



NON - CONFIDENTIAL

BAA's response to issues and allegations raised
by the Competition Commission at the
hearing on 12 March 2008

BAA/CC2008/650

BAA Limited
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A. Introduction

1. This document and annexes comprise BAA's comments following the hearing with the Commission on 12 March 2008. It includes the additional information which BAA offered to provide as well as BAA's response to the Commission's information requests arising from the hearing dated 20 March 2008 (the "20 March Request").¹ References to the transcript are in the form [page/line].
2. Section B of this document contains BAA's general comments on the hearing and the matters raised by the Commission. Section C contains detailed comments by reference to the transcript and the responses to the Commission's information requests. Section C follows the order of the hearing.

B. General Comments

3. The bulk of the hearing addressed the following issues:
 - i. Capacity Development;
 - ii. Relationship with the airlines; and
 - iii. Non-regulated BAA airports.
4. Although we deal with each of these issues in detail in section C of this paper, BAA has some general comments to make on each.

Capacity Development

5. The Commission put various allegations to BAA that it has failed to develop its airports and press for additional runways as much as it could have; it was suggested that separate owners of the BAA airports would have done more than BAA has. Some of these allegations involve reaching back into the past to suggest that with hindsight BAA could have done more but with no explanation as to why separate owners would have acted differently.
6. BAA's response to these allegations is as follows:
 - i. It rejects these allegations. It has not seen compelling evidence which supports these allegations (which have been put in extremely vague terms).
 - ii. The record shows that BAA has successfully developed its airports in the past, increasing the capacity of facilities and infrastructure with sustained investment. In doing so it has been limited by government policy but has sought to influence that policy in favour of airport development whilst at the same time avoiding any adverse impact on its planning applications. It has had to make concessions in the course of those applications in order to secure planning permissions but such concessions have not gone beyond what was reasonable or necessary to secure the permission.

¹ Email from Julie Hawes of the Commission to Louise Pengelly (BAA).

- iii. In important respects these “concessions” were not set in stone and could be overturned if government policy were to support new capacity being built. Since government support was a requirement for major capacity expansions in the south east, in any event, in important respects these “concessions” gave nothing away.
 - iv. BAA supports the 2003 White Paper and is alone in actively pursuing runway developments set out in the White Paper. Its conduct in the consultations leading to the White Paper and its response to it is the most reliable and compelling evidence as to BAA's current and future approach to airport development.
 - v. By contrast allegations relating to matters in some cases 20 years ago (even if correct) are irrelevant and certainly not compelling evidence as to BAA's approach to capacity development in the recent past or indeed the future.
 - vi. Whilst the focus of the Commission's questions were on what separate owners might have done in the past we note the Commission did *not* put to BAA that separate owners would implement the White Paper more quickly than BAA. Nor did it suggest that there is scope to secure government policy support for greater airport development than is set out in the White Paper.
7. Again, the Commission did not engage with BAA on the issue of the way in which the 2003 White Paper determines the location and sequence of future capacity development in the period to 2030. In BAA's submission this is an essential issue for the investigation.
 8. An issue we return to later is the consideration by the Commission of the same (or similar) issues to those considered by previous price control reviews. At each review, BAA's record of investment over the proceeding five years was considered, as well as its plans for investment over the next five years. BAA notes that many of the issues raised by the Commission at the hearing were either not raised in the course of price control reviews or if they were the Commission made no adverse findings against BAA.

Relationships with Airlines

9. The Commission raised a number of complaints made by the airlines regarding BAA's alleged behaviour towards them and in particular the adequacies of the constructive engagement processes. Much of this part of the hearing focussed on engagement with the airlines in relation to proposals for G2 at Stansted.
10. BAA would like to make clear that it does take constructive engagement seriously and approaches this in good faith. It is willing to consider improvements to the process. However, it is inevitable that there will be disagreements with airlines: BAA is not unique in this regard.
11. In relation to the particular issues raised by the Commission:
 - a. *HET Delays* BAA considers that it has not been slow in informing airlines about delays in the construction of HET and it has taken the necessary steps to mitigate the delay as far as possible.

