



CONFIDENTIAL

Response for BAA Limited

Response to working paper on the
financial & investment performance of
BAA's non-designated airports

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BAA Limited
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1. This note presents BAA's response to the Commission's analysis of profitability and investment performance of BAA's non-designated airports, as presented in its working paper. It also comments on the Commission's general approach to the analysis and reviews the Commission's calculation of returns.
2. The objective of BAA's response is to highlight potential issues and challenges related to the Commission's analysis, to outline additional points for consideration relevant to the analysis, and to assist the Commission, where possible, in interpreting its preliminary results. The response is not intended to present results according to an alternative methodology or to provide the Commission with definitive conclusions on the financial and investment performance of non-designated airports.
3. Given the nature of the Commission's analysis, this note should be read in conjunction with the response to the paper on benchmarking.

Summary

4. **The Commission's approach to measuring returns.** The use of accounting-based indicators, which is the approach employed by the Commission, often suffers from a set of shortcomings and might result in biased estimates. For example, return on capital employed (ROCE) measures based on accounting data can be sensitive to the accounting principles used for financial reporting, or to the choice of the estimation period.
5. The choice of ROCE¹ as a measure of returns makes assessment of the absolute level of profitability relatively difficult given that such comparisons are typically meaningful only under a stringent set of conditions. If these conditions are not met, it is difficult to reach robust conclusions on the absolute level of profitability.
6. **Comparative analysis of returns.** These shortcomings do not invalidate the use of ROCE altogether, under all circumstances. First, it might be possible to gain some insights into the potential biases introduced by the ROCE measures. Second, while accounting-based indicators may not allow one to reach a robust conclusion on the *absolute* level of profitability at any one airport, they may sometimes be useful for comparative analysis, to provide insights into the *relative* level of financial performance of UK airports. This might be true especially if it can be shown that all estimates over a certain period or in a given sector are likely to suffer from a similar bias in terms of magnitude and direction. Nevertheless, it should be noted that the latter approach has its own limitations which are drawn out in the main body of the text in this response.
7. Overall, bearing in mind the caveats outlined above, the high-level analysis discussed here suggests that BAA's non-designated airports earn, as a group, average returns when compared with a relevant sample of UK peers. This broadly supports the conclusions in the Commission's 'Financial and investment performance' working paper and the 'Emerging

¹ Competition Commission (2008), 'The financial and investment performance of BAA's non-designated airports', table 1, p.5

thinking' paper about the profitability of BAA's non-designated airports relative to their peers.²

8. **Level of investment.** Capital expenditure at an airport depends on business and customer needs. The nature of airport infrastructure often means that capital expenditure is lumpy in nature. For these reasons, high-level benchmarks of capital expenditure based on truncated time periods are difficult to interpret.
9. BAA is not aware that the Commission has taken these factors fully into account and notes that the Commission does not appear to have undertaken a robust analysis of the capital investment programme of BAA's non-designated airports, against the background of users' needs, commercial requirements and wider business drivers. Nor has it undertaken a similar exercise for non-BAA airports to establish an appropriate benchmark against which it could reasonably judge the performance of BAA's non-designated airports.
10. Further comparative analysis supports BAA's position that the level of investments at BAA's non-designated airports reflects business and customer needs, and that it is broadly in line with that of non-designated UK peers when adjusted for business characteristics.
11. **Investment performance of Aberdeen airport.** In 'Emerging Thinking', the Commission presents some analysis of potential underinvestment at Aberdeen.³ However, this observation seems to be based on limited evidence. In particular, a robust examination of the level of investment should take into account several different metrics and the business characteristics that drive investment requirements over time.
12. Therefore, it is important to take the specific features of Aberdeen fully into account when analysing the financial performance and investment decisions of the airport. The Commission's analysis does not appear to have incorporated the impact of factors such as Aberdeen airport's dependence on the oil and gas industry, its unique traffic structure, and its limited catchment area. When these are taken into account, the investment performance of Aberdeen is neither inadequate nor abnormal. This implies a rather different nature and level of business risk as well as capital expenditure requirements compared with other airports.

Commission's approach to measuring returns

13. The Commission has assessed the returns of the non-designated airports using an accounting measure of the ROCE. The Commission does not appear to consider other profitability measures based on cash flows, time value of money, relevant asset values

² Competition Commission (2008), 'The financial and investment performance of BAA's non-designated airports', para.27 p.10, and (2008), 'Emerging thinking', April 22nd, para.70 p.57.

³ Competition Commission (2008), 'Emerging thinking', April 22nd, para.53 p.50.

(including the value-to-owner principle), which might be less vulnerable to distortions or biases and could produce more meaningful results.⁴

14. More specifically, when accounting measures are used to estimate returns in the airports sector, biases might occur due to assumptions about depreciation profiles over a long asset life, accruals, and potentially significant differences between accounting and economic asset values. The results might therefore be difficult to interpret in absolute terms since the asset base is unlikely to be appropriate for the measurement of profitability.
15. In circumstances where the data required for estimating other metrics is not available, proxy measures might be used, such as the ROCE, the return on sales (ROS), or the return on equity (ROE). However, their estimation and interpretation are not straightforward and great caution should be exercised when deriving conclusions from such a simplified analysis, especially if the potential differences across different measures are not explored in detail.
16. In the case of the UK's non-designated airports, the data that might be required to employ alternative profitability measures is likely to be available and can be supplemented by appropriate adjustments. Therefore it is not clear why the Commission has opted to base its analysis of financial performance solely on ROCE measures.
17. In principle, the use of accounting measures of profitability does not invalidate the analysis per se. However, the use of accounting-based indicators is subject to a number of prerequisites. In particular, the ROCE can be made to correspond to the internal rate of return measures, where the following important conditions are met:⁵
 - the value-to-owner principle is used for valuing assets;
 - all changes in the book value of assets are reflected in the profit and loss account; and
 - the ROCE is calculated as a weighted average over time using Kay's formula.⁶
18. It is unclear whether these methodological requirements are satisfied in the Commission's analysis. At a minimum, the potential biases involved in the use of such indicators should be explored and clearly acknowledged, and the analysis should include appropriate sensitivities with respect to the assumptions underlying the estimation. Moreover, the conclusions should not be based on a single indicator or metric, but should take into account other approaches as cross-checks.
19. In general, the main difficulties that might affect the measurement of the ROCE are the following:

⁴ See also OFT (2003), 'Assessing profitability in competition policy analysis', prepared by Oxera, July.

