain cost growth, some of which relates to equipment not subject to labour cost pressures, closer to AWE and RPI.'

This assertion about future cost growth is not supported by any evidence at all or substantive reasoning.

SDG comment in paragraph 5.56 and 5.57:

- 'Within the Gatwick procurement system it would appear that there are various opportunities to achieve cost accuracy:
    - Initial costing of the project by the Gatwick cost team is dependent on the level and detail of information available. At this stage, in addition to the project base cost, project on costs, project specifics and risk are also added in as identified above;
    - The project cost allowance built in the Q5 and BQ5 forecasts provide for a +/- 30% cost variation; and

- The tender process generates further cost variation either in the form of savings or increases on the planned budget allowance, depending on the criteria stipulated in the tender process.

On the basis of the information supplied, our concern is that there is room for contingency costs to be "baked into" the system, and once in the system there is a natural tendency to spend or, at least not to challenge, rather than ruthlessly weed out cost that may be unnecessary.'

The approach which Gatwick follows is robust and in line with industry standards; the comment in paragraph 5.59 is "consultant speak" based on a demonstrable lack of evidence.

Contradictory or unbalanced comments:

We are concerned that SDG's report contains a number of contradictory and/or unbalanced comments and conclusions. The mere presence of comments of this nature suggests that SDG are struggling to identify valid and balanced sources of efficiencies and are resorting to "nit-picking" and grasping at straws.

SDG comment in paragraph 5.17:

- 'We were not provided with evidence that the alternative to capital investment, i.e. maintenance improvements, had been investigated. Whether these have been tried in the past and rejected due to increasing operating costs, or that it is impracticable due to obsolescence, is unclear.'

This conclusion does flies in the face of the evidence provided to SDG on the processes in place at Gatwick. It is also contradictory to SDG comments in paragraph 5.13 where it suggests that we are not replacing as many assets as we maybe should. Our asset stewardship process, as certified through PAS55 finds the optimum spot for asset replacement and drives out maintenance possibilities along the process.

SDG Comment in paragraph 5.19:

- Additionally, the focus on critical assets for capital investment can lead to unexpected consequences. It seems that either all assets are currently on a criticality scale or there is a secondary list of assets that may seldom get attention until they become critical. There needs to be a means of identification and investment in 'supporting assets' that while not critical are nevertheless required for effective operations.

This comment is unbalanced and disregards the process we demonstrate through our PAS55 certification. This certification demonstrates that we attribute a suitable criticality assessment to all of our assets. Just because an asset has a criticality assessment it does not make it 'critical'. It simply means that its criticality has been give n suitable consideration to optimise its maintenance or renewal.

SDG comment in paragraph 5.33:

- This consistent percentage split between third party planned and reactive maintenance leads us to believe that the split is arbitrary and for reporting purposes only. If this is the case, it may indicate that supplier reporting systems are not yet sufficiently developed in order that the true split can be identified. As such a true analysis of maintenance strategy efficiency is not possible without better data.

SDG comment in paragraph 5.43:

- *'Overall however, we reiterate that across all the asset groups the underlying evidence from the data supplied by Gatwick is that the maintenance strategies achieve a close to optimal distribution between planned and reactive maintenance.'*

These conclusions are contradictory; we agree with the second comment. As proved by our PAS55 certification, our asset stewardship is close to optimal.

SDG comments, paragraph 5.95 onwards:

Gatwick's benchmark rates emanate from a variety of projects both prior to, and during the economic downturn. This information was provided in detail to the ACC's consultants and a brief summary is provided below:

- We have details on the facility/sub-facility/component benchmark data for 82 internal Gatwick/BAA projects, for which we have information broken down into the following facilities:
  - Piers (New and Refurb.) – 14 Projects (2004-13);
  - Terminals (New and Refurb.) – 24 Projects (2000-12);
  - Airfield -17 Projects (2005-12);
  - Landside Infrastructure – 14 Projects (2004 – 2012);
  - Ancillary – 8 Projects (2001-2010); and
  - Baggage – 5 Projects (2004-2012).

The above list shows that our data sample range covers over a 12 year period from 2001 to 2013, (i.e. a period including, before, during and after the construction boom).

In regard to the un-scoped works comment, we would like to remind the CAA and their consultants that these projects are at a Tollgate 2 stage of information – which means the brief has been confirmed and we are yet to progress to considering options. It is unrealistic to suggest that all items would be fully scoped at this stage of development, particularly bearing in mind that some of these works are 5-6 years away from being required.

The next item relates to the recording of project specifics. Below we repeat the response given to the ACC:

- The main contractor prelims have been included in all benchmarked rates at a facility/sub-facility level. However, we can confirm that there is no double counting of preliminary costs within the benchmark data.

- Within our benchmarking methodology, all items that were "specific" to a project due to factors which are particular to that project (for example, asbestos removal) were excluded from the benchmark data, rather than "included elsewhere" as suggested above. By taking this approach, all the projects could then be compared on a like for like basis, without having the specifics of one project skewing the data set.

Gatwick does not believe that the on-costs we have applied are too high. Gatwick's approach to assessing on costs is for each project to be assessed individually with the aim of providing a project team that is sized appropriately to manage the contract and design activities. Accordingly the on costs percentage will vary on a project by project basis and a general application of on cost percentage cannot be made. We continually review the on costs attributable to projects to ensure that efficiency and value is delivered. Our assessment takes cognisance of a number of airport related factors including the delivery of projects within a 24 hour 365 day environment and the continuously changing demands and requirements of our customers. There can be no direct comparison made between Gatwick and other airport or non-airport projects.

We have invested significantly in our staff delivering cost positive strategies which have reduced our overheads by £7m, delivered £20m of procurement savings and up to £100m capex efficiency savings. Our processes have now achieved ISO 9001, ISO14001, PAS55 and CIPS Certification which is significantly higher than our peers have achieved. The two main systems that we have developed are Building Information Modelling (BIM) and Documentum. Currently we have 14 live projects totalling in excess of £300m in BIM that delivers cost efficiencies on these projects, but this technology will also deliver efficiencies in all future projects. The Documentum system is currently being used on all projects and handles in excess of 3,400 transactions each week, delivering efficiencies on a daily basis.

Our approach to applying the risk allowance is detailed in our procedures. While we follow the guidance afforded by the methodology, each project is considered individually. Our cost estimating methodology adds a 20% risk allowance to class 5 estimates at tollgate zero, unless a specific project warrants a reduced risk percentage of 10-15%, due to its scope and methodology of construction delivery. There are a number of projects to which this applies.

Three projects have a risk allocation of 0%, as the estimates for these projects are only notional contingency allowances and it would be inappropriate to add a risk percentage until the scope is developed further and class 5 estimates can be prepared.

Again, we would emphasise that you cannot compare working at the airport 24/7, 365 days a year live operational environment with non-airport sectors. Indeed Gatwick with its constrained location, so that the vast majority of projects are taking place within the live operation, is particularly non-comparable with a construction site which is merely brownfield.

The methodology outlined in paragraph 5.99 and 5.100 is flawed. While the work being carried out may not be airport specific equipment such as baggage systems; the environment is an airport which inherently adds to the complexity of trying to carry out works in a live environment with the on costs and risks associated with that work. The conclusions of this work detailed in Table 9 are therefore not based on sound methodology.

The further conclusions drawn by SDG to reach the 'super stretch' savings targets are also questionable, as they rely on the argument that at this early stage of development all costs should be based on a greater level of detail which is just not available so far in advance.

We are disappointed that the core and 'super stretch' savings identified by SDG are based on flawed methodology and a misunderstanding of the timescales for the process that the regulatory cycle imposes on Gatwick.

SDG comment in paragraph 5.13:

- 'The initial size of the works portfolio was indicated as significantly larger than available budgets and shows that a number of projects may well be 'stacked' in the prioritisation process. The number and scope of these works needs further investigation as it was suggested by Gatwick that investment programmes over recent years have not been sufficient to deal with the accumulation of smaller works.'

This is an unbalanced comment based on the evidence. The reasoning does not accurately reflect the conversations held between Gatwick staff and SDG, or give enough credence to the rigour of our PAS55 certified asset stewardship process. The point made was that we do not over inflate the asset stewardship requirements on an annual basis and very much 'sweat the assets'. Clearly, if there was more money available we could easily identify the next worst assets to be replaced. At no time, however, would an unsafe or low performance asset be allowed to continue in use. This is demonstrated for example by our good performance in service quality metrics.

SDG comment in paragraph 5.29:

- '*While we agree with the reasoning and endorse the drive to save operational costs and reduce CO2 emissions we have been provided with only minimal information on need and condition of the assets. Typical examples of asset condition assessment are shown in 5.27, however we have not been provided with specific condition assessments of the asset renewal items scheduled for Q6.*'

This is unbalanced comment that does not reflect the rigour that we have demonstrated in our PAS55 approach to asset stewardship.

Overall we are very disappointed that so little credence is assigned to industry certifications such as PAS55 which demonstrate the rigor with which we undertake work.

Taking note of comments:

Finally there are a number of areas where relevant information has been provided by Gatwick, but SDG has failed to take this information into account.

SDG comment in paragraph 2.7:

- 'We requested information going back to 2005/06, but this was not provided by Gatwick management.'

This comment gives an inaccurate impression. It has not taken into account the response we provided to the interim report where we stated – *"It is clear that management systems and asset stewardship maintenance tracking was not as robust under previous ownership. Such information as we have has been forwarded as we are keen to demonstrate how robust our processes are now. The lack of previous clarity underlines just how much progress has been made since the transfer of ownership in 2009."* It is evident that we provided as much information as we had and the comment made by SDG suggests that we were in some way unwilling to provide information and this is simply not the case. SDG should consider that the sale of Gatwick and separation from BAA was operationally more complex than a simple transfer of ownership, requiring functions to be established a new which were previously handled centrally within BAA. This should be expected and acknowledged and not miss-represented as an attempt by Gatwick to withhold information.

SDG comment in paragraph 5.20:

- 'In reviewing preventative and reactive maintenance where some assets are left to be reactive maintenance, we are unclear as to the rationale, but may be due to the lack of criticality or not being subject to the to the SQR scheme. The maintenance of these assets may be generating additional resource demands that point to operational efficiencies in the future.'

This conclusion does not reflect accurately the explanations given of the rationale behind the reactive/planned split across the asset groups. Those with lower criticality and performance requirements had higher reactive maintenance to ensure cost efficiency.

SDG comment in paragraph 5.35:

- *'However, there are areas that require greater consideration in order to yield potential efficiencies including those highlighted, electrical, building fabric and electronics, each of which exhibits a reactive maintenance level well in excess of the planned maintenance level.'*

This conclusion does not reflect accurately the explanations given of the rationale behind the reactive/planned split across the asset groups. Those with lower criticality and performance requirements had higher reactive maintenance to ensure cost efficiency. Electrical, building fabric and electronics were the very examples given where it was more cost effective to 'run to fail' (i.e. carry out reactive maintenance) on these assets.

Appendix 11: Gatwick comments on SDG's assessment of commercial revenues

Summary of key points

Retail

We have noted that SDG have taken on board many of Gatwick's retail comments from the interim report. However, we are concerned that some key items remain unchanged in the retail projections. We also remain cautious of the revenue benchmarking where comparable airports are judged on size alone. Other factors that need to be considered include traffic mix and whether the other airports are the 'number two' airport for their locality.

Further, the optimistic assessment of underlying economic activity in the UK and in the Eurozone painted by both SDG and Javelin simply does not hold water. It is not appropriate to consider airports to be immune from these drivers, especially an airport like Gatwick, which is more geared to discretionary spend from leisure travellers.

This section starts by responding to the assessment of the market drivers of retail performance, and then discusses the key themes of retail space and concession margins. Category specific points are then addressed, and we have included our comments on Javelin's assessment in Appendix A.

Market drivers of recent Retail performance

- 3.4 SDG make the point that "Europe has traditionally been the strongest geographical market for duty free and tax free". They do recognise that Asian sales "have grown out of all proportion to the many airport developments and the rapid development of its huge emerging middle class".

It is important to recognise that Gatwick serves more European destinations than any other airport in the UK. Many of the destinations that Gatwick serves are at the centre of the European economic downturn. While Gatwick is actively marketing opportunities to carriers from Asia our current proportion of high spending Asian traffic is low which limits our opportunity to benefit from growth in the Asian passenger market.

- 3.6 SDG note that many the market challenges mentioned in 3.5 are not new, and have been present during Q5.

Gatwick would also add that these challenges remain very real and challenging even though they have been around a while. Many of the casualties on the high street have succumbed to issues which have been around since 2008/09.

Gatwick also notes that the Eurozone crisis was not foreseen when Q5 was set in early 2008.

- 3.6 SDG makes the assumption that Gatwick is able to "deal quickly and effectively with any on-going trading problems, including termination of contracts".

Gatwick has and will continue to adopt a performance management culture with our retail partners. However, it is not always straightforward to terminate contracts, as often high unamortised capital would need to be repaid. In the current economic climate concessionaires are looking for greater level of certainty, and therefore a more flexible approach cannot be assumed.

- Table 3.2 of SDG's analysis shows a marked real decline in income per passenger from 2008/09 to 2011/12.

In table 3.5 SDG agree with the Javelin statement that spend per passenger has continued to grow strongly in Q5 even though this contradicts their analysis in table 3.2. This statement is mentioned again in paragraph 3.38 in the Javelin analysis.

- 3.14 SDG suggests that Landside specialist shops have been reduced in order to encourage passengers to go through security instead of waiting landside.

We have reduced landside retail (particularly in the ST) in order to facilitate improvements to security (and therefore created Europe's best security experience); however it is our view that there is not a big demand for landside retail apart from some key basic service offers, CTN, Pharmacy, Food and Groceries and a F&B offer. We do not see a big opportunity to grow revenues in landside retail and it is more likely that we will further consolidate stores in the NT during the business plan period. SDG have now agreed with our analysis and have accepted our landside income forecasts.

<u>Retail Space</u>

3.48-3.51

- SDG suggest that Gatwick could grow airside space by a further 3000 sq. metres relative to that which is already planned. This is based on achieving retail space of 1000 sq. metres per million passengers rather than the planned number of 865 sq. metres. As a result SDG suggest that with a mix of additional catering, retail and duty free space Gatwick could achieve additional retail income of £16.4m per annum.