- b. *Contingencies* BAA's contingencies for projects are within industry norms. That said recognising airline concerns on the expenditure of contingency monies BAA has committed itself to greater transparency and engagement with airlines on the expenditure of contingency monies through Enhanced Information Disclosure and Consultation (CAA Decision Annex G).
- c. *Capex reviews* There are good reasons for the increase in capex programmes at Heathrow and Gatwick which reflect the addition of new projects requested by the airlines. There is broad agreement with these programmes and they have been approved by the CAA. In an unregulated world, consultations would be continuous and to some extent open-ended. The regulatory framework introduces artificial deadlines and there is inevitability some compression of the process as those deadlines near, which increases the risk that agreement will not be reached. That said BAA does not use the timetable tactically or in bad faith.
- d. *Stansted* BAA clearly disagrees with the ACC concerning the appropriate option for G2. BAA considers its option addresses all the necessary criteria for such a project: cost, passenger experience, environmental impact and flexibility, and operational performance. It believes that it has provided the information that the ACC needs to comment on the BAA option and/or formulate their own. We have sought to engage with the ACC to discuss the merits of potential alternatives. The ACC have not advanced an alternative option.

Non-Regulated Airports

- 12. The thrust of the questions put to BAA at the hearing was that BAA had not sufficiently developed its business at Southampton and its Scottish airports with comparisons being made with non-BAA airports. In the case of Southampton it was suggested that the reason for this was that BAA did not want it to compete with Gatwick.
- 13. BAA's response as regards Southampton is as follows:
 - a. Southampton's closest competitor is Bournemouth with which it competes vigorously. Moreover, common ownership with Gatwick does not diminish Southampton's incentives to draw business away from Gatwick because of binding price caps and scarce capacity at Gatwick. Taking business from Gatwick simply reduces the level of unmet demand and does not affect the profitability of Gatwick.
 - b. There is no evidence of a lack of commercial ambition on the part of Southampton:
 - i. It has increased traffic at the airport and has plans to grow further. There are constraints in terms of the types of aircraft that Southampton can currently handle which cannot readily be addressed because of the physical difficulties in lengthening or re-orientating the runway; however, BAA is developing the business as far as possible within these constraints.
 - ii. The s.106 Agreements at Southampton are a less significant restriction on runway development than the physical difficulties. However, the existence of these agreements cannot be the basis for any inference as to the lack of commercial ambition of BAA at

Southampton since they were largely negotiated *before* BAA acquired the airport and BAA was required to accept the runway development restrictions as part of its acquisition of the airport.

- c. BAA promotes Southampton aggressively to airlines and to the public. It offers route development discounts to airlines. ✂ This is reflected in a strong record of traffic growth and route development.
14. BAA's response in relation to issues raised in relation to Scotland (bearing in mind that the Commission spent little time at the hearing on the Scottish airports in contrast with Southampton) is that there is a strong record of business development which is as good if not better than that of non-BAA airports, in particular:
- a. Charges at BAA's Scottish airports are lower on average than for non-BAA airports and they are committed to ongoing price reductions;
 - b. They have been successful at business development. Applying what BAA considers to be more appropriate measures of development, including passenger growth, BAA's Scottish airports compare well with other airports in the UK.

Significance of Previous CC Reports

15. During the hearing BAA highlighted that the Commission had previously examined some of the factual issues which it is now investigating in its Q4 investigation and made findings on these issues [43/12- 43/16]. For example, the Commission found as a matter of evidence that there was no systematic under-investment by BAA at the three SE airports.² Since that time the likelihood of achieving major capacity expansions, including at Heathrow, has substantially *increased*, and as matters stand the record is now stronger than that prevailing when the Commission made its favourable assessment in 2002. BAA agrees that the fact that the Commission has examined matters in the past does not mean that it is precluded from doing so now. However, having dealt with issues in previous reports, at a time more proximate to those issues, it is BAA's submission that the Commission would need to have new and compelling material to justify departure from its earlier views.

Evidence

16. BAA is grateful for the invitation by the Chairman that BAA should develop the evidence that it gave at the hearing where it repudiates allegations made by third parties to the Commission or points made by the Commission itself [51/15-51/19]. In section C we have done so. Obviously if the Commission requires further information or evidence on any of these matters BAA would be willing to provide that additional material.

² This finding was made both in the context of public interest issues as well as a comparison of the investment incentive effects of single vs. dual till. See CC Report BAA plc (2002) at paragraphs 2.82, 2.98-2.101, 2.110-2.111, 2.117, 2.122, 2.222 and 2.406 - 2.413.