⁵ OFT (2003), 'Assessing profitability in competition policy analysis', prepared by Oxera, July.

⁶ See Kay, J. (1976), 'Accountants too, could be happy in a golden age: the accountant's rate of profit and the internal rate of return', *Oxford Economic Papers*, 28.

- The measurement of operating profits (ie, the numerator) depends on the timing of recognition of revenues and expenses.
- The standards used for measuring asset values (ie, the denominator) vary considerably across different airports' accounts, and not all valuation standards are relevant in the context of a market investigation. It is unclear from the Commission's paper why the book asset values were used for the analysis, and whether other standards, such as replacement values or market values, were considered and to what effect. In particular, the value-to-owner principle does not appear to have been applied, which could lead to a revision of the results.
- It is important to note that asset valuation issues affect all profitability measures. However, the impact may be more significant on a ROCE analysis. This will particularly be the case when the asset values are subject to substantial fluctuations over the period in question. This is likely to be this case for BAA's non designated airports, given the level of investment in airports over the period from 2000 to 2006.⁷
- The Commission has asked BAA to provide estimates of returns for BAA's non-designated airports based on a regulatory asset base approach to valuing assets. The resulting ROCE estimates based on RABs differ significantly from estimates based on net book values. This highlights the vulnerability of the ROCE measure to the asset valuation method chosen.⁸
- Finally, ROCE estimates are sensitive to the time period chosen. The Commission's estimates are based on a series of measurements for one-year time periods. A single year's estimate cannot be relied upon since it might be driven by factors specific to that year.⁹ Moreover, simple averaging of the ROCE estimates over time is unlikely to eliminate potential biases. A more economically meaningful approach would be to consider the returns over a period of time measured against the appropriate opening and closing asset values.

20. BAA has checked the ROCE calculations provided by the Commission. The calculations appear consistent with the use of a historical-cost basis. However, the *absolute* level estimates of returns using ROCE based on historical costs, without support from other measures and an investigation of the measurement issues, are unlikely to be suitable for

⁷ The length of the time period over which returns are estimated is important. In particular, in the case of airports, returns could be looked at using different timeframes. This will have an impact on profitability values. For example, profits over the last five years may not fully reflect investment activity undertaken by the owner over the last decade.

⁸ Differences in accounting and economic depreciable life assumptions will affect estimates based on the ROCE. If the accounting depreciable life is shorter than the economic life of an asset, as is usually the case in the airport industry, in later years ROCE values will overestimate profits.

⁹ The ROCE is sensitive to the lumpy nature of capital investment. In years with a relatively intensive capital programme, ROCE values tend to be low, whereas in periods with relatively low CAPEX, the ROCE tends to be high.

meaningful economic interpretation, and may lead to distortions, including upward biases, in estimates of profitability.¹⁰

Comparative analysis of returns

21. While ROCE might not be meaningful as an absolute comparative tool, a relative comparison of profits with appropriate peers may provide some insights into the level of returns earned by BAA's non-designated airports. Nevertheless, it is important to bear in mind the caveats discussed above, as some of these are also likely to be relevant to the comparative analysis of returns.
22. The Commission appears to have undertaken a benchmarking analysis based on the TRL dataset and methodology, as well as the data for non-designated UK airports (in particular, non-BAA airports).¹¹ However, the evidence presented in the 'Benchmarking Operating Performance of BAA Airports' working paper does not allow any clear conclusions to be drawn. According to the indicators such as aeronautical revenue per passenger, commercial and other revenue per passenger, and total revenue per passenger, BAA's non-designated airports as a group have lower returns than the average for non-BAA UK airports. However, on the basis of the EBITDA margin and operating profit per passenger, BAA's airports appear to earn somewhat higher profits.¹²
23. In the Financial performance paper, the Commission does not explicitly compare BAA's non-designated airports against other non-designated UK comparators. Instead, it compares returns at the Scottish airports and Southampton airport with those at BAA's designated London airports. This is not appropriate for several reasons outlined below. Moreover, the Commission does not explain why it considers its adopted approach to be the appropriate basis for comparison, nor why it considers it to be more appropriate than comparisons with other non-designated, non-BAA airports.
24. At the same time, the Commission's overall conclusion [27] that Glasgow, Edinburgh, Aberdeen and Southampton airports are broadly characterised by levels of returns that are not higher than their non-designated UK peers, appears correct and is supported by further evidence presented below.¹³
25. Given the difficulties associated with the ROCE calculations, the implicit assumption underlying the Commission's analysis appears to be that the potential biases associated with ROCE estimates are present at all airports and average out in the comparative exercise. In principle, it may be possible to reduce such biases further by making certain adjustments to the data obtained directly from financial reports.

¹⁰ For example, in the case of airports, the treatment of operational land is particularly important. Appreciation in the value of the land, which reflects the cost of an alternative use, should be included in the asset base. Exclusion of the value of the operation land will introduce upward bias in the ROCE-based profits.

¹¹ Competition Commission (2008), 'Benchmarking Operating Performance of BAA Airports'.

¹² Competition Commission (2008), 'Benchmarking Operating Performance of BAA Airports', para.25-29.

¹³ Competition Commission (2008), 'The financial and investment performance of BAA's non-designated airports'.