There has been a lot of detailed work carried out in formulating the development plans for the North and South Terminal for the period to 2018/19 throughout the last year. Gatwick has developed a set of space standards following a review undertaken looking at the position under BAA ownership, benchmarking against other airports and external businesses e.g. Westfield, West London. We have also cross referenced Gatwick's own data in propensity to spend in each terminal and area. We have reviewed the different demands of catering space and retail space along with the need to ensure appropriate circulation and seating in a drive to ensure that the overall passenger experience will support our aim to compete to become London's airport of choice. In short, our planned retail space is based on thorough analysis.

In addition throughout the Constructive Engagement process with our Airline colleagues we have been transparent in the different options we have considered when looking at Terminal expansion. The current business case for the NT is based on a project with a capital spend of £90m compared to the initial business case of £157m. This now delivers a price neutral position within the period beyond Q5 to 2018/19, and a strong rate of return throughout the life of the asset.

The projects planned within the BQ5 period have been carefully developed to achieve the right balance of:

- Delivering the best customer experience;
- The optimum use of capital spend; and
- Delivering commercial return on investment.

It is also true that the regulatory process may hinder our ability to react to business requirements i.e. the timing of retail deliverables may not always be beneficial within the regulatory period, but they may still be projects that deliver a strong rate of return.

Our plans beyond 2018/19 in South Terminal, however, do envisage further expansion of retail areas of c.3,400 sq. metres. Some of this investment is required during the period to 2018/19, in order to ensure it will open at a time that is necessary to meet space standards and optimise revenue generation.

3.52

- SDG suggest through analysis shown in Table 3.9 that Gatwick should reduce catering space by 1% with a corresponding increase to Duty Free space. They believe that additional space of 258 sq. metres to Duty Free could deliver additional revenue of £1.6m per annum.

There are several factors that we need to take into account when considering this suggestion. Firstly we know that Gatwick significantly overtrades at certain times in the North Terminal in catering. This is due to the nature of intraday and seasonal peaks. We know from our research that customers require a quality catering offer and there is a trend given the strength of low cost carriers in Gatwick for passengers to enjoy meals/drinks prior to boarding their flight. Therefore reducing catering space could adversely affect the passenger experience.

The other factor that could impact the decision is that much of our catering is on mezzanine levels and may not be effective space to use for an element of duty free stores. One of the key issues is that duty free as a category works well when it has real critical mass hence the move towards walkthrough/larger scale stores. It is unlikely therefore that this suggestion would be viable in practical terms or that it would deliver the incremental income of £1.6m per annum.

Concession Margins

3.60, 3.77-3.79, 3.108

- SDG summarise that Gatwick can achieve some improvement in Specialist Shops margins during BQ5 from the introduction of more premium brands and would expect this to increase by +1% above the revised business plan assumptions, phased in evenly over the course of BQ5 at +0.2% per annum.

Gatwick would challenge the assumption that we can gain a further +1% in margin from Specialist Shops. SDG have provided no rationale or justification that speciality shop margin could improve by +1% while at the same time highlighting the point made about electrical stores being included in this category, which has an adverse impact on the blended margin. The specialist shop regulatory definition includes Dixons which lowers the weighted average margin %:

- ✂;
- ✂; and
- ✂.

It is important to ensure that assumptions on higher margins delivering upside for specialist shop margin take full account of this.

Another risk to airport business generally may become more apparent as the economic climate drives changing deals on UK high streets. Gatwick has recently had a prospective new retail partner withdraw from a new store proposition on-airport as they have been able to find space available on the high street that delivers a stronger commercial proposition. The reason for this is that landlords externally are becoming increasingly willing to give significant incentives to ensure their properties are occupied. These include:

- Rent Free periods;
- Capital Contributions; and
- No Minimum Guarantees.

While sales densities will not be as strong as on the airport the costs and risks are significantly lower. This could see more retailers reviewing their strategy and the deals that they are prepared to enter into with Gatwick. This is a developing downside risk, reflecting the continued deterioration on the high street, which is not accounted for in the Business Plan.

The ST IDL redevelopment, which is currently underway, as well as the ST and NT IDL capacity projects, will introduce more premium stores at higher margins. When considering the additional margins from these new stores, the average margin will rise in excess of 2% points. Layering another 1% point by 2018/19 on top of these margins is unrealistic and Gatwick has not been in any commercial discussions to date with prospective brands that would reap margins of this magnitude.

3.61/62/63

- SDG suggest that there may be an opportunity to deliver an increase in margin by the offer of contract extensions; however they also recognise a risk in minimising airport flexibility and a potential for increased costs if exit is forced further down the line. They suggest that Gatwick could increase WDF rental % by 1% for the whole of the period, and that if we fail to achieve that, 'in practice this may be delivered through a combination of deals with other operators'.

Gatwick believes that building in income upside to our forecasts on the basis of a hypothetical and highly risky proposal such as this is unacceptable. ✂

✂

Offering a contract extension now may have the potential to drive an increase in margin but it is important that we do not take a short or medium term view now that could damage our future ability to create real value through a competitive tender for the Duty Free business. It is definitely inappropriate to build any upside into the business plan on this assumption.

Further, the idea that, if we fail to achieve this extra WDF margin we should find some other way of filling this spurious gap, is not credible. SDG must provide evidence that such a strategy is deliverable in practice.

Duty Free

3.65

- SDG state that the sales in the new walkthrough duty free store as well as future plans for the North Terminal will enhance current duty free performance

The South Terminal store was only opened towards the end of July 2012 and has not yet traded for a full year; as such we see the performance as an emerging situation. Currently the store is on target to meet the business plan sales targets for this project but we do not expect to exceed expectations. These targets are included in our business plan. It is also true that as the sales mix changes Gatwick may receive different income levels dependent on category margin. The South Terminal is seeing a stronger level of growth in luxury and food categories that are lower margin compared to tobacco, liquor and beauty. It is possible that the increase in income from the project may not keep pace with the sales increase due to this change in mix of sales.

Impact of Tobacco Display Act

3.66-3.76

- SDG suggest that the decline in tobacco sales associated with the tobacco display act is likely to -12% to - 20%. SDG also suggest in their review of the Javelin report that they would expect management to seek to develop strategies to offset the effects on revenues of the Act.

The Gatwick view of the likely decline in tobacco sales is discussed in Gatwick's Javelin response in Appendix A but we maintain our stance that we could see a 50% drop in income. SDG refer to how Birmingham and Dublin are performing now and Gatwick is referring to likely performance in 2015. Given the current drive to reduce smoking there can be no assumption that the decline will not continue to trend between 12 -20% down on the year for the next 2 years. Therefore the Gatwick estimate is not unreasonable. This view is supported by WDFG and the UK Travel Retail Forum. Even in the event that we can increase space to other categories there is no guarantee that these sales will compensate for the high margin on tobacco products. In addition it may mean that overall sales densities in the extended categories reduce meaning that income per square metre declines. There can be no confidence in any mitigating income number were they to be built into the business plan.

It is also true to say that the greatest level of decline in smoking is among managerial and professional workers. Evidence from the UK Cancer Research website shows that the majority of the decline in smoking in in the ABC1 demographic, which represents 80% of Gatwick's passengers. Gatwick will be disproportionately affected by this trend.

Bookshops

3.80 -3.82

- The SDG assumption is that the demands of the operator's shareholders will lead to an income per passenger that is at least maintained throughout BQ5 from the 2013/14 forecast of £0.29 per passenger.

Comments on the performance of WH Smith have been made earlier in this report and we work very closely with their senior management team to mitigate risk in fundamental changes to customer behaviour and spending patterns. Like for Like performance in this category is in decline, and we believe it is unrealistic and over simplistic to assume that income per passenger can be maintained in RPI terms throughout BQ5 at the 2013/14 forecast of £0.29 per passenger.

There is no evidence based assessment of the assumption that income per passenger can be maintained. Although SDG have spoken to WHSmith management who are positive about the prospects of the business there is no detail on how they intend to mitigate the challenges for this category. It is not surprising that WHSmith senior management team would want to talk with confidence about their business. Our task in the Business Plan is to produce a realistic assessment which takes account also of demonstrable trends in the market.

In addition this is a category where we do not believe it would be possible to maintain income per passenger due to bookshop sales increasing in line with CPI when we are indexed to 13/14 prices using RPI. This alone accounts for £0.02 of the £0.05 decrease in real terms that we have in our plan to 2018/19, from a 2013/14 base.

Bureaux de Change

3.83-3.87

- The SDG report is supportive of the Gatwick strategy to move the Bureaux de Change business to a single operator while recognising that it is expected that Moneycorp will trade on minimum guarantees that are reflected in the Revised Business Plan.

We are attempting to adopt a more innovative approach to the foreign exchange business and are looking to try and compete with the high street and on line business as well the trend towards use of ATMs overseas. Income from the new contract with Moneycorp is recognised within the latest business plan ✂. As technology such a “mobile wallet” develops, there is likely to be further risk to penetration in the on airport foreign exchange business. Any new contract post 2017/18 will have to therefore reflect this declining base and a lower starting point in 2018/19 when the old Moneycorp contract expires.

Catering

3.88 -3.90

- Based on their review SDG agree with the forecasts made in the Revised Business Plan.

The above statement is a contradiction to a point on Page 30 of the report (3.57) that suggests that there may be margin development from individual units within the catering category as contracts end, particularly in North terminal where margins are forecast to decline from 2012/13. Any upside in margin is already built into our business plan assumption. In table 3.12 showing the SDG view of income assumptions on catering they are suggesting £500k additional opportunity on margin which is something that Gatwick would reject as being without any real substance. It is also possible that we may see further challenge on catering margin as current trends suggest consumers will demand better quality food while pricing will need to remain sharp for outlets to remain competitive. Again, the Gatwick demographic makes us more susceptible to such trends.

Landside Shops

3.91-92

- Based on their review SDG agree with the forecasts made in the Revised Business Plan forecast

There is a risk to this statement in that we are seeing decline in demand for the landside offer throughout the airport. In particular the landside space in the NT does not achieve a strong income density and it is not viewed as a good opportunity by the retail partners. A targeted offer is important to delivering CTN, Pharmacy, Food and Groceries and a F&B offer. We do not see a big opportunity to grow revenues in landside retail and it is more likely that we will further consolidate stores in the NT during the business plan period in order to facilitate operational improvements.

Advertising

3.93-3.107

- SDG have compared Gatwick advertising revenue of £0.15 with the European and Global airport averages using the ACRS benchmarks, these are £0.26 and £0.21 respectively. They have also looked at selected airports in Europe which suggest that advertising income at Gatwick could conceivably reach levels of circa £0.30 - £0.40 per passenger. SDG recognise that the Outdoor advertising sector has been a challenging market between 2008 and 2011 and recognise the risks associated with the development of this business. They do suggest that there is an opportunity to grow income in sponsorship by £300k per annum from 2015/16 but recognise that this is only likely to mitigate the risk associated with ✂

Our view is that for a truly viable comparison of this sort, Gatwick should only be benchmarked against other airports which occupy a place behind a larger airport serving the same city. Single airports in major cities with strong business traffic makes achieving the benchmark of £0.30-£0.40 per passenger very difficult for a second airport like Gatwick.

In addition, at this relatively early stage of Gatwick's rebirth after the acquisition by GIP, this comparison ignores the advances and progress Gatwick has made from where it was to where it is now. The "second-class citizen" status it suffered under BAA's ownership is a thing of the past and its identity as a major transport asset in its own right has improved dramatically. The Gatwick/EYE partnership has delivered a healthy year on year income increase in line with business plan and is developing plans for further progress. Nevertheless, for the present Gatwick in advertisers' eyes comes behind Heathrow and that has a constraining impact on advertising revenues.

✂

Gatwick is projecting income per passenger growth in excess of 50% over the 5 year forecast period. SDG conclude that this projection will place the airport in line with the global average and converge towards the European airports average. Based on these conclusions and the considerable risk already inherent in our projection, we see no evidence for layering further stretch onto these numbers.

Car Parks

Overall the report endorses our car park strategy and approach to yield management. The main challenge we have to the report is that it states in paragraph 4.33 that "we consider that there is opportunity to outperform the Revised Business Plan revenue forecasts for car parking", going on to state in paragraph 4.37 that this can be achieved through:

- "*taking into account seasonality to improve yield*" in long-stay pre-book products (£750k net p.a.);
- "*assuming greater third party distribution of all products and advertising/marketing of airport parking to support the products and car parking strategy*" (cost £150k p.a.); and
- "*Incremental revenue in short-stay car parks from enforcement of forecourt pick-up activity into the car parks from 2014/15*" (£750k - £800k p.a.).

We do not believe there are any grounds at all to justify the first two of these statements, and while there is an argument for the third, we believe the amount quoted is optimistic, and does not reflect the risk of the project involved.

Paragraph 4.38 also proposes the "introduction of a forecourt drop-off charge", assessing the revenue benefit of this at £6m p.a. This is contrary to our current strategy, does not appear to be feasible given the layout of our forecourts, and cannot be considered in isolation from the impact on passenger numbers and consequent impact on aero and non-aero revenue streams. It would represent a fundamental change in approach to our passengers to which Gatwick is opposed, not least given the likely adverse impact on our competitive positioning.

Lastly we would note that the Q5 performance was up to 10% below the Q5 settlement, reflecting the risk of over-optimistic assumptions being made on revenue projections going forward.

Considering each point in turn in more detail:

<u>Pre-book long-stay parking</u>.

The report states in paragraph 4.23 that "we believe there is opportunity to increase yield particularly during peak periods on the basis the Gatwick Airport have always been price leaders in the local market". In paragraph 4.37 it then goes on to state that "increases in long-stay pricing for pre-booked products taking into account seasonality to improve yield" could support the achievement of stretch targets.

In summary, we do not agree with the assessment that there is a potential revenue upside from doing this, as we follow precisely this strategy today.

Our pre-book pricing strategy in peak periods is to increase long-stay prices as far as the market and competitive reaction will bear. Whether or not to raise prices or keep them static in a highly competitive market is always a judgement call, and we are constantly reviewing our decision making process in order to optimise this as efficiently as possible; however to suggest as the report does that there is simply extra revenue that can easily be unlocked through raising prices is wishful thinking, and does not reflect the reality of the price transparent, competitive market we are in.