17. As the Commission will appreciate the hearing was the first time that the Commission has put some of these allegations to BAA. A number of these allegations were made in vague terms and without reference to the source of the allegation or the evidence relied upon, for example, the suggestion that BAA could have moved more quickly in relation to the T5 development or that BAA has sought to suppress capacity in the South East. Both allegations are discussed in more detail below. However, the general point is that without further detail of these allegations and/or evidence being relied upon by the Commission, it is difficult for BAA to advance evidence to rebut the allegation. Whilst BAA appreciates that there may be issues of confidentiality it also should have a proper opportunity to respond to those allegations if they are to be pursued in this inquiry; this will entail the Commission providing to BAA greater particularisation of these allegations and where possible (subject to confidentiality) the evidence upon which they are based.
18. This is particularly important where the Commission has raised allegations in relation to which BAA has already provided information. The Commission appears to be suggesting that it does not accept the evidence provided by BAA and by implication that it has more compelling evidence to the contrary. Indeed, the point was made during the hearing that the Commission would need to weigh up the evidence that had been provided. If this is correct the Commission needs to set out its detailed appraisal of the evidence provided by BAA and to identify the evidence to the contrary so that BAA has an opportunity to respond to it.
19. In section C of this paper we highlight the areas in which BAA has already provided a considerable amount of information and evidence to the Commission.

Legal Professional Privilege

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C. Specific Comments

Corporate Matters

20. It was agreed that BAA would provide notes on the following which are attached as annexes to this paper:
- i. Submissions to the CAA concerning credit markets [10/2 and 191/2-4] (**Annex 1**)³; and
 - ii. Details of approaches/discussions about the possible sale of an airport [15/15] (**Annex 2**) (also requested by the Commission [Question 2 of the 20 March Request]).
21. BAA has already provided details of the refinancing [11/23-12/6] and [13/22-14/2] in submission [BAA/CC2008/641] Question 1 of the 20 March request.

Capacity Development

Frankfurt and Other Continental Airports

22. During the course of the hearing Professor Moizer raised the issue of whether development of Frankfurt airport was relevant to the Commission's inquiry, in particular:
- i. He said Frankfurt had been able to develop notwithstanding strong opposition from the "green lobby" [17/20-25]; and
- ✂
23. Having carefully considered the transcript it remains unclear to BAA what point is being made by the Commission in relation to runway developments at Frankfurt or indeed other continental airports that were referred to by Mr Holroyd [44/21-23]. Obviously if there are points that the Commission wants BAA to address concerning whether runway development at Frankfurt airport (or indeed Paris CDG or Schiphol) then BAA will address these but it would be helpful if the Commission could set out the points in writing with any evidence that BAA should be aware of.
24. There is obviously a danger in seeking to draw international comparisons without a careful consideration of the wider political, environmental, legal and commercial context in which those other airports operate to assess whether any useful conclusions can be drawn.
25. At this stage BAA would make the following additional comments to those made at the hearing:
- i. Government policy support is critical to obtain the necessary planning permission for new runways in the UK. It was not until the 2003 White Paper that the Government gave the necessary policy support for a second runway at Stansted and a third runway at Heathrow. We understand that in Germany, France and the Netherlands positive government policy support (at both national and regional level) is also necessary for runway development. Runway developments have not proceeded without it. The manner and timing of the formulation of government policy will vary in each country. Moreover, how this policy affects

³ The refinancing paper which was also the subject of question 1 of the 20 March request has already been provided to the Commission [BAA/CC2008/641].

the planning process and in particular the speed of that process will vary from country to country depending on the legal/planning frameworks in place. For example, in Germany it is policy support at the state level which is most important. The fourth runway proposal at Frankfurt received the necessary support from the State of Hessen which is also a part owner of the airport in 2000/2001 following an "open-mediation process" which was started in 1998, precisely because the opposition to the third runway had been so violent. The planning process was only begun once state government support was secured. In France government support for additional runways at Paris CDG was very strong enabling the airport to rapidly secure the necessary planning approvals;