26. Indeed, to ensure like-for-like comparison, some of these adjustments are applied by TRL.¹⁴ As highlighted in BAA's response to the Commission's benchmarking paper, TRL focuses on core airport activities only—ie, the provision of runways, taxiways and aprons for the use of airlines and their agents; the provision and operation of terminals in which passengers' pre- and post-flight formalities are completed, including baggage handling; and the provision of space within terminals in which concessionaires in a variety of retail businesses may provide shopping, restaurants and cafes, and amusement facilities for passengers' use. Accordingly, TRL attempts to remove all measurable effects of non-core activities, such as air traffic control services, catering services, as well as hotel ownership and operation.¹⁵
27. The Commission does not seem to carry out any such adjustments when conducting its own analysis. The different scope of activities carried out by airport operators (including ANS, surface access and training etc) could impact on the relevance of profitability indicators. Furthermore, the Commission's analysis does not explicitly take into account the differences in business and financial characteristics of the airports that might significantly affect profitability indicators, as well as underlying profitability estimates.
28. BAA recognises that such adjustments are not always easy to make. Careful consideration should be given to the data manipulation used in comparative analysis. In several instances, the Commission has attempted to make adjustments to the data. However, in a number of instances these adjustments are erroneous, which makes the comparison less reliable and introduces biases.¹⁶
29. Furthermore, in order to strengthen this comparison exercise, it might be helpful to identify relevant *exogenous* factors that affect profitability and/or risk differentials that suggest different levels of required returns across airports. It might also be helpful to use the appropriate methodology to control for such factors. This process could involve narrowing down the sample for comparison to include only the airports that are more directly comparable or which can be seen as being equally exposed to such factors as BAA's non-designated airports. In this context, BAA's paper on benchmarking discusses a number of factors that might be of relevance in this context.
30. With regard to the sample selection, the comparison of Glasgow, Edinburgh, Aberdeen and Southampton with BAA's designated airports, as well as with *all* non-designated UK airports, might be inappropriate due to significant differences in business characteristics. Some of the most important characteristics, which might have an impact on profitability and risk, include size, structure of traffic, geographical location, capacity utilisation, and the historical profile of investment over the long term, although this is unlikely to be an exhaustive list.
31. The comparison of non-designated airports with the London designated airports might be of limited relevance. The designated airports are the three largest airports in the UK by

¹⁴ TRL (2006), 'Airport performance indicators 2006', Section 2, p.3.

¹⁵ BAA (2008), 'Benchmarking response', Section 3, footnote 11.

¹⁶ This is further discussed in BAA (2008), 'Benchmarking response'.

passenger volume (and among the largest airports in Europe), and are significantly larger than any other UK airports (with the exception of Manchester). They also have very specific and substantial capital investment programmes, different revenue sources and specific traffic structures. Above all, the fact that London airports are designated invalidates such comparisons given that these airports have been subject to RPI-X regulation for the past 20 years. This is because regulation implies, among other factors, different business and commercial strategy, different timing of investment decisions, a different approach to pricing, as well as different cost incentives.

32. The non-comparability issue highlighted above is further exacerbated by the fact that the returns of BAA's designated airports, as estimated by the Commission, have been measured for the regulated parts of the business, while the profits earned by BAA's non-designated airports were estimated for a broader and different range of activities, including, for example, property management, car park leasing, training, and surface access.
33. In terms of other comparators, most of the airports presented in the TRL dataset are major international airports. Therefore, their financial and operational characteristics differ significantly from those of an average UK *regional* airport. Thus, the comparison of BAA's non-designated airports with these international airports, on the assumption that they are appropriate comparators, is not meaningful.
34. Sample selection can be approached in a variety of ways, including using statistical techniques, such as clustering analysis that provide a less subjective technique for identifying the most appropriate group of peers. However, clustering analysis requires specification of the criteria to be used to derive clusters, and a wide range of factors could be considered. As an illustration, four factors have been considered in this case: size, capacity utilisation, seasonality, and traffic structure. These could be seen as relevant because size will imply economies, as well as diseconomies, of scale (ie, airports are more likely to be comparable to other airports of similar size);¹⁷ traffic structure affects the split between aeronautical and non-aeronautical revenues;¹⁸ seasonality has an impact on the level of investment an airport needs to commit in order to satisfy peak demand; and capacity utilisation is associated with higher operational risks.¹⁹ This is unlikely to be an exhaustive set of factors that might be relevant in this case, but it already provides some insights into the likely impact of such factors on comparability of airports. The clustering analysis based on these four factors as the defining criteria identifies the following airports as potential comparators for BAA's non-designated airports: Luton, Birmingham, Newcastle, Bristol, Belfast, Liverpool and East Midlands.²⁰

¹⁷ The interaction of size with other business characteristics might also be complex. For example, a larger size might typically be associated with a more diversified customer base, but this might not be the case for more specialised airports serving a particular type of clientele.

¹⁸ Traffic structure also affects operational costs, as long-haul passengers are more costly to the airport than short-haul passengers.

¹⁹ Capacity utilisation is also associated with the increasing congestion costs incurred by airlines and airport operators.

²⁰ The analysis can be provided to the Commission.