The report also makes the mistake of assuming that, as we are the operator with the largest capacity in the Gatwick market, this equates to our being able to lead on price. This is only true if we wish to reduce price; in most cases our competitors will respond to this. However if we raise prices, unless competitors are confident that they will operate to near capacity they will not respond to these price increases, and in most cases demand will drop and the overall revenue impact to us will be negative. There are a small number of occasions where for certain products (in particular Short-Stay and Valet North Terminal) at peak periods we can raise prices independently of the 'market' rate, as demand is sufficiently strong, but in most other cases doing this would be revenue negative.

<u>Third Party Distribution</u>

We note that since the draft report SDG have spoken to APH and Holiday Extras, and assume that these conversations have informed the comments in the final report. However, SDG's conclusions are not soundly based.

The report states in paragraph 4.36 that "Gatwick Airport does not however appear to be working collaboratively with its key booking consolidators, driven by a need to drive down third party commissions and concentrate on developing its own routes to market. If this relationship could be improved it might enable further growth in the business, particularly during peak periods".

✂

✂

The report is correct in stating that we are concentrating on developing our own direct channel. In the 11 months to February 2013 have increased revenue through this channel by ✂ (in essentially a flat passenger market). This contrasts with sales through consolidation channel of ✂and a decline in roll-up revenue of ✂.

Advertising and Marketing

The comments in the draft report suggested that incremental revenue could be generated through above the line advertising of car parks. This appears now to have been modified to state that the greater advertising / marketing of on-airport parking would support the improved revenue from long-stay pricing in paragraph 4.37.

Our marketing budget for 13/14 is ✂, of which ✂ is dedicated to paid search media costs. While this is accounted for as a traditional budget, it is managed as a cost of sale; in other words if we took the view that increased marketing spend would generate incremental revenue at an acceptable cost of sale, we would fund this regardless of nominal budgetary constraints.

We do not spend money on above the line marketing, as when we have done this in the past, we have not been able to identify any return on investment.

Incremental revenue in short-stay car parks through enforcement of forecourt pick-up activity into the car parks from 2014/15 (about £750 - £800k p.a.)

Incremental net revenue of £800k p.a. means that approximately 1750 cars per day currently picking up on the forecourt will in future switch to using the short-stay car parks. If we assume this traffic is concentrated in 8 peak hours per day, this equates to approximately 200 incremental cars per hour using the short-stay car parks. This seems completely unrealistic, considering both the difficulties in enforcing a 'no pick-up' rule on the forecourts, and the alternatives to parking in the short-stay car parks.

While we recognise that there should be some upside resulting from improved forecourt enforcement, we do not think that the figure quoted is at all realistic. Our business plan assumed that there would be a small, non-material, upside, and did not represent this separately from overall short-stay roll-up revenue. For context, short-stay roll-up revenue will end this financial year down (5%), or (£570k) on the prior year.

Incremental revenue from the car parking licencing scheme, equivalent to £0.7 - £1.2 million per annum

While we agree there should be income upside from the licencing scheme, SDG's forecasts are too optimistic. Our assumptions on the licence scheme (that have been consulted on) are presented below, which show SDG's assumption to be unfeasible:

✂

Forecourt drop-off charge

The report states in paragraph 4.38 that £6m p.a. income could be generated through the introduction of a forecourt drop-off charge, although it is not reflected in the "core" stretch targets in table 4.4.

At the present time the strategy for the airport is to continue to offer free drop-off on the forecourt, and there are currently no plans in place to change this. This is for both customer service reasons, and also that it is not evident that charging for forecourt access would be feasible given space constraints and the necessity to reduce, not increase, forecourt congestion. Putting to one side the feasibility issue, if the decision was made to charge for drop-offs, this would impact the numbers of passengers choosing to fly from Gatwick, with the consequent reduction in aero and non-aero revenues. It is clearly not valid to consider an income upside in isolation of this.

Other comments:

4.3

- We would note that the Q5 performance has significantly underperformed the settlement on an income per passenger basis, as well as on an absolute revenue basis;

4.15

- The report states that we compete in the main with 3 off-airport competitors, APH, Airparks and Maple Manor. While these may be the largest off-airport operators, this rather understates the reality which is that there are over 50 competitor operators at Gatwick, a number of which are significant in size; and

- The report states that in the last 2 years we have elected to be competitive with our long –stay pricing, and that this "may have suppressed income growth". This is misleading. We have elected to be competitive with our long-stay pricing purely in order to optimise revenue, not as an objective in its own right. While all pricing is a matter of judgement, we do not in any way choose to sub-optimise revenue for a broader objective of keeping pricing competitive.

4.16

- This states that while there has been significant growth from seasonal off-airport meet and greet operators, they remain small in terms of spaces occupied and are poorly distributed. This ignores the impact on market price from these operators, in the sense that the marginal operators in a market are generally the lowest priced, which impacts the price of the larger competitors above them, and so on up the chain. So while we do not consciously compete on price against the smaller marginal operators, the capacity they bring to the market and the impact that has on price is felt by all operators including us.

4.17/4.18

- As this correctly states, we have removed the requirement for additional capacity from our revised business plan. It is not quite right however to say that this is "*based on our belief that there will be significant growth in capacity off airport to meet demand during Q6*". Rather it is that the growth in off-airport capacity will impact achievable yields during BQ5, meaning that it is difficult to deliver a positive NPV project.

4.22

- Any example price comparisons have to be treated with caution, as we price for multiple products, entry dates, and lengths of stay, and prices are constantly changing. ✂

4.24

- Again, the report quotes a price for the Whitsun holiday, and claims we are only £0.71 more expensive than Airparks and £4.36 cheaper than APH. At the time of writing our long-stay south terminal price for this period is £56.08, which is £6.09 more expensive than Airparks (£49.99) and £10.15 more expensive than APH (£45.93). It is hard to comment on the prices quoted in paragraph 4.24 as no detail is given and we do not have access to historical price points for competitors; ✂ Any examples of us being priced below APH would be outliers, and not in any way reflective of the price differentials normally present in the market.

4.29

- We do not recognise where the £2 charge quoted comes from.

Real Estate

SDG's final report agree with Gatwick that market conditions do not support increased rents, and that it would be counter-intuitive to impose index-linking where the aviation community would bear the increase in costs (Gatwick has planning restriction in place that limit us to renting property only for aviation related purposes)

5.14

- SDG believe that there are a number of opportunities for Gatwick to improve the property revenues. Concorde House – SDG suggest that an assumption around the letting of Concorde should be added. They allowed for a 12month refurbishment commencing in Summer 2014, and then a subsequent 12 month letting period with a phased occupation of the 45,000 sq. ft. Gatwick maintain that the letting of this space in BQ5 is unrealistic for the following reasons:

1) The UK economic position is unlikely to change in the near future.

2) Change in airline mix resulting in smaller property requirements for airlines operating at Gatwick.

3) The aviation related restriction preventing Gatwick from letting to a wider market place.

4) Significant competition with Crawley. Crawley currently has in excess of 700,000 sq. ft. of void office accommodation equating to over five years supply. Grade A rents are circa £23 per sq. ft. with significant capital contributions and rent free periods offered.

Even if these issues could be overcome it would be unlikely that the suggested levels of occupations could be achieved. SDG recognize the change of airline requirements, typically new start-up airlines at Gatwick will take somewhere between 400 – 1,000 sq. ft. Existing airlines are consolidating to achieve efficiencies, ✂. As a result of the consolidation of statutory bodies there are further reductions occurring across the portfolio of circa 20%.

In addition Concorde does not lend itself to small lettings of sub 700 sq. ft. Recent experience shows that suites in excess of 700 sq. ft. are not in demand.

Gatwick do not agree with the proposed recommendation of SDG for the above reasons.

Ramp – SDG suggest that additional ramp accommodation of 10,000 sq. ft. could be let over the BQ5 period in Pier 5 and Pier 6. Within the Pier 6 business plan it has been assumed that an additional letting of 1,500 sq.ft. will be achieved. Gatwick do not believe that any additional ramp accommodation could be let for the following reasons:

1) Change in airline mix resulting in smaller property requirements for airlines operating at Gatwick.

2) The restricted market relating to airside operations.

The letting assumption of 10,000 sq. ft. represents a 10% letting of the total ramp space over BQ5 period. The trend over the previous four years show circa 20,000 sq. ft. being occupied and 33,000 being vacated leaving a net loss of 13,000 sq. ft. in the period. Within the Gatwick business plan we have assumed no vacations. There is therefore a real risk that ground handlers and airlines will want to consolidate further and as a result we will see a higher level of vacations.

Gatwick does not agree with the proposed recommendation of SDG.

Hotels – SDG have suggested that an additional turn over element for the hotels could be achieved. Although both Hotel contracts allow for a turn over element ✂the hotel operations will be new to the market and will take some time to build up their business. In addition the new operations are competing with established hotel operations at Gatwick without significant passenger increases. As a consequence additional income in the first years of operation is unlikely.

Ad hoc contractor's accommodation – Within the base business plan, there is an assumption that existing lettings to contractors remain. It is unlikely given the nature of projects over the BQ5 period than any significant additional contractor lettings will be achieved over those already in the plan.

Finally we note that SDG converted the property income to a per passenger basis (table 6.1). As passenger numbers are not yet agreed we are concerned that an arbitrary figure will be applied to property income. As property income is not volume driven, increases in passenger numbers do not necessarily equal an increase in space requirements and income.

Appendix 12: Traffic – new SH&E forecast

Attached overleaf

ICF SH&E
an ICF International Company

2013 Traffic Forecasts

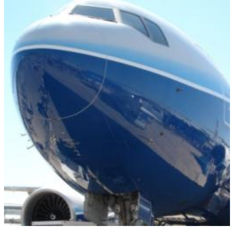
An update

Prepared for:

Gatwick Airport Limited

May 2013

Contents



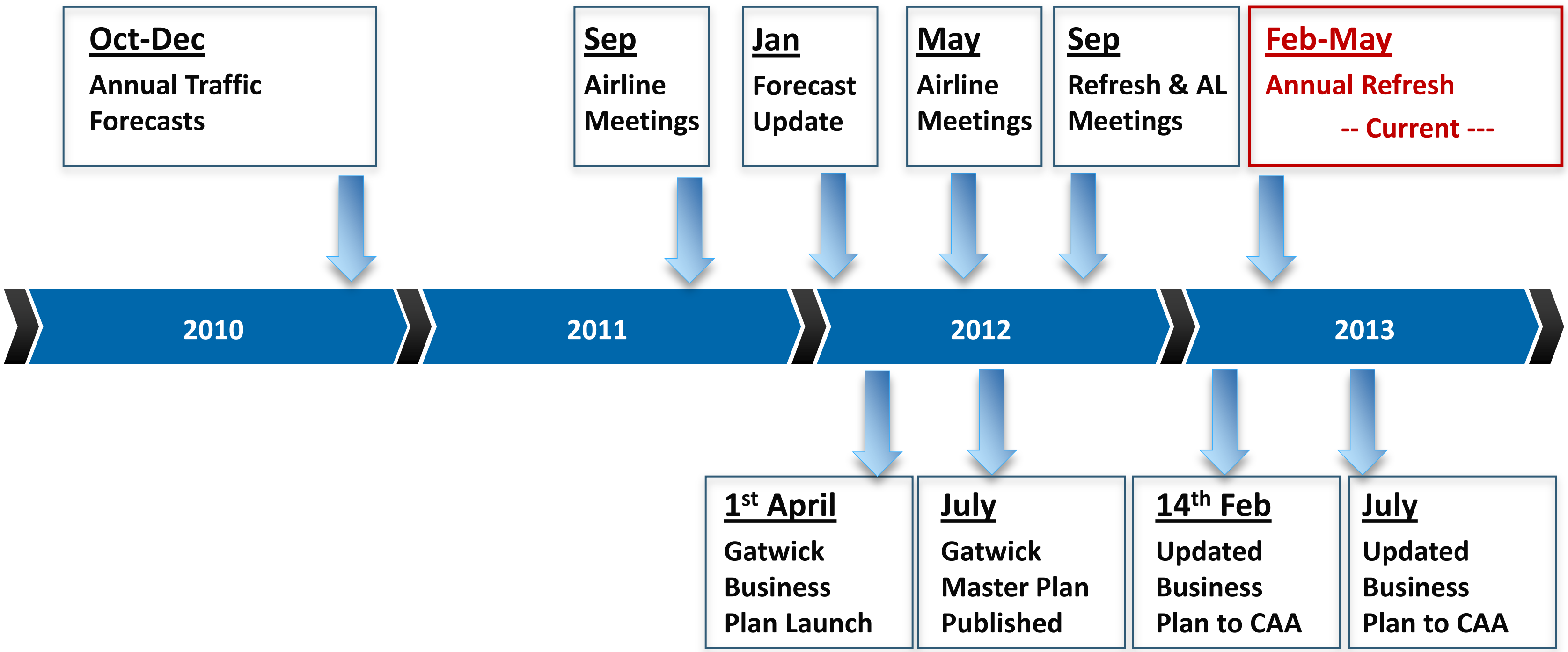
SECTION 1

Context and Purpose

Why Update?

Background and Context

- ICF SH&E has been working with GAL since late 2010 on traffic forecasting, and other strategic topics. These forecasts have been used to inform Gatwick's Master Plan, Business Plan, airline consultation discussions and regulatory submissions



- In line with forecasts produced to date, and the GAL Business Plan, the following forecasts are based on Gatwick Airport operating a single runway throughout the period

- The following forecasts are intended primarily for GAL's internal use but may also be shared with GAL's airline customers, the CAA, and any other relevant stakeholders, subject to prior discussion and agreement with ICF SH&E

Updating Forecasts is Best Practice

- All forecasts should be updated regularly. Market conditions change, and despite people's best efforts and best information, unforeseen events can lead to significantly different outcomes than expected, even a few months previously.
- Revisions may be positive or negative, depending on how conditions and outlook have changed since forecasts were previously prepared
- The frequency of updates is determined by the nature of the forecast and its purpose. Detailed airport forecasts of security staff requirements may be updated weekly as actual flying schedules are confirmed, airlines may update their forecasts once a quarter for revenue planning but daily for crew resource planning.
- Long term forecasts tend to be updated once a year on average, but may be updated more or less frequently depending on specific circumstances.
- In the US, the FAA, in the UK, the Department for Transport typically produces national forecasts every 1-2 years, and the aircraft manufacturers also publish long term forecasts once a year.