- ii. The expansion of runway capacity at Stansted and Heathrow will have major environmental impacts which will need to be mitigated. This is evident from the 2003 White Paper. This is not to say that Stansted and Heathrow are unique, as other airports have also faced similar difficulties.
- iii. The Commission is under a misapprehension if it believes that runway expansion at Frankfurt was achieved quickly. BAA understands that the third runway at Frankfurt was also controversial and took approximately 20 years from the time of the planning application to come into operation. The planning permission granted at the end of 2007 for the fourth runway at Frankfurt is now subject to legal challenge (see below). This just underlines the fact that sensitive and controversial developments can take longer to secure planning permission even where there is government support. It is true that Paris CDG has been able to complete the development of two new runways within 8 years of the original political decision to proceed, despite strong opposition. But that reflects the very strong policy support for those developments;
- iv. BAA is not suggesting the planning process in the UK is uniquely difficult or time consuming or that the level of opposition is materially greater. However, as noted above, the process can vary from country to country. BAA understands that the planning process on the fourth runway at Frankfurt began in mid 2001 and planning permission was obtained in December 2007. There is now a challenge to that permission and it is not expected that the litigation will be finally determined until 2010-2011. So although the planning system is different in Germany runway developments can take considerable time to secure the necessary approvals. By contrast, we noted at the hearing that the ease with which Paris CDG was able to secure planning permission for runway development *is* a reflection of the way that major infrastructure is planned and delivered in France.⁴; and
- v. Runway developments cannot in any event be easily compared: runways are not identical in terms of the proposed use or environmental impacts. For example, at Frankfurt there was a need for a fourth runway as there were limits on the use of the existing runways. Runways one and two are closely spaced parallel runways and as a result cannot both be used to their full potential. Due to conditions imposed during the planning process, runway three can only be used for take-offs and runway four will only be used for landings.

⁴ [44/24 – 45/1]

Heathrow - Terminal 5

26. The Commission (Professor Moizer) suggested that there appeared to have been a lack of urgency on the part of BAA in securing the Perry Oaks site (which was necessary for the development of T5) and putting the development forward [18/12-16], although he did not identify any specific step which could have been undertaken more quickly. At the hearing BAA rejected this suggestion and offered to submit a paper which sets out in more detail the steps taken to secure the site and progress the T5 development [19/17-18]. This paper is attached at (**Annex 3**) (also requested by the Commission [question 3 of the 20 March Request]).
27. In summary, the paper shows that BAA did actively pursue the release of the site and the preparation of the T5 planning application following the 1985 White Paper but that the combination of lack of clear support for a fifth terminal in the 1985 White Paper, the need to deal with a third party to secure the release of the Perry Oaks site in what was a complex and detailed set of negotiations, and the need to undertake various feasibility studies in coordination with government agencies made the process complex and time consuming.
28. If the Commission wishes to take this issue further it may be helpful if it could set out which steps in the process of preparing and submitting the planning application (which are set out in the annexed paper) it contends (or has been suggested to it) could have been undertaken more quickly and then BAA can provide comments on the reasons for the time taken in each case and any relevant evidence.
29. It is notable that this allegation was not raised in the context of the Q2 and Q3 references (there is no mention of it in the 1991 and 1996 MMC Reports). In particular, even though BA was the airline expected to operate from T5, it is not noted as having raised the issue in its evidence to the MMC. Clearly had delays been an issue, one would have expected them to have been raised at this time.
30. In the 2002 Commission Report it is stated that although no airline blamed BAA for the delays in T5 arising from the planning inquiry some airlines did believe that BAA could have sought planning permission sooner.⁵ BAA suspects this reflects frustration about delays in the planning process rather than any real concern about the timing of the planning application given the fact this concern appears to have only been raised nearly 10 years after the planning application was submitted. In any event the Commission made no adverse public interest finding against BAA on this issue nor did it suggest that BAA could have sought planning permission sooner.

⁵ Paragraph 2.392 of the 2002 Commission Report: BAA plc .

HET

31. The Chairman stated that it had been put to the Commission that BAA does not anticipate developments and suggested that the Heathrow East (HET) development *was not really thought about until relatively late in the process* [25/21-26/4].
32. As BAA explained at the hearing this was simply not the case. The opportunity to develop the central terminal area following the opening of T5 has been apparent to BAA's management since at least the late 1980's, as noted by the MMC in the report on the 1991 reference.⁶ We have attached a short note which outlines the history of development of HET (Annex 4). In summary, HET became a possibility in late 2003 when agreement was reached with BA to change its strategy for re-location to T5. Following this agreement, BAA began to develop proposals for HET.
33. BAA's original proposals to redevelop T1 and T2 were based on an MOU entered into with BA in April 1997 which provided that BA would become the prime occupier of T5 (if planning permission were given) but that BA would only gradually relocate to T5 in the years following its opening and that BA would still have operations at T1 by 2012. In November 2001 planning permission for T5 was given. In October 2003 BAA and BA entered into an MOU which provided for BA to move to T5 in one step in 2008. This MOU recognised that BA would accept service quality reductions as a consequence and that this single step relocation would have benefits for other users of the airport. BAA therefore took advantage of this redevelopment opportunity and, following consultation, reached an outline agreement with Star Alliance in September 2004 to co-locate their operations in a single terminal. This agreement was further developed in a MOU in