35. In order to supplement the Commission's analysis, a comparative exercise was performed on the basis of this sample using a range of accounting measures: ROCE (on book values), ROCE (on historical values), ROS (EBITDA/revenue), aviation revenue per pax, total revenue per pax, and EBITDA per pax. The results which are presented in Appendix 1 of this paper indicate that the returns at BAA's non-designated airports are broadly in line with those reported by non-BAA airports in the UK that have similar characteristics.
36. At the same time, these results still have to be viewed in light of the challenges associated with the use of accounting measures of returns, as outlined above. As discussed, some or all of these measures might be affected by, or sensitive to, among other factors, the accounting principles chosen by individual airports. The fact that the results of this comparative analysis are broadly consistent across the accounting measures further supports the conclusions of this high-level, relative profitability analysis.²¹

Level of investment

37. The Commission's analysis in the Emerging thinking paper singles out the level of capital expenditure at Aberdeen as insufficient:

*"The above criticisms are in our current view indicative of a lack of ambition in development of Aberdeen, with evidence of underinvestment, inadequate facilities"*²²

However, this conclusion does not seem to rely on a thorough examination of the capital investment programme of BAA's non-designated airports and its appropriateness to Aberdeen's business needs. In particular, the Commission does not present its own analysis of the investment programme that it considers should have been undertaken by the airport to meet users' needs. As such, it is difficult to comment on the reasoning behind the Commission's views when the Commission has not presented the performance benchmark against which it is assessing BAA's performance at Aberdeen.

38. Airport investments tend to be lumpy in nature, and specific to the facilities and the time period in question. If the intensity of the investment programmes at different airports is to be compared, a number of appropriate metrics need to be examined. This could include ratios such as capital expenditure to depreciation charge, depreciation charge to fixed assets, and/or capital expenditure growth relative to passenger growth. The evolution of these metrics over time might also need to be considered carefully.
39. These metrics can be obtained from statutory accounts, although differences in accounting principles may impair comparability. Table 1 below presents investment levels at BAA's non designated airports, which tend to be higher than BAA's peers.

²² Competition Commission (2008), 'Emerging thinking', April 22nd, para.14 and 53.

Table 1 Capital expenditure (£'000s)

	2001	2002	2003	2004	2005	Total CAPEX
Aberdeen	860	2,400	3,300	5,000	7,100	18,660
Belfast International	2,769	4,109	2,900	2,665	6,140	18,583
Birmingham	31,873	62,287	13,464	13,336	20,317	141,277
Bristol	6,038	4,251	6,138	4,944	15,361	36,732
Edinburgh	5,556	9,100	30,000	39,000	23,300	106,956
Glasgow	17,011	8,300	13,500	13,100	15,900	67,811
Liverpool	32,691	5,700	17,794	7,236	17,800	81,222
Luton	1,163	6,475	11,780	8,987	31,957	60,362
Newcastle	7,951	1,916	3,646	14,300	10,757	38,570
East Midlands	3,275	5,715	5,715	5,075	9,036	28,816
Southampton	7,740	625	8,820	6,198	5,536	28,919

Source: CRI, statutory accounts, CAA, BAA.

40. BAA has been continually investing at its non-designated airports. In particular, in recent years, the level of investment in BAA's non-designated airports has been amongst the highest in the UK airports industry. Investment performance at Aberdeen airport is discussed separately below.
41. The extensive capital expenditure programmes at BAA's non-designated airports are associated with fast growth in the value of tangible assets. The growth rates of fixed assets exhibited by Glasgow, Edinburgh, Aberdeen and Southampton are some of the highest in the industry, as shown in Table 2.

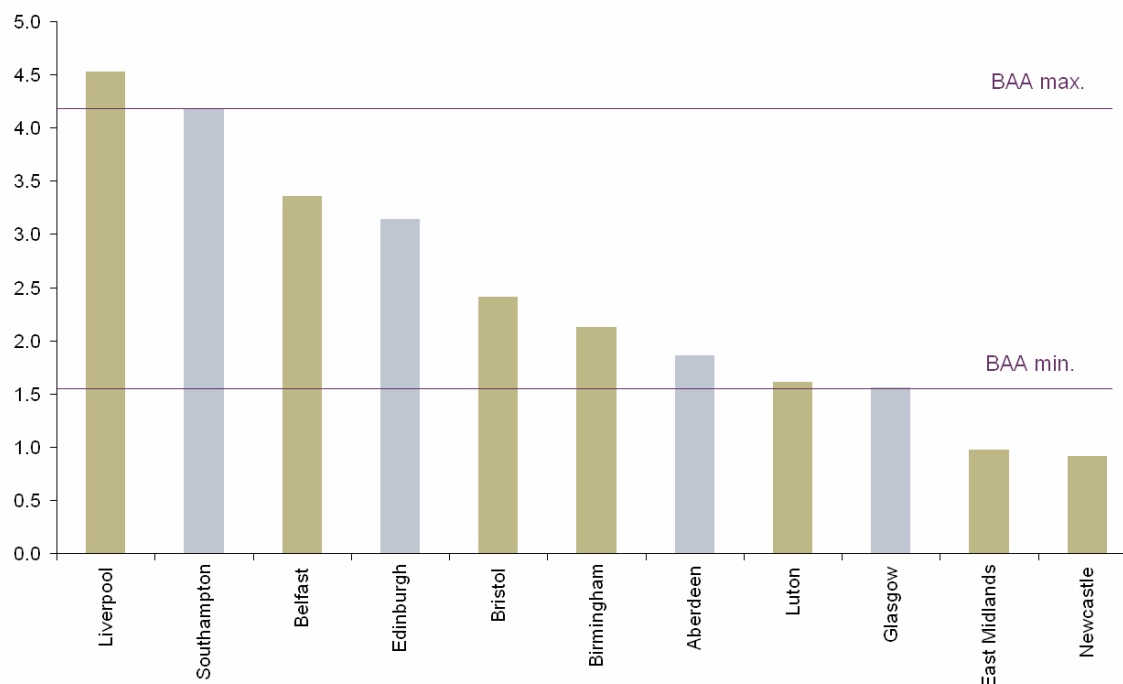
Table 2 Fixed assets (£'000s)

	2001	2002	2003	2004	2005	CAGR
Aberdeen	70,558	73,954	80,275	92,395	104,954	10.4%
Belfast						2.3%
International	46,447	46,752	47,500	47,642	50,917	
Birmingham	268,721	315,379	313,334	310,516	312,033	3.8%
Bristol	62,439	63,563	67,075	69,442	81,083	6.8%
Edinburgh	167,366	174,431	203,175	247,847	269,709	12.7%
Glasgow	220,272	210,217	222,804	247,347	266,844	4.9%
Liverpool	80,967	81,693	94,065	95,320	105,768	6.9%
Luton	76,163	76,424	81,380	84,256	107,227	8.9%
Newcastle	95,612	92,193	91,093	247,813	244,359	38.4%
East Midlands	185,360	185,890	189,870	270,137	279,218	10.8%
Southampton	58,949	58,936	71,284	84,297	98,274	13.6%

Note: CAGR, compound annual growth rate.