"European Markets In Positive Territory As BoE Lifts GDP Forecast"
RTT news, 15 May 2013

"EasyJet raises year-end profit forecast"
ATW, 3 October 2012

"IATA revises forecast – Big Downside Risks on Weak Profitability"
IATA, 11 June 2012

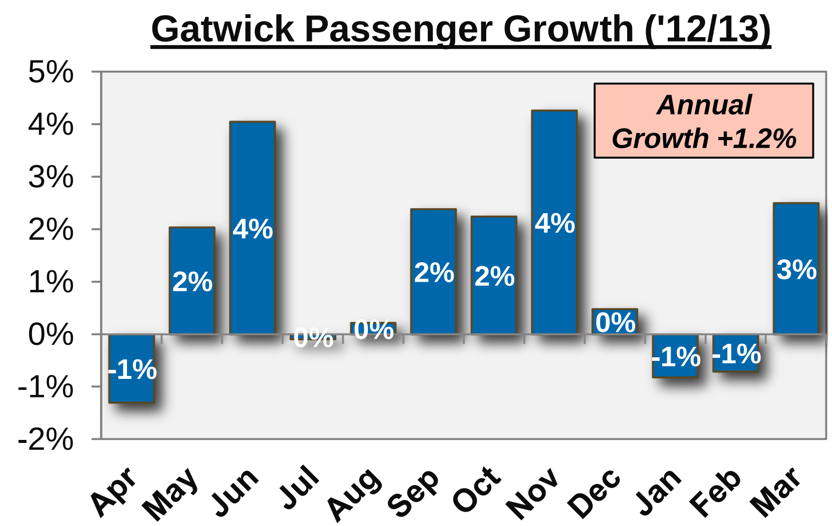
SECTION 2

Market Conditions and Market Outlook Update

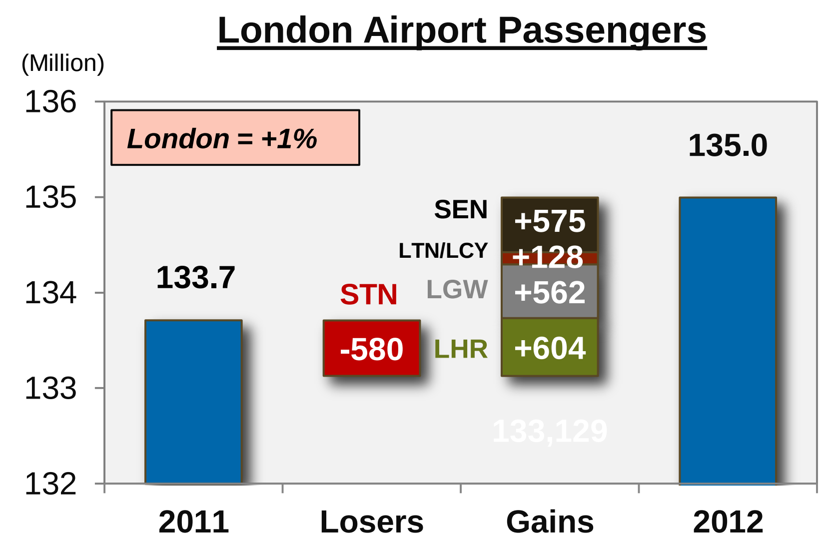
What has changed?

2012 was a moderately successful year for Gatwick

- After an early Easter, growth was driven by easyJet and Monarch
- Weaker summer period as Olympics suppressed demand, leisure markets down the most. Recovery after August
- Weaker winter performance following carrier exits (e.g. Delta) and frequency reductions (e.g. Ryanair)



- **London** posted a similar performance
  - Passengers grew 1%, an increase of 1.3m
  - Stansted decrease offset by Southend's growth off a low base
- Total London ATMs decreased nearly 1% driven by P/ATM increases at Gatwick and Heathrow

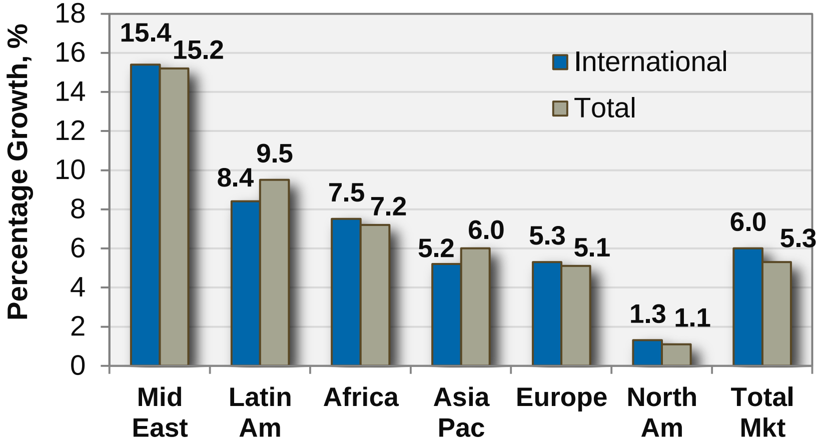


Source: CAA Statistics, ICF SH&E Analysis

The global aviation market in 2012 was relatively robust overall although with significant regional differences

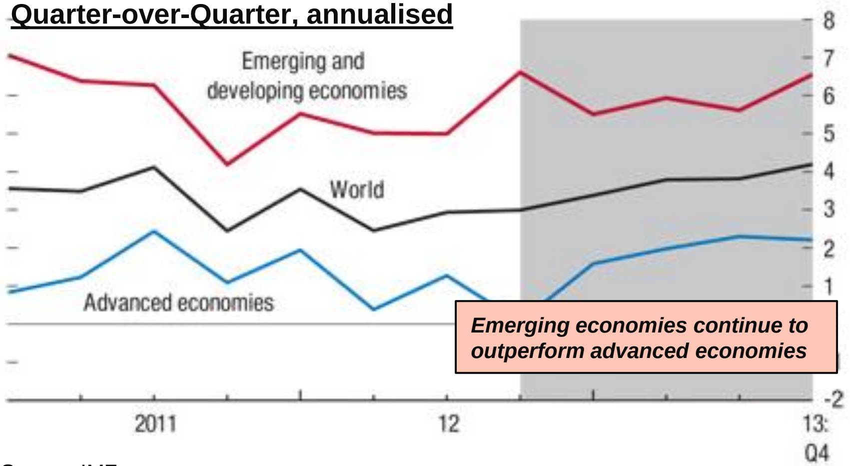
- During 2012 global air travel grew at 5.3%, down from the high of 5.9% in 2011 but above the 25 year average of 5%
- International travel grew more than domestic (6% and 4% respectively), driven largely by Middle Eastern carriers, while both European and North American carriers grew less than in 2011

Year on Year Growth in RPKs by Region, 2012



Source: IATA

Global GDP Growth, %, Quarter-over-Quarter, annualised

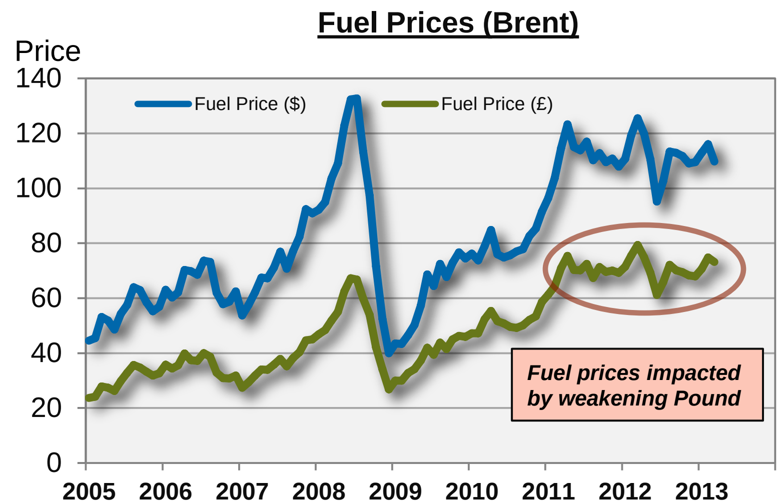


Source: IMF

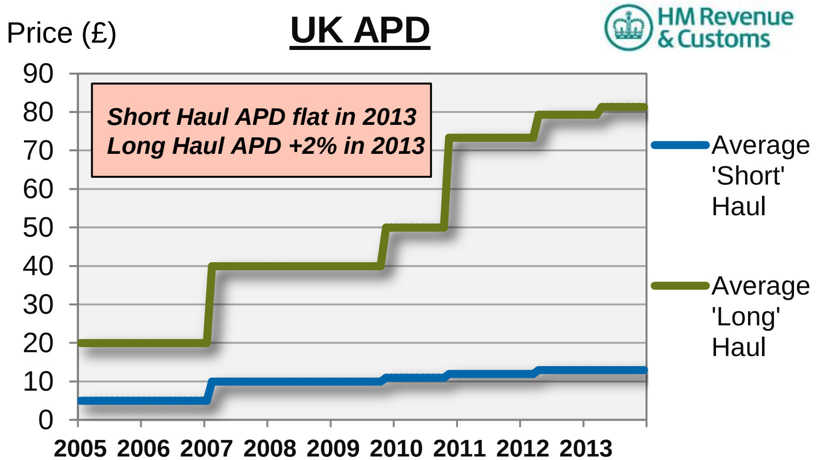
- This pattern is in line with relative economic growth around the world, as the UK and the Eurozone in particular struggle to emerge from the recent recession
- Emerging economies continue to outperform the Eurozone though their growth rates have been reducing

Emerging economies continue to outperform advanced economies; fuel prices remain high

- Oil prices have returned to over $100 per barrel, although are still below their 2008 peak
- However the weakening pound has driven prices up further for UK airlines



Source: EIA, Oanda



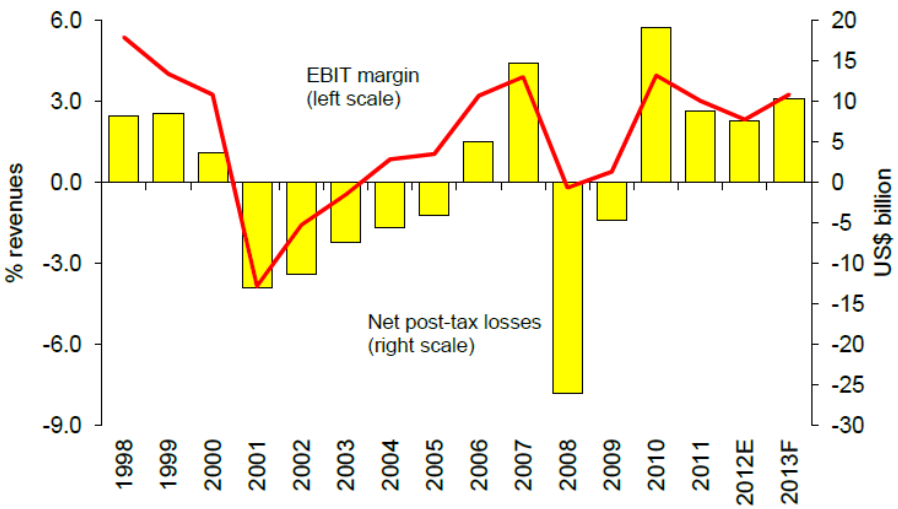
Note: Domestic APD is levied twice on a return journey

- The continuing rise in the tax burden on aviation through the APD in the UK is making air travel more expensive
- Although not unique (see for example Eco-tax in Germany), the UK regime is considered the highest in the world and is argued to be impacting demand from both business and leisure passengers

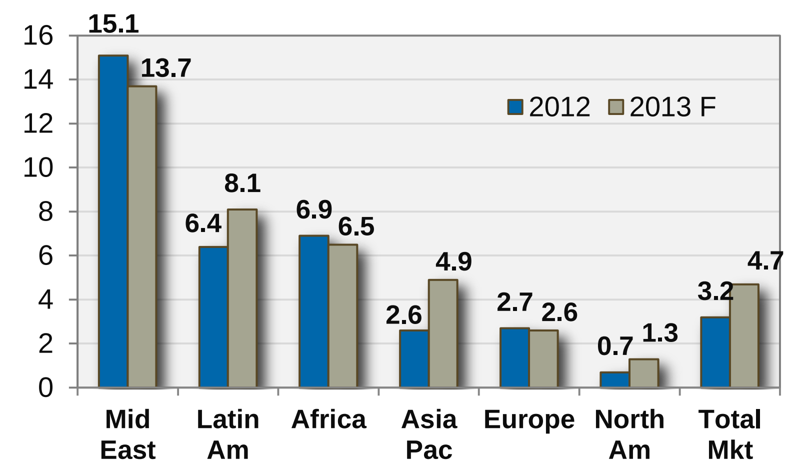
Both Traffic and Profitability are expected to improve slightly in 2013 compared to 2012

- IATA's latest forecasts show a slight improvement in global airline performance
  - But this is contingent on no Eurozone crisis
- IATA's volume forecasts show a mixed picture by region, but higher overall growth in 2013 than in 2012

Global Commercial Airline Profitability



Year on Year Growth in RTKs by Region, 2012 and 2013



Source: IATA
Note: RTK=Revenue Tonne Kilometre, includes passenger and cargo by weight, both domestic and international

The latest economic news for the UK remains mixed

*“'**Growth to be a little stronger** and inflation to be a little weaker than we expected three months ago. That's the first time I've been able to say that since before the financial crisis”*
Source: Mervyn King, May 2013

*“TUC warns of '**lost decade**' as IMF arrives to scrutinise UK economy. Officials to investigate economic outlook as unions argue austerity policies are causing UK to lag behind in global recovery.”*
Source: The Guardian, May 2013

*“Fitch cuts UK credit rating on **'weaker economic and fiscal outlook'**
Britain has been stripped of its AAA credit rating by a second rating agency as a result of poor growth”*
Source: The Telegraph, April 2013

*“We are **more pessimistic** about the economy's medium term growth prospects than we were in March. We expect weak productivity to constrain nominal earnings growth for longer, with a slower fall in inflation delaying real incomes. The outlook for the world economy and UK exports has deteriorated and we expect the difficulties of the euro area to depress confidence ...”*
Source: ONS, December 2012

*“The UK economy flat-lined in 2012, with a poor trade performance offsetting encouraging trends in consumer spending and business investment. However, **near-term prospects look brighter**. The export environment is likely to improve this year ... Growth should gather pace in the later part of 2013 and average 2.1% in 2014.”*

Source: IFS, March 2013

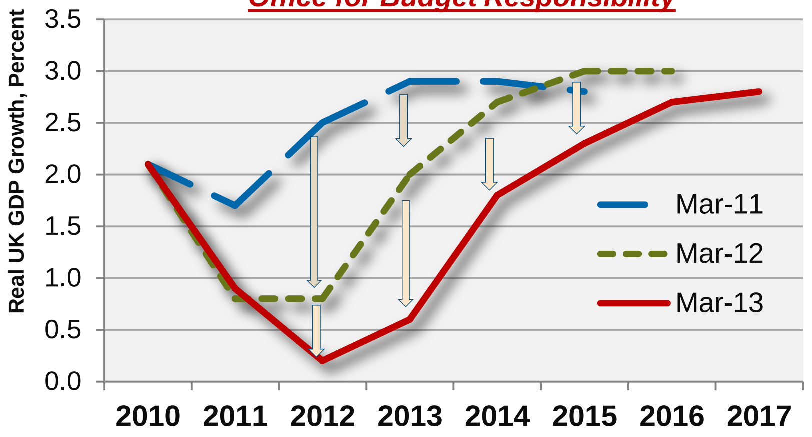
“*UK economy **moving from flat to growth**.”*
Source: CBI, May 2013

*“We see a **gradually improving outlook** for most UK regions, but the recovery will be slow and bumpy across the country. Consumer spending will benefit from rising employment and a gradual easing of the recent severe squeeze on real incomes, **but households generally remain cautious about spending**, as do businesses. .”*
Source: The Guardian, May 2013

The outlook for beyond 2013 remains fragile and uncertain

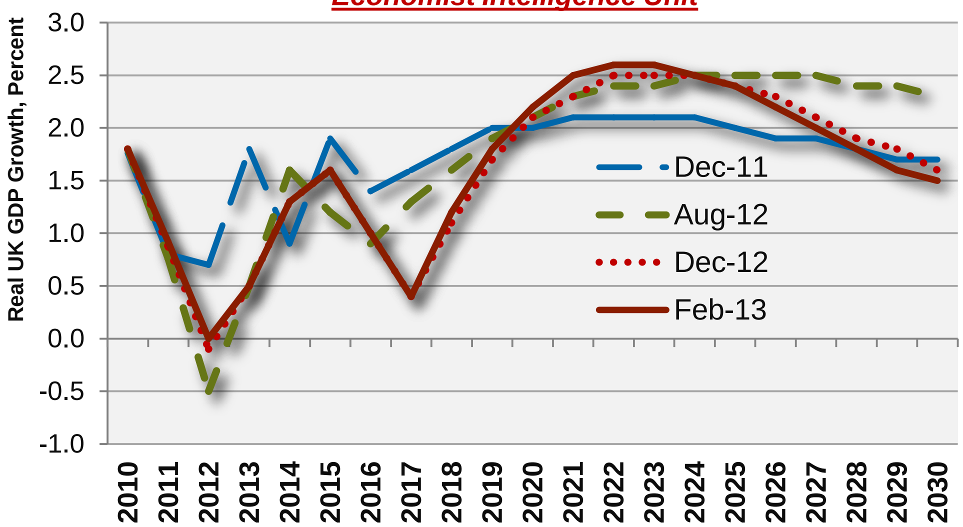
- In March 2013 the OBR once again revised downwards its short and medium term forecasts for the UK economy;
- Reasons for this include: weaker outlook for consumer spending, business confidence and exports

UK GDP Growth Forecasts,
Office for Budget Responsibility



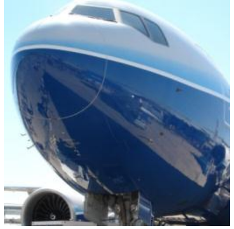
Source: Office for Budget Responsibility

UK GDP Growth Forecasts,
Economist Intelligence Unit



Source: Economist Intelligence Unit

- The EIU is one of the few independent forecasters who produces projections beyond five years;
- Their latest (Feb 2013) forecast sees modest recovery to 2015, followed by a dip after the next election due to the cumulative effects of ongoing private-sector deleveraging, an underperforming banking system, rising trends in energy costs and even sharper fiscal retrenchment



SECTION 3

2013 Forecasts

Inputs, Assumptions, Results

The econometric relationships have been re-estimated to include CY 2012 data

- The general approach is unchanged
- Including another year of historical data had only minor impact on historical relationship
- ICF SH&E's general position on market maturity and relative growth potential of long haul, short haul and domestic demand are unchanged

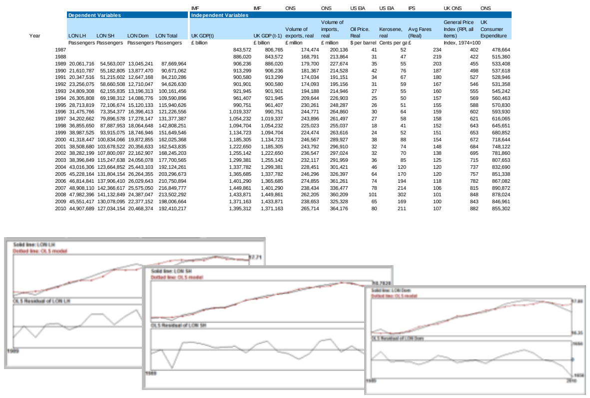
Overall Forecast Methodology Remains Unchanged:

1. Bottom-up forecast for first three years based on airline and route level outlook
2. Top-down unconstrained London market forecast for 25 years based on econometric relationships and market maturity
3. Gatwick Forecast derived from natural market share[1] and interplay of capacity constrained airports through traffic spill

1/ Following the sale of Stansted in Feb 2013, it is expected that the airport will begin to recapture some of its lost market share from the London system. A gradual increase in Stansted 's share has therefore been included in the modelling, although the impact on Gatwick is expected to be relatively minor

Recap of the Forecast Approach – Top-Down

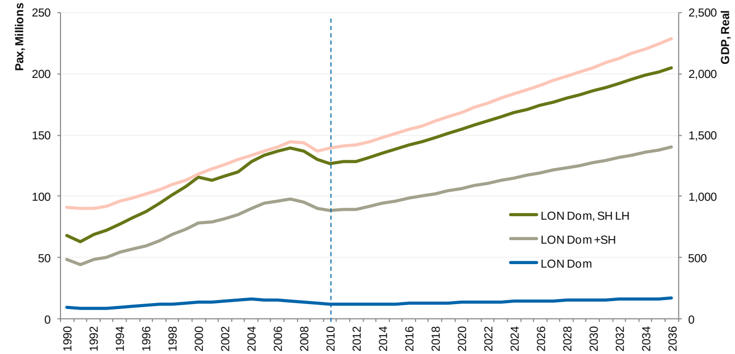
Historical time series of traffic, GDP, avg fares, oil prices, imports, exports, consumer spending, RPI



OLS Regression analysis identifying long run historical correlation between traffic and drivers

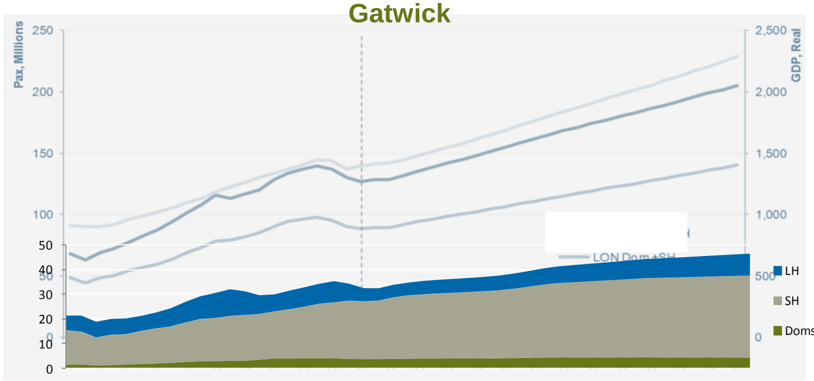
Forecasts for independent variables + elasticity relationship + maturity and adjustments = unconstrained forecast of SH, LH and Dom Traffic

Unconstrained long term demand forecasts for London market as a whole

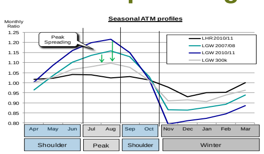


Allocation of unconstrained demand by London airport based on location, surface access, demand profile

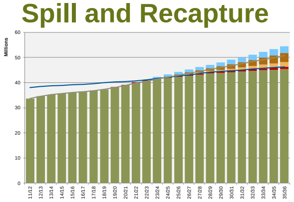
Unconstrained long term demand forecasts for Gatwick



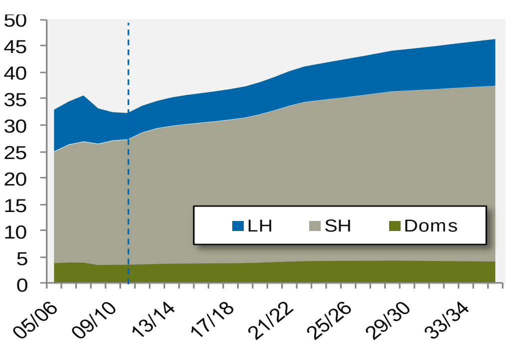
Peak Spreading



Spill and Recapture



Top-Down Constrained Forecast for Gatwick



Gatwick is part of a constrained airport system and these dynamics are captured in the forecasts through capacity and spill assumptions

Limited morning capacity

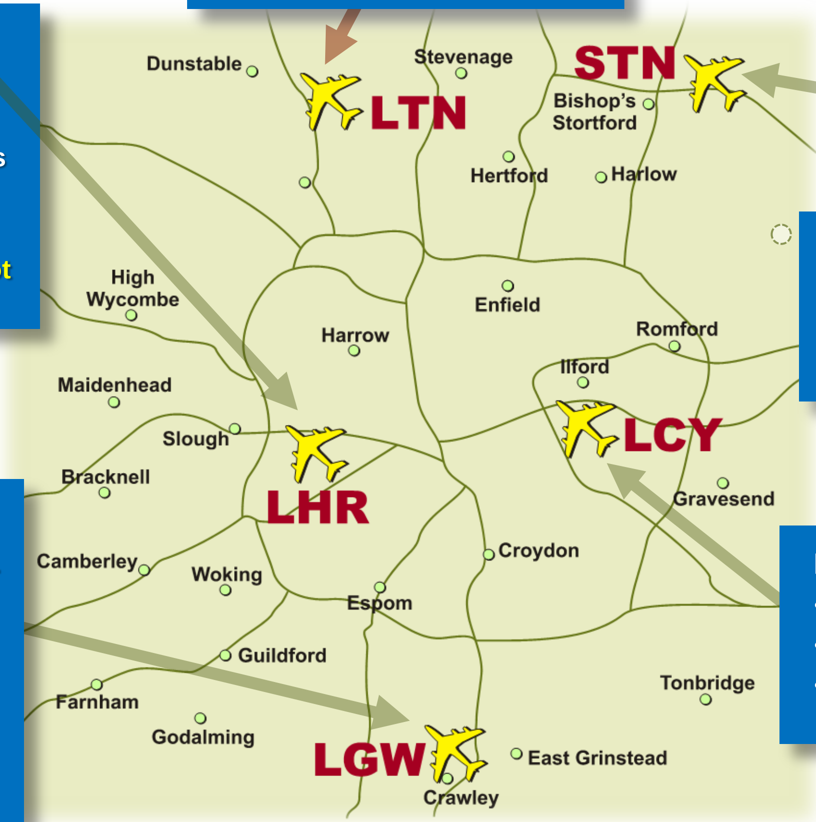
Luton (LTN)
- Single runway (2,160m)
- One passenger terminal
- Plans to support 18Mppa

Stansted (STN)
- Single runway (3,048m)
- One passenger terminal
- Cap currently set at ~35Mppa / 264k ATMS
- Potential expansion
- New ownership (MAG)

Heathrow (LHR)
- Two runways (3,901m/3,660m)
- Four passenger terminals
- ATM Cap of 480k
- Pushing for 3rd runway / Mixed mode potential (not assumed)

~99% full

Southend (SEN)
Single runway (1,605m)
One passenger terminal
Limited growth potential beyond 1-2m



Gatwick (LGW)
- World's busiest single-use runway (3,660m)
- Two passenger terminals
- Hourly ATM limits being increased to 55
- Considering 2nd runway options

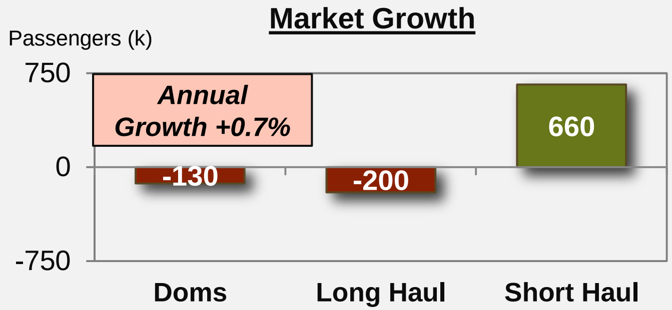
Quite full in peak

London City (LCY)
- Single runway, One terminal
- Restrictive operations
- Growth potential for certain airline groups

Source: ICF SH&E Analysis, Airport Master plans / websites etc.