Source: CRI, statutory accounts, CAA, BAA.

42. One potentially useful indicator to examine when conducting a high-level assessment of the capital investment programmes at different airports is the 'capital expenditure to depreciation' ratio. This ratio approximates the net improvement of the asset base for a given airport and can be seen as a proxy for the development of fixed assets over time.
43. Figure 1 presents the 'capital expenditure to depreciation' ratios for a selection of airports. The estimated ratios for all three Scottish airports and Southampton are all above unity (i.e. they imply the value of assets has been rising, rather than falling).
44. In principle, the validity of the interpretation of this ratio as an indicator of the net improvement in assets may be affected by historical cost accounting as well as other variations to the accounting policies. However, the overall conclusion is corroborated when the ratio is analysed alongside the other metrics discussed in this section, especially the level of growth in fixed assets.

Figure 1 CAPEX to depreciation (5-year average)

Note: Belfast refers to Belfast International.

Source: CRI, statutory accounts, CAA, BAA.

45. Evidence presented on the absolute and relative (to depreciation) levels of investment, as well as on the growth in fixed assets, suggests that the investment performance at BAA's non-designated airports is at least adequate and, in some cases, significantly above the average. On the basis of this high-level analysis, the level of investment at BAA's non-designated airports does not appear to be out of line with that of other UK airports.

Investment at Aberdeen airport

46. The Commission considers Aberdeen to be an outlier among its peers. The performance of Aberdeen is represented by the Commission as that of high profits and low investment.²³

47. Notwithstanding the measurement issues associated with the indicators used by the Commission, a thorough examination of the drivers of these performance metrics does not appear to have been explored by the Commission. Overall, this is an area of the Commission's analysis where additional evidence would clearly need to be developed before reliable conclusions could be reached.

²³ Competition Commission (2008), 'Emerging thinking', April 22nd, para.14 and 53.

48. More specifically, the level of capital investment at any particular airport would need to be assessed against the pace of traffic growth at that airport and the overall economic situation in the region where the airport operates, as well as commercial and passenger needs.
49. Table 3 clearly indicates that Aberdeen is unique in terms of its business characteristics. Not only does it stand out in comparison to non-BAA airports, but it also differs from the other BAA airports with respect to these characteristics. It should therefore be analysed separately, in terms of both its investment behaviour and its financial performance.

Table 3 Comparison of key metrics for Aberdeen and other non-designated UK airports

	Passenger traffic, 2005/06 ('000s)	Proportion of aeronautical till in revenue, 2005/06 (%)	Domestic traffic, 2005/06 (%)	Non-EU traffic, 2005/06 (%)	Proportion of business passengers	Average CAPEX per passenger over last four years (£/PAX)
Aberdeen	2,956¹	57%	49%	43%	56%	1.63
Belfast International	4,828	47%	79%	3%	23%	0.96
Birmingham	9,465	57%	28%	8%	23%	2.20
Bristol	5,212	49%	41%	5%	20%	1.74
East Midlands	4,157	58%	27%	7%	16%	1.55
Edinburgh	8,510	60%	75%	2%	43%	3.20
Glasgow	8,842	54%	69%	6%	30%	1.51
Liverpool	4,655	47%	45%	5%	20%	3.36
Luton	9,181	46%	20%	8%	20%	1.91
Newcastle	5,248	54%	49%	5%	22%	1.63
Southampton	1,860	59%	72%	0%	39%	4.7
Average	5,809	53%	50%	8%	28%	2.5

Note: ¹ Aberdeen's passenger traffic figure does not include helicopter traffic. Given the unique traffic structure at Aberdeen and dependence on the oil and gas industry, inclusion or exclusion of the helicopter traffic may have a significant impact.

Source: CRI, statutory accounts, CAA, BAA.

50. Aberdeen exhibits the lowest passenger traffic volume within the sample, and the highest proportion of business travellers and non-EU traffic.

51. These characteristics are likely to reflect a different risk profile for Aberdeen.

- Traffic at Aberdeen depends heavily on the oil industry. The development and sustainability of the oil business in the North Sea is subject to some uncertainty, which should be considered when assessing investment over time.
- The cost of oil exploration and production in the North Sea has increased significantly over the past decades, making it one of the most expensive oil-producing regions in the world. At the same time the volume of oil extracted is declining; Oil & Gas UK estimates that, without an appropriate level of investment, production will decline by around 15% to 20% per year.²⁴
- This dependence on the oil industry is reflected in a unique traffic structure at Aberdeen, characterised by a large proportion of helicopter ATM,²⁵ a majority of business passengers, and a high proportion of non-domestic, non-EU traffic.
- As highlighted in the Commission's Emerging thinking paper,²⁶ Aberdeen's catchment area is local and peripheral: 87% of its passengers are drawn from Aberdeen and Aberdeenshire. In addition, there is no evidence of airline switching to and from Aberdeen airport. Therefore, the potential for growth of traffic from the local population is somewhat limited. Rather, the traffic is most associated with oil and gas-related activities.