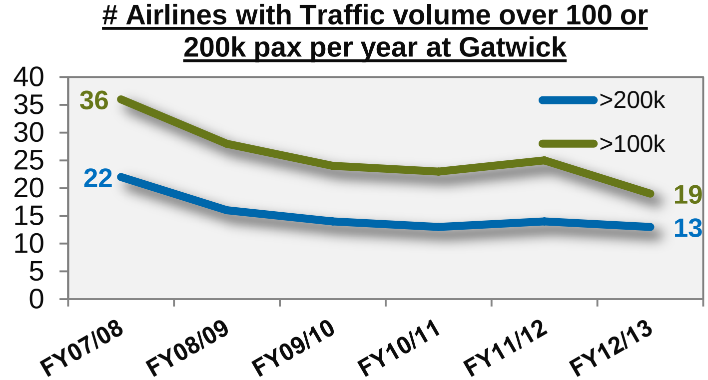
GAL's own latest forecasts for 2013 are used to inform Year 1

- **Total traffic growth of 200k* to 34.4m**
  - Domestic: -3% -130k
  - Long Haul: -6% -300k
  - Short Haul: +3% +660k



- **Domestic:** BA/Flybe reductions partly offset by easyJet and Aer Lingus
- **Long Haul:** Exit of US Airways and Korean drive decline versus FY'12/13
- **Short Haul:** Norwegian and easyJet growth offsets declines from other carriers

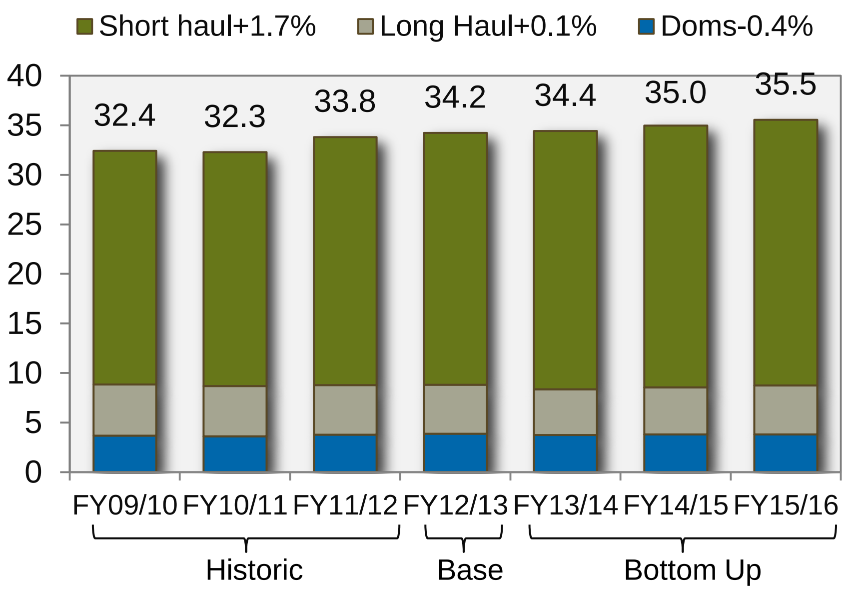
- Gatwick's top airlines continue to grow their market share as the number of airlines continues to decrease
- Some expected market growth may not be sustainable. For example:
  - *Barcelona with >1,000 extra ATMs in Sum'13*
  - *ATM growth to Iceland of 250% in Sum'13*

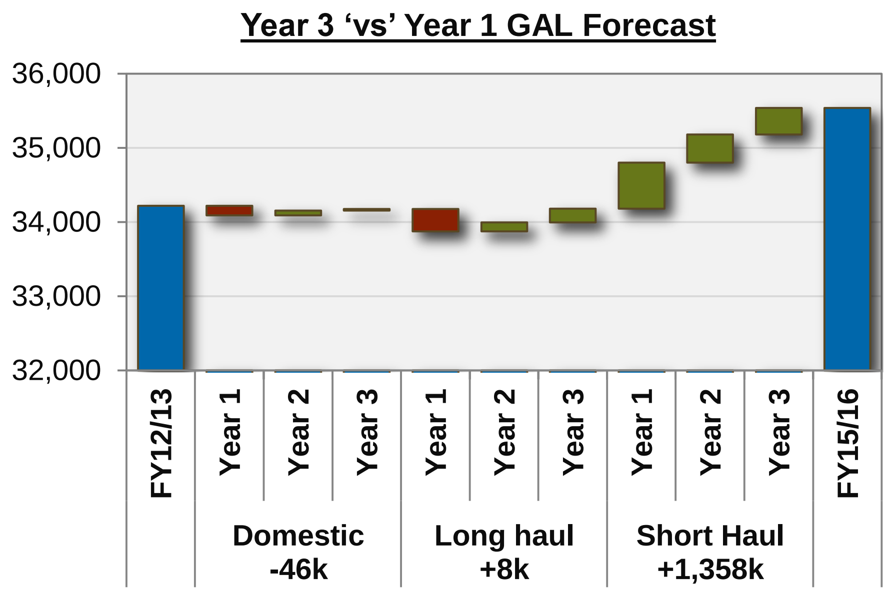


*Source: Bottom up GAL Business Plan

Years 1 to 3 are modelled on a bottom-up basis, not driven by GDP

- The latest available schedule, fleet, financial performance and market insights from ICF SH&E and GAL Business Development Team are used to produce an airline-by-airline forecast for 2013/14 to 2015/16





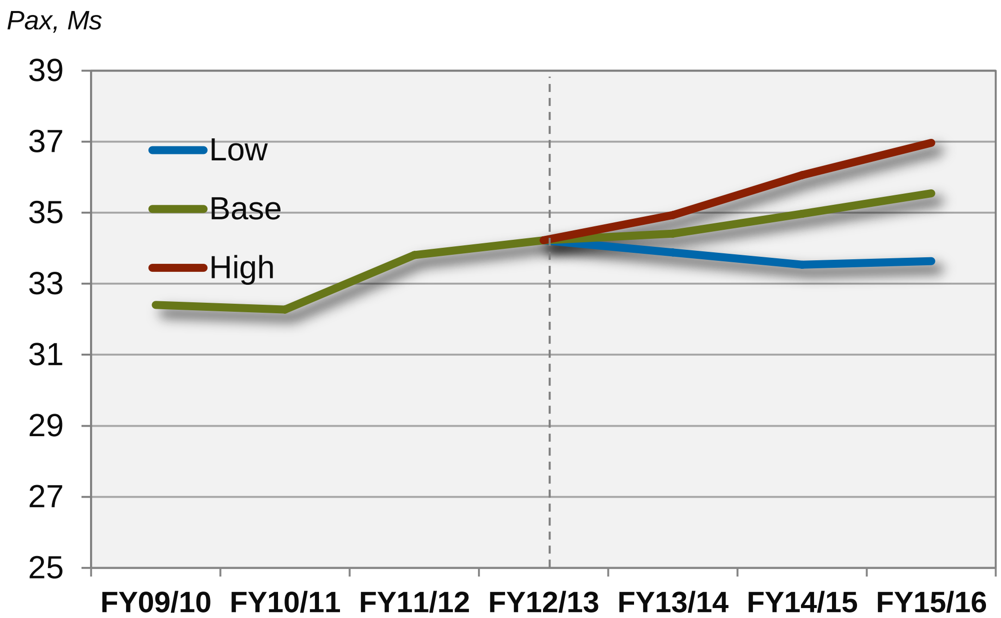
- Domestic, Short Haul and Long Haul segments are forecast along main airline groupings

- In the near term (Base - Yr3) Short Haul produces the greatest increase in passengers (driven largely by ATM increases)
- This is mostly due to new based aircraft by LCCs

Source: ICF SH&E Analysis

The High and Low Case scenarios are based on specific assumptions related to routes and carriers

Bottom-up Forecast for Gatwick: High, Base and Low Case

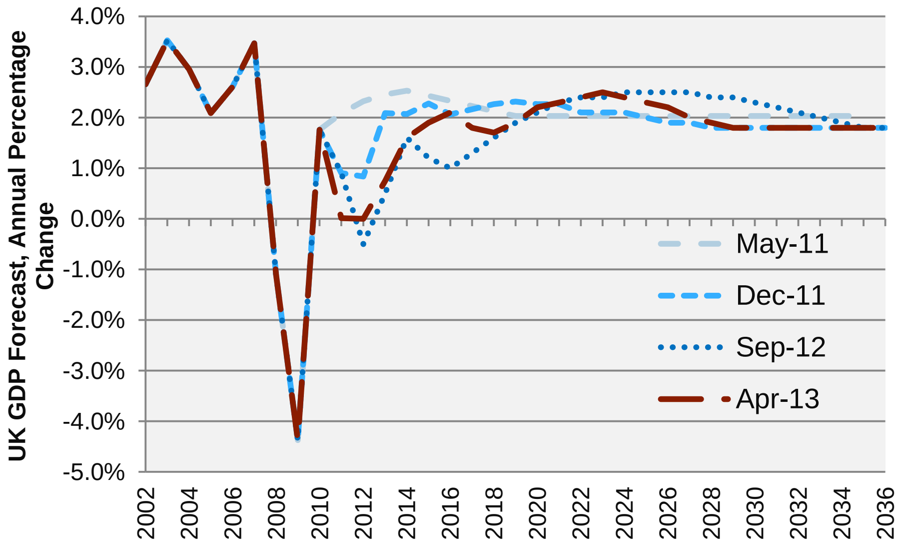


- The High Case includes the addition of further based aircraft, higher load factors on recently added capacity than in the Base Case and the addition of new services, including some long-haul
- The Low Case represents a set of more pessimistic assumptions, including the withdrawal of some carriers, as well as lower growth in based aircraft than in the Base Case
- Greater downside is forecast due to market uncertainty and potential impact on traffic base due to new ownership assumed at Stansted

Source: ICF SH&E Analysis

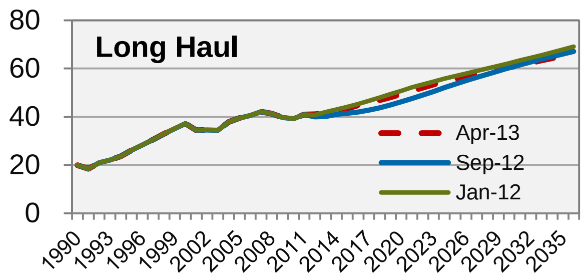
GDP remains the main driver of long term unconstrained demand

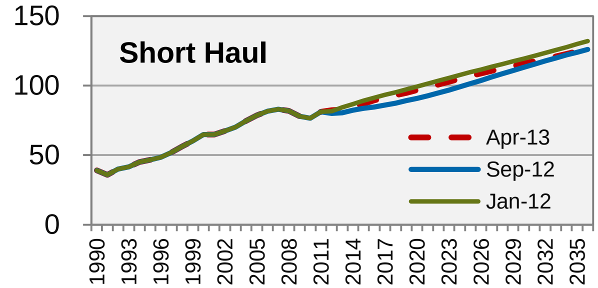
GDP Forecasts underpinning London Traffic Forecasts

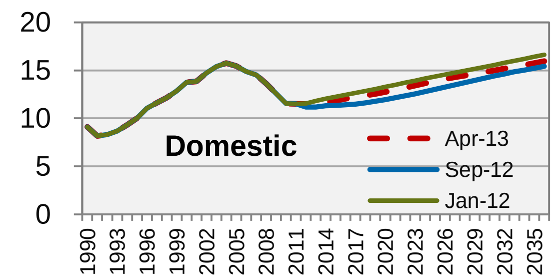


- Although still lower than a year ago, the current near and medium term outlook for GDP is higher than in September last year
- ICF SH&E has also considered the feedback of the ACC regarding choice of GDP input and has used a wider range of inputs than last year, including the latest Treasury Consensus forecasts
- This has the impact of raising the unconstrained demand for all three traffic segments. However, significant uncertainty remains around the forecasts and they continue to be revised regularly. Questions over the future of the Eurozone remain, although no collapse or major crisis is included in the Base Case GDP assumptions

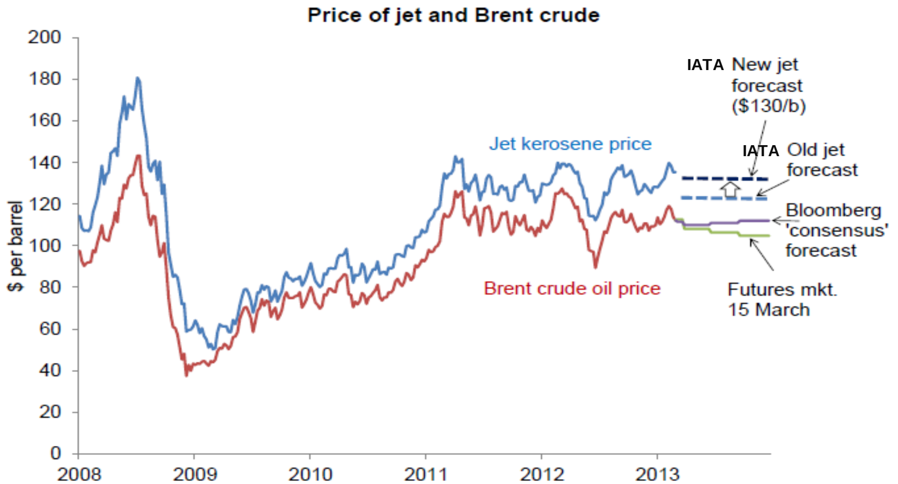
Unconstrained Forecasts by Segment, Previous and Latest



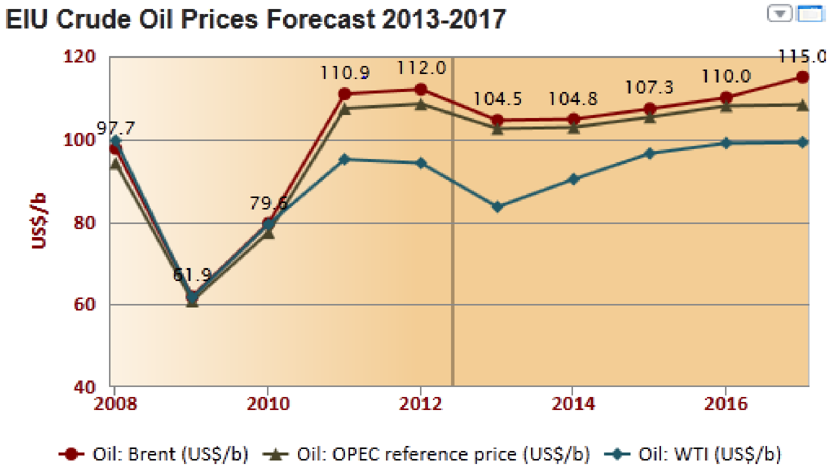




Fuel prices will continue to affect air fares and thus demand, although typically less than incomes

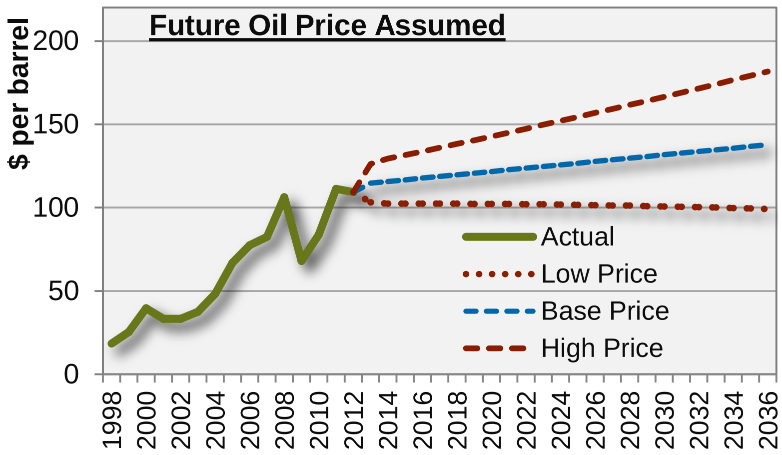


Source: IATA March 2013

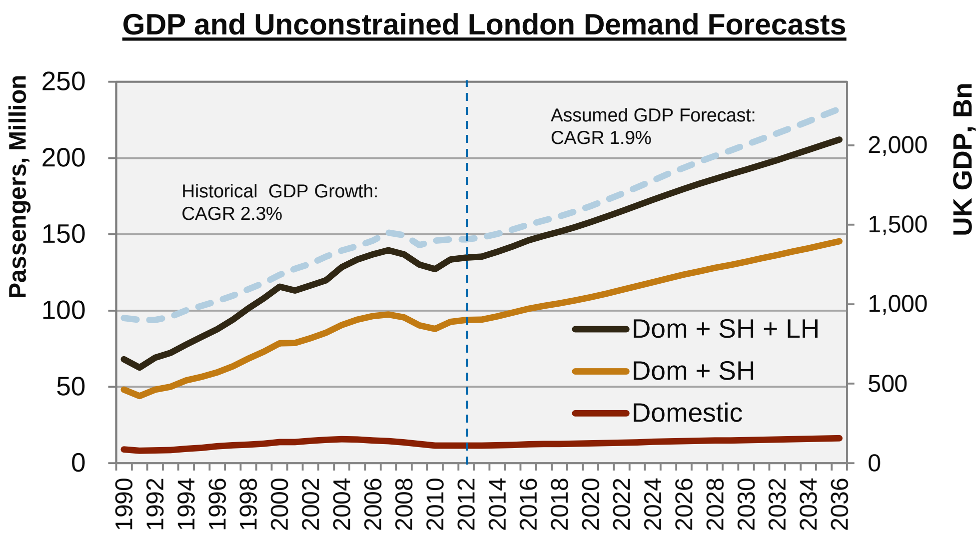


Source: EIU Economic and Commodity Forecast 2013-2017

- IATA has revised its 2013 jet fuel forecast from $120 to $130 a barrel
- Crude oil is also forecast to be over $100 by the Bloomberg consensus forecast for 2013
- The EIU forecasts for the longer term, also at an upward trend
- However, there is significant uncertainty over longer term prices, and thus the forecast assumes a relatively wide range



Unconstrained Growth, from which Airport-specific demand is derived, is forecast to grow at under 2% per annum



- This is a combination of:
  - Domestic demand growing considerably more slowly than UK GDP
  - Short-haul demand growing at around the same rate as GDP
  - Long-haul growing slightly faster than UK GDP owing to the positive influence of less mature inbound (and some outbound) long haul flows

CAGR	Long Haul	Short Haul	Domestic	Total
1990-2002	4.7%	4.6%	4.1%	4.6%
2002-2012	1.8%	2.0%	(2.4%)	1.5%
2012-2017	2.3%	2.0%	1.6%	2.0%
2017-2022	2.4%	2.0%	1.5%	2.1%
2022-2027	2.1%	2.1%	1.6%	2.1%
2027-2037	1.7%	1.7%	1.3%	1.6%
2011-2037	2.0%	1.9%	1.4%	1.9%

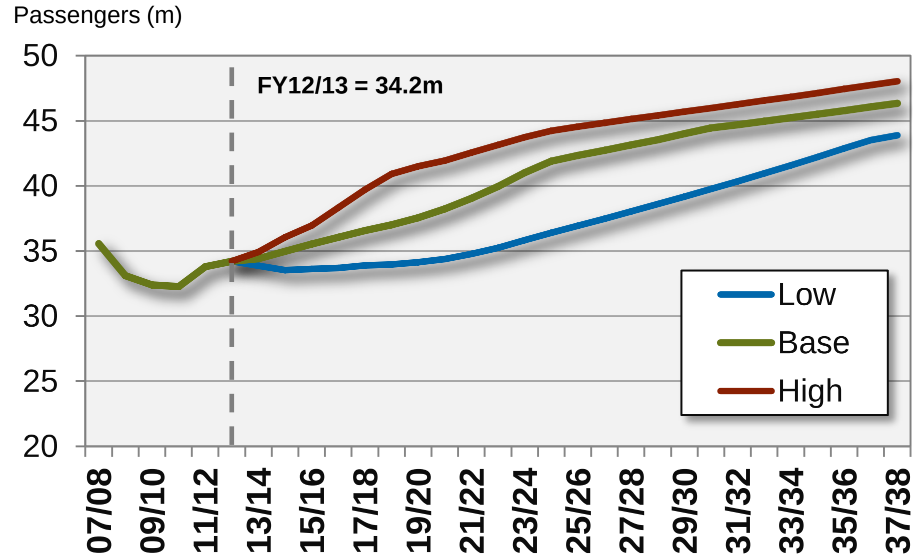
Even the unconstrained growth assumes market maturity, which results in a declining multiplier relative to GDP. If long term historical relationships were maintained the London area forecast would reach over 300 million by 2037, equivalent to a CAGR of 3.2%

Source: ICF SH&E Analysis

The long term forecasts for Gatwick reach 40m in 2022

- Gatwick demand is forecast to grow at 1.6% (10 year CAGR) and reaches 40m passengers by 2022
- Demand due to pass previous high of 35.6m in 2016/17
- Beyond 2025/26 binding capacity constraints start to apply - growth will depend on the ability to greater utilise off peak hours and airlines to operate longer seasons

Gatwick Passenger Forecasts



Passenger Volumes

Period	Low	Base	High
2015/16 (3yrs)	33.6	**35.5**	37.0
2017/18 (5yrs)	33.9	**36.6**	39.7
2022/23 (10yrs)	35.2	**40.0**	43.1
2037/38 (25yrs)	43.9	**46.3**	48.0

Passenger Growth Rates (CAGRs)

Period	Low	Base	High
12/13 - 15/16 (3yrs)	-0.6%	**1.3%**	2.6%
12/13 - 17/18 (5yrs)	-0.2%	**1.3%**	3.0%
12/13 - 22/23 (10yrs)	0.3%	**1.6%**	2.3%
12/13 - 37/38 (25yrs)	1.0%	**1.2%**	1.4%

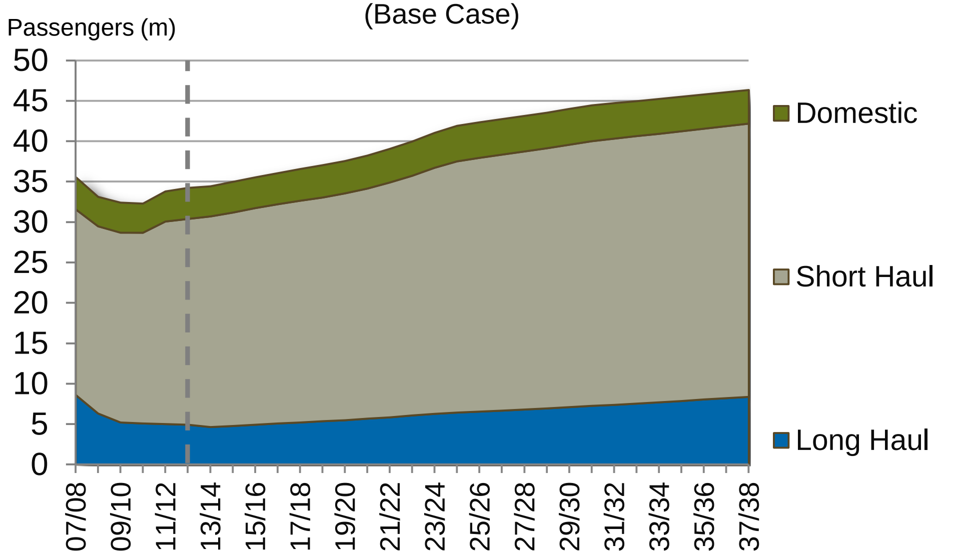
*Source: GAL, ICF SH&E Analysis

Short Haul demand continues to dominate whilst long haul volumes grow at over 2% p.a.

- Short Haul demand maintains share above 70% and grows towards 34m, comparable to today's total annual demand

- Long Haul demand forecast to grow to nearly 8.5m, an increase of 70% versus today.
  - *This is comparable to volumes before open-skies*

Gatwick Passenger Forecasts
(Base Case)



Passenger Traffic Mix

Year	Domestic	Long Haul	Short Haul
2012/13	11%	14%	74%
2017/18	11%	14%	75%
2022/23	11%	15%	74%
2037/38	9%	18%	73%

Passenger Growth Rates (CAGRs)

Period	Domestic	Long Haul	Short Haul	Total
12/13 - 15/16 (3yrs)	-0.4%	0.1%	1.7%	**1.3%**
12/13 - 17/18 (5yrs)	0.3%	1.1%	1.5%	**1.3%**
12/13 - 22/23 (10yrs)	0.9%	2.1%	1.6%	**1.6%**
12/13 - 37/38 (25yrs)	0.3%	2.1%	1.1%	**1.2%**

*Source: GAL, ICF SH&E Analysis

SECTION 4

Comparison to Previous & Other Forecasts

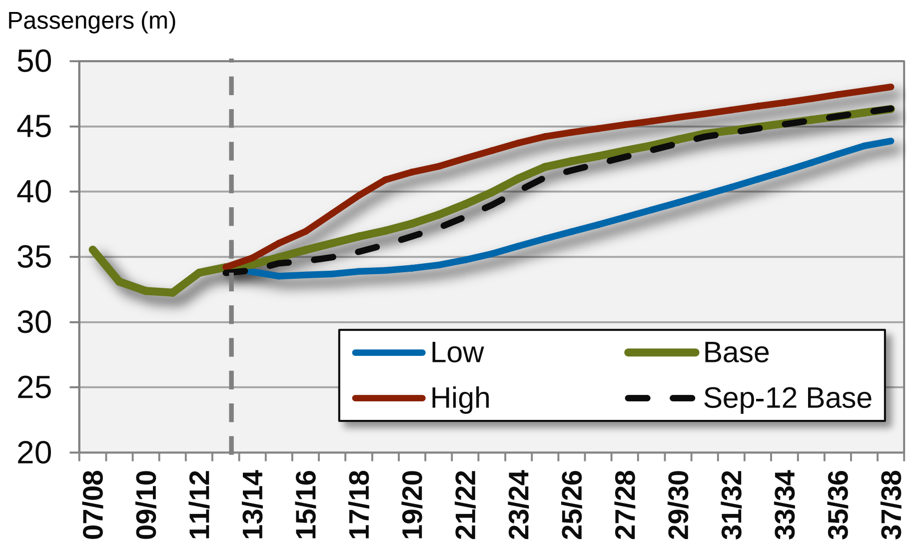
What has changed?

The latest forecasts are around 2% higher than those prepared in September 2012, at least in the short term

- The forecast has increased in the short term due to:
  1. Supply side increase
  2. Slightly improved GDP outlook
  3. Potential for further spill from Heathrow*

- The latest bottom up forecast is within the previous 'high' case reflecting this upside from supply:
  - *Norwegian basing x3 aircraft in year 1 and expected to grow further*

Gatwick Passenger Forecasts



*Source: GAL, ICF SH&E Analysis

*LHR has lowered their predicted growth in aircraft sizes resulting in potentially more spilt demand to other London airports

This upside has been driven by the short haul market segment whilst the others remain broadly neutral

- Domestic
  - Limited growth forecast going forward
  - Short term has 'churn' of routes as some airlines grow whilst others decline
  - Medium term expect greater proportions to be flown by LCC segment

Passenger Comparison

Year	Apr'13	Sep'12	Var (%)
2012/13	**3.9**	3.8	+0.8
2015/16	**3.8**	3.9	-3.3
2017/18	**3.9**	4.0	-1.3
2022/23	**4.2**	4.3	-1.5
2037/38	**4.2**	4.4	-4.3

- Long Haul
  - Recent withdrawals impact the bottom up period of the forecast
  - Some Asian growth has offset exits by US carriers
  - Longer term growth benefits from LHR spill as LGW volumes reach over 8m

Passenger Comparison

Year	Apr'13	Sep'12	Var (%)
2012/13	**4.9**	4.9	+1.1
2015/16	**4.9**	5.2	-5.2
2017/18	**5.2**	5.3	-2.4
2022/23	**6.1**	6.1	-0.4
2037/38	**8.4**	8.8	-5.1

- Short Haul
  - Improvement in base year (+360k)
  - Bottom up (1-3 years) supply side has grown (+600k)
  - Demand growth brought forward ~2-3 years in the short term