52. Arguably, this high degree of dependence on one industry and a relatively small population centre, increases the risk of stranding for the airport's investments. These factors have been reflected in slower traffic growth at Aberdeen over the recent period, compared with the other Scottish airports. Traffic at Aberdeen has stagnated for most of the period since the mid-1990s. It decreased by 7% in 1997/98, and only reached its pre-1997/98 level again in 2004/05.

53. In the Commission's view, the level of investment at Aberdeen airport has been inappropriately low. BAA strongly disputes this view, and believes the Commission may have attached undue weight to the evidence presented by third parties.

54. Typically, capital expenditure in the airports industry consists of large, discrete projects. Thus capital expenditure observed over any short period of time is unlikely to provide an accurate representation of the steady-state capital costs of airports. For this reason, it is important to examine future as well as historical capital expenditure plans.

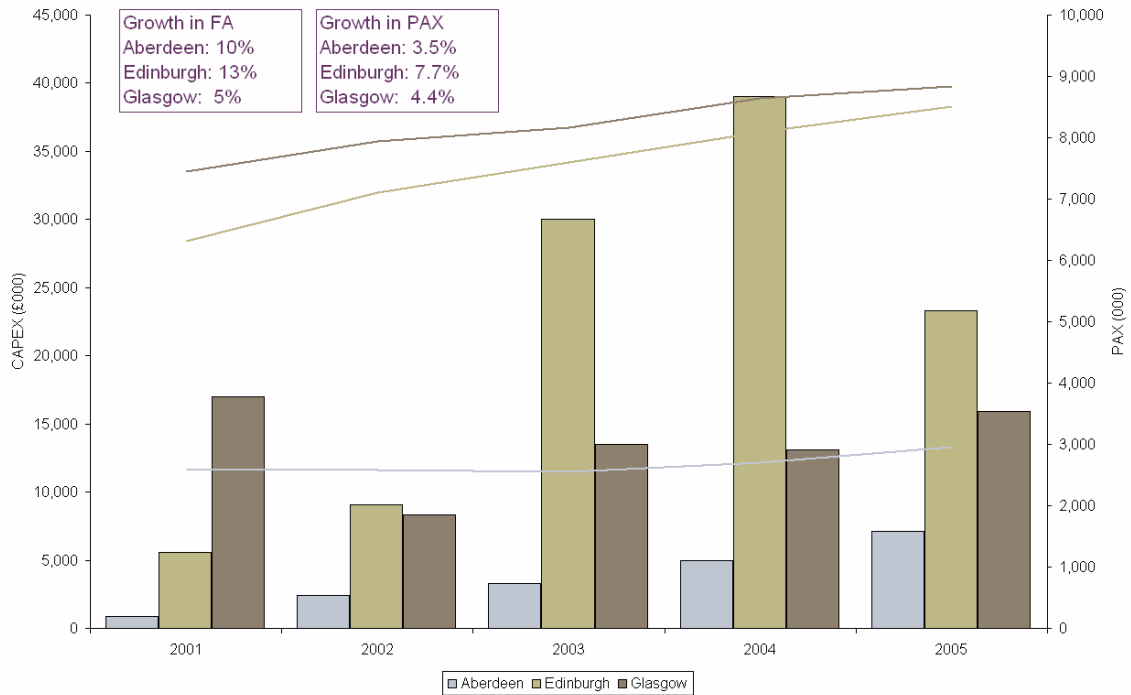
²⁴ *Financial Times* (2008), 'Soaring costs put pressure on North Sea', May 29th, <http://www.ft.com/cms/s/0/a7734c88-2d18-11dd-88c6-000077b07658.html>.

²⁵ The available data does not seem to suggest a significant proportion of helicopter ATM at other UK airports.

²⁶ Competition Commission (2008), 'Emerging thinking', April 22nd, para.126d p.88.

55. Figure 2 below suggests that the level of investments at the three Scottish airports has been commensurate with passenger growth. Of note is the fact that capital expenditure has continued to grow at Aberdeen even as traffic was declining or stagnating.

Figure 2 Capital expenditure and passenger growth



Note: FA, fixed assets.

Source: BAA.

56. Following 2001, during the period of low traffic growth, the capital expenditure at Aberdeen increased by more than 60%—one of the highest rates in the industry. This investment was undertaken with the support of airlines, local authorities and other local stakeholders.

57. In addition, the asset base at Aberdeen airport was growing at one of the highest rates in the industry: 10% per annum. This suggests that, at a minimum, the level of investment at the airport was not out of line with that at other UK airports.

58. Overall, the evidence presented in this section indicates that the level of investment undertaken at BAA’s airports has been at least commensurate with the business and economic environment faced by these facilities. Importantly, this conclusion applies to Aberdeen airport as well as Glasgow, Edinburgh and Southampton airports.

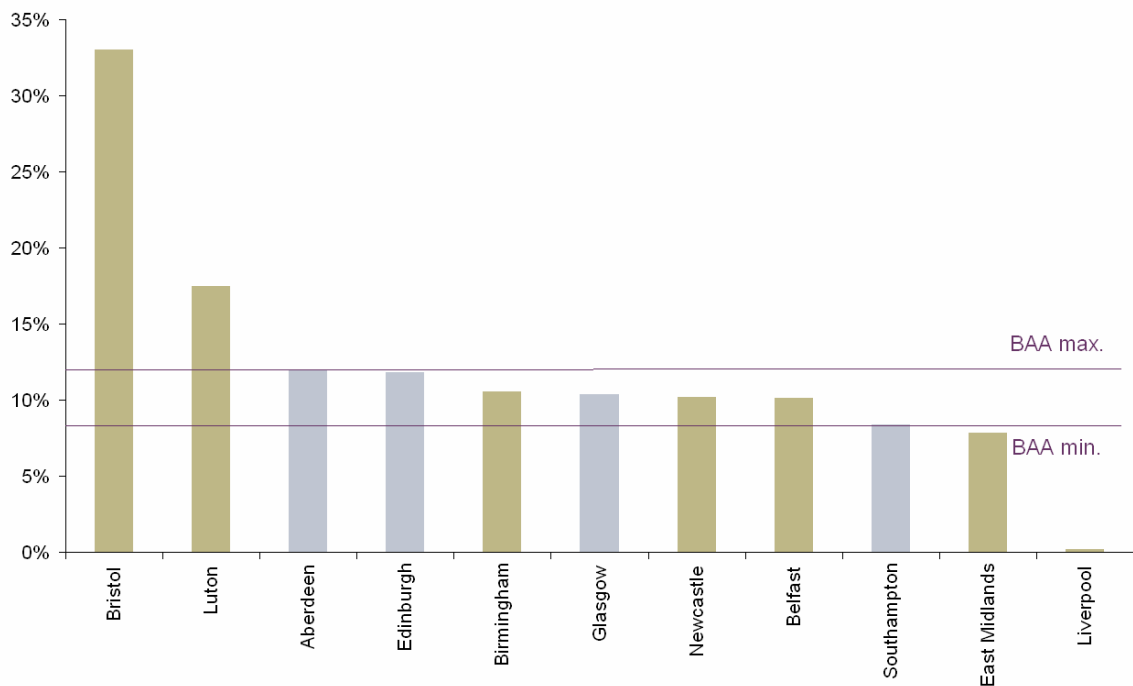
Appendix 1

This appendix presents the results of a high-level comparative analysis of returns. As outlined above, the comparison with relevant peers may provide some useful insights into the *relative* financial performance levels of Glasgow, Edinburgh, Aberdeen and Southampton.

The returns presented in this section were estimated on an annual basis and averaged over a period of five years. The note discusses the potential limitations of this approach as well as the approach adopted by the Commission.

Figure A1 represents a comparison of returns measured using ROCE based on book values of assets. Over the period from April 2001 to March 2006, BAA airports earned between 8% and 12% returns, with the industry average of around 12%.

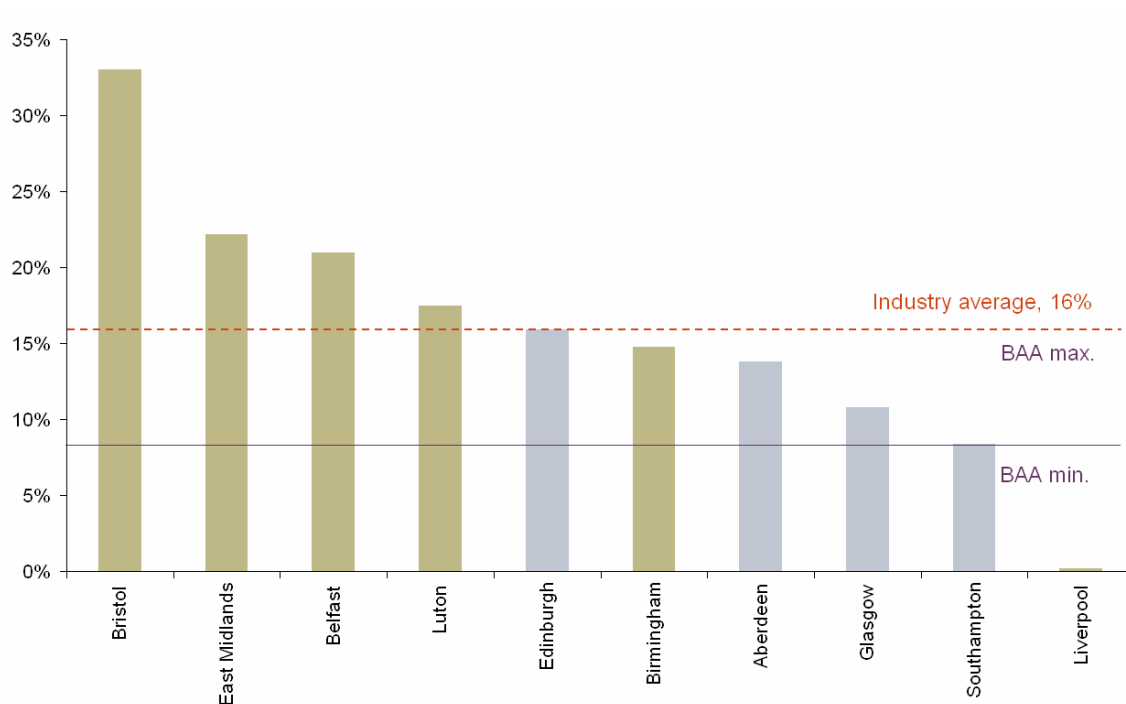
Figure A1 Return on capital employed (book values, 2001/2–2005/6)



Note: Belfast refers to Belfast International.

Source: CRI, statutory accounts, CAA, BAA.

Figure A2 shows the results of comparison of the ROCE based on historical costs of assets. Using this measure, the returns of BAA's airports range from 8% to 16% with the industry average of around 16%.