Passenger Comparison

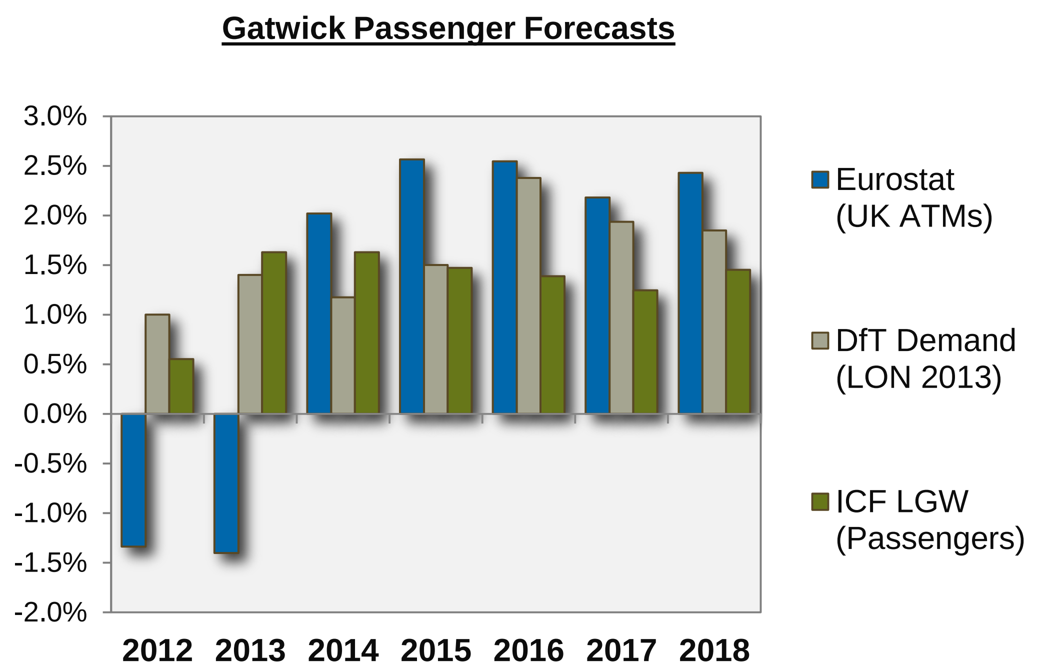
Year	Apr'13	Sep'12	Var (%)
2012/13	25.4	25.1	1.4
2015/16	26.8	25.5	4.8
2017/18	27.4	26.1	5.1
2022/23	29.7	28.6	3.8
2037/38	33.8	33.2	1.9

- The bottom up improvement is largely due to
  - Additional morning departure capacity released
    - Permits growth in based aircraft
  - Norwegian opening base at LGW (x3 based aircraft with plans to grow further)
  - Improvement in BA performance and switching Domestic capacity to Europe though uncertainty exists in the longer term

*Source: GAL, ICF SH&E Analysis

Compared to other forecasts, Gatwick growth is stronger in the short term but returns towards trend over time

- Eurostat have recently lowered their growth expectations for UK ATMS and now forecast a decline in 2013 with growth returning in 2014
- The DfT's forecasts of London demand have been updated to reflect ongoing economic weakness in the UK with demand lowered 7% over the longer term, compared to their 2011 forecasts
- Gatwick is currently looking like it will out-perform the wider market in the near term, owing in large part to near term gains from based aircraft and the commencement of new services.



*Source: Eurostat, DfT, GAL, ICF SH&E Analysis

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Appendix 13: Traffic further information

Airline information

The information received by the CAA from the airlines appears to be more comprehensive than that provided to SH&E. The Initial Proposals state that the CAA received information from airlines accounting for 70% of Gatwick current passenger traffic. We have been informed by SH&E that the confidential responses direct to them accounted for less than 40%. It is plausible that the shortfall in responses had a material impact on the short-term forecast.

It is also worth noting that commercial forecasts from airlines individually tend to be optimistic, due to their very nature and purpose within the airline commercial organisation. They may not for this reason be consistent with one another, cumulatively enhancing any optimism bias. As in other markets, a summation of individual firms' forecasts not infrequently exceeds the overall industry out turn.

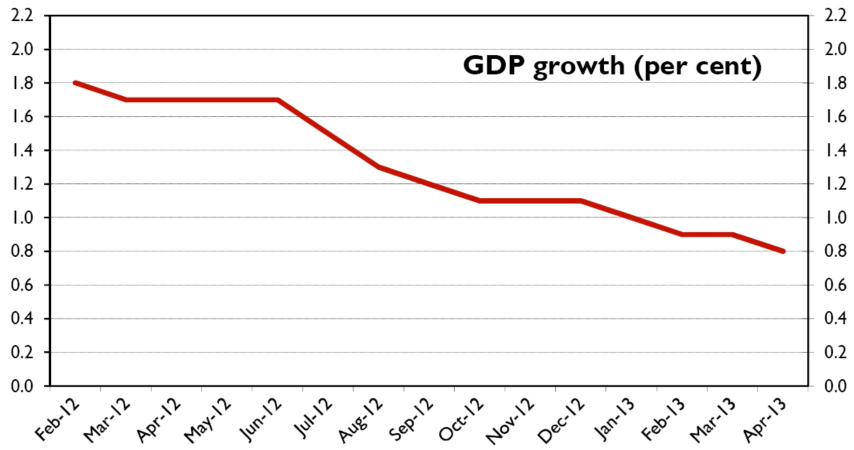
While we understand that the airlines may have been reluctant to share such information with Gatwick's consultant, assurances were offered on data confidentiality and procedures put in place to ensure commercially sensitive information would not be passed from SH&E to Gatwick or to other airlines. Facilities to submit information in a confidential manner remain available, to inform future forecasts.

Should the airlines not be forthcoming with this additional information, we would also ask that the CAA considers methods by which it can anonymise the additional data it received to allow its incorporation into an updated forecast, should one be produced.

GDP Forecast

The CAA expressed concern that the economic forecasts provided by EIU lie at the 'low end' of the spectrum of forecasts. We note that the EIU forecast for growth in 2013, issued in August 2012, was 0.5% and that the current OBR forecast is 0.6%. We also note that the consensus on short-term growth has declined consistently for the previous 14 months at least, as shown by the chart below.

Figure: Average of independent forecasts for 2013, by date of forecast



Source: HMT Comparison of Independent Forecasts, April 2013

The CAA Initial Proposals refers to Consensus Forecasts (CF) and the Office of Budget responsibility (OBR) as alternative providers of GDP forecasts. We are not minded to use the OBR forecast as an alternative, as it is considerably above consensus from 2015 onwards (the forecast does not use GDP as a driver for the periods 2012/13 and 2013/14, where the OBR is more aligned with consensus).

SH&E has reviewed the choice of economic forecast provider and has used a wider range of inputs in its 2013 updated forecasts, which are discussed and shown in Appendix 13.

Spill traffic

The CAA comment regarding traffic spill is not entirely clear but appears to make two points:

- Change in Gatwick traffic which results in traffic being turned away; and
- Heathrow spilling traffic to Gatwick in 2022/23.

Taking these in turn, the reference to spill in 2019/20 from the July 2012 memo is in fact to net spill and was in relation to spill from LHR. Spill from Gatwick occurred in 2024/25 in the IBP. Regarding spill from Heathrow, the capacity assumptions are based on the planning cap of 480,000 annual ATMs and a set of reasonable assumptions regarding average aircraft size and load factor. While some excess demand arguably already exists – there is certainly anecdotal evidence to support this – it is not forecast to reach a level whereby airlines would actually add capacity at Gatwick instead until the date suggested in our forecast.

Other Issues

Reference is made in the Initial Proposals to the announcement made in late October 2012 indicating that Norwegian Air was establishing a base at Gatwick. This information became known after the RBP forecast had been completed. This has now been incorporated in the 2013 forecasts and helps to explain some of the higher traffic numbers in the early years of the forecast.

The Initial Proposals also assert that any reduction in capacity by some carriers would be backfilled at Gatwick due to the intrinsic attractiveness of the airport to other airlines. We note that the CAA does not provide a timescale for such backfill, which could in our opinion extend to several months or more and thus, depending on the scale of the reduction, have a material effect on annual traffic levels. We further note that traffic at Gatwick has fallen in 5 out of 12 of the previous years, which we have difficultly reconciling with the assertion made by the CAA.

The Initial Proposals consider the GDP forecast for the high case to be 'unduly optimistic' beyond 2019. Given that the GDP rates quoted (2.6% to 2.9%) match the OBR rates for 2016 (2.7%) and 2017 (2.8%), and given that the high case is by its very nature optimistic, we consider that our approach to the high case forecast continues to be justified.

The CAA supports the concern raised by the ACC of an overemphasis on long-haul traffic, and cites the forecast growth rates for the London system as supporting evidence. The constraints on traffic movements at Gatwick mean that we must evaluate the relative merits of growing different traffic segments. As long-haul movements typically carry higher numbers or passengers per movement, and deliver higher volumes of cargo per movement, it is natural that this segment will be the focus for growth, and will thus grow disproportionately quickly at LGW compared to the rest of the London market. We note that LHR has seen a gradual displacement of low capacity flights by high capacity flights over the previous decade or longer which tends to support the approach we have taken and undermines somewhat the CAA's criticism.

The initial proposals state that the regression model used for the medium-term forecast may underestimate long-haul traffic and overestimate short-haul and domestic traffic. This statement is based on the model's performance in predicting traffic for 2007 to 2011 using data from 1990 to 2006. We would treat any results that cover the years 2008 and 2009 with a great deal of caution, and would be reluctant to regard any conclusions as robust, given the extreme economic and political events of that period. Note that this analysis was performed in response to a request from the airlines. We also note the apparent contradiction between this issue and that addressed in the paragraph above.

Appendix 14: Tables replicated with 2011/12 price base

Table: Capital investment core projects ongoing consultation (2011/12 prices)

Project / Programme	Cost (£m)	ACC Position	Comment
Delivery of 95% pier service in North Terminal	£165.63	Support expenditure to date (£8.269m)	The ACC does not have a common view on whether there is support for this project moving beyond Tollgate 3
NT security reconfiguration	£23.76	Support	Some budget brought forward to Q5
Early bag store (NT)	£22.66	Do not have common view	Further working sessions held
Upgrade check-in and bag drop (including ceilings and floors) NT	£22.66	Partial support	Outputs from first trials shared. The ACC does not have a common view as to whether to support the replacement of floors and ceilings. It supports the bag drop equipment and installation, but it does not support removal of mezzanines
Upgrade check-in and bag drop ST	£16.62	Partial support	
Border zone NT	£12.48	Not supported	
NT IDL reconfiguration and expansion	£82.86	Support	Some budget brought forward to Q5
Runway 2	£9.44	Unknown	Ongoing monthly consultation
Business Systems transformation	£14.91	Support	The ACC sees this as a development project
Stand reconfigurations	£9.44	Support	
Product development – car parking	£4.72	Support	
Digital media	£5.00	Support	
CIP departures	£2.17	Support	
NT baggage reclaim	£2.64	Not supported	
NT arrivals transformation	£11.20	Not Supported	Reduced scope and budget
ST IDL capacity	£28.32	Not Supported	Now £34m budgeted for next period
CIP arrivals	£2.02	Support	
Additional NT coaching bays	£2.28	Support	Amended scope and budget
ST public transport & DDA access	£8.69	Support	
Consolidated car rental & MT facility	£7.55	Support	
New projects consulted post-RBP			
Stands 551, 552, 553	£8.83	Decision awaited	
Hangar facilities	£5.05	Decision awaited	
Minor projects	£9.44	Decision awaited	Fund for minor projects not yet known or scoped

Table: Capital investment development projects– changes to the RBP (2011/12 prices)

Project / Programme	Cost (£m)	ACC Position	Comment
HBS replacement by 2018	£149.36	Support	Gatwick/ACC agreed on joint approach to the DfT regarding date of requirement. Gatwick and the ACC agree this should be a development project as it is prior to TG2
Liquid explosives detection	£1.56	Decision awaited	The ACC indicated likely support, as a development project

Table: Capital investment asset stewardship projects – changes only to the RBP (2011/12 prices)

Project / Programme	Cost (£m)	ACC position	Comment
Stand replacement	£18.46	Support	Following review of Pavement Condition Index (PCI) replacement of 100% (50%) of stands predicted to be poor condition by 2018
ST ceiling replacement	£22.76	Support	Some budget brought forward to Q5
Commercial minor projects (incl. KFC drive through, ST retail enhancements)	£8.62	Support	ST IDL reconfiguration project removed & retail enhancements via 'churn' incorporated instead to asset line

The ACC made it clear that while it supports all of the asset stewardship projects, this support is based upon the overall budget incorporating the maximum level of potential savings identified by the ACC's consultants

Table: Capital investment carry over projects – including changes since the RBP (2011/12 prices)

Project / Programme	Cost (£m)	ACC Position	Comment
ST baggage & pier 1	£83.64	Support	No change since the RBP
Pier 5	£2.73	Support	
Gatwick stream flood attenuation	£0.36	Support	
Consolidated security gate	£0.91	Support	Project currently at tollgate 3
FEGP replacement	£0.05	Support	
River Mole	£0.29	Support	Capital contribution to EA

Table: Gatwick's capital investment programme for the period beyond Q5 (2011/12 prices)

	5 year period Cost (£m)	7 year period Cost (£m)*
Total asset stewardship	£346.71	£524.38
Total carry-over projects	£87.98	£87.98
Total core projects	£478.36	£685.86
Sub-total	**£913.05**	**£1,298.22**
Development projects	£150.91	£150.91
Sub-total	**£1,063.96**	**£1,449.13**

Table: Comparison of capital expenditure vs pier service ("PSL") benefit – Gatwick projects (2011/12 prices)

Pier project	Cost (£m)	PSL Benefit	Cost / % PSL Benefit (£m)
Pier 1 (Pier element not incl. baggage costs)	£87m	-1.20%	N/A
Pier 2 Reconfiguration	£36m	0.80%	£45m
Pier 5 Reconfiguration	£71m	2%	£36m
Pier 7	£378m	6%	£63m
Pier 6 Southern extension	£170m	6%	£28m
Pier 6 Southern extension – Pier service element (minus remote stands @ £20m, minus asset replacement scope @ £29.5m)	£123m	6%	£21m

Depreciation Charge - New Assets 2011/12 Prices	Beyond Q5 to 2018/19					
	2014/15	2015/16	2016/17	2017/18	2018/19	Total
CAA Initial Proposals	1	16	23	29	42	111
Update to Business Plan	2	18	29	37	53	140
Variance	1	2	6	8	11	29