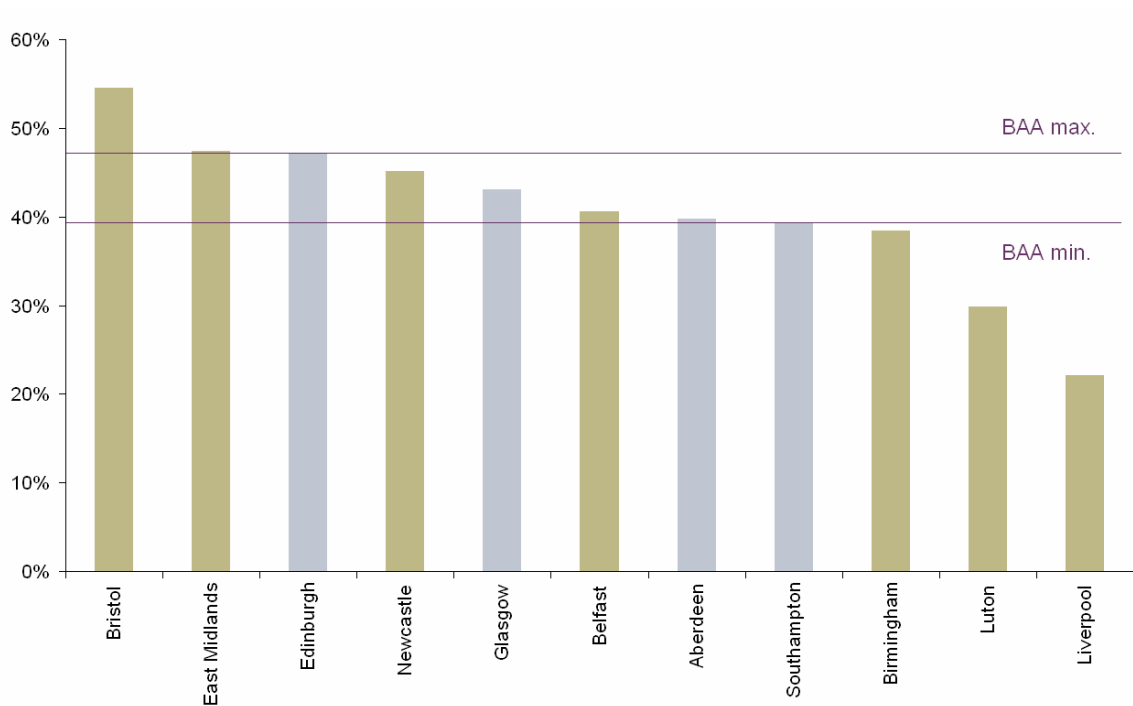
Figure A2 Return on capital employed (historical costs of assets, 2001/2–2005/6)

Note: Belfast refers to Belfast International.

Source: CRI, statutory accounts, CAA, BAA.

Historical ROCE measures indicate that BAA's airports earned substantially lower returns than were typical at the selected UK non-designated airports.

The comparison of Scottish airports and Southampton with selected non-designated UK airports using the EBITDA margin shows that the returns of BAA airports are not out of line with the margins at other airports. This is shown Figure A3 below.

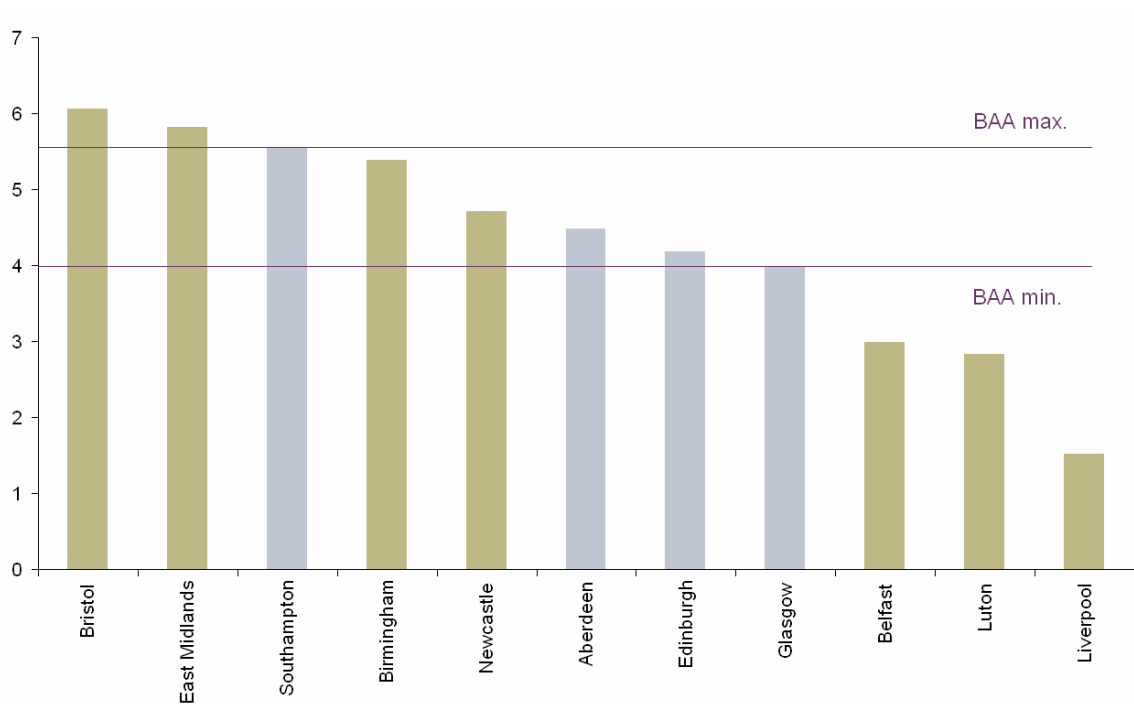
Figure A3 Return on sales (EBITDA/revenue: average 2001/2–2005/6)

Note: Belfast refers to Belfast International.

Source: CRI, statutory accounts, CAA, BAA.

If EBITDA per passenger is used instead as a measure of returns, the comparison shows a similar result to the previous one. See Figure A4.

Figure A4 EBITDA/passenger (average 2001/2–2005/6)



Note: Belfast refers to Belfast International.

Source: CRI, statutory accounts, CAA, BAA.

The results of the comparisons based on accounting measures of profitability, indicate that returns earned by Glasgow, Edinburgh, Aberdeen and Southampton are broadly in line with the returns of other non-designated UK airports. All of the results presented above should be viewed in light of the comments about the measurement issues, the choice of profitability metrics and time periods, as well as comparability of results across different airports discussed in the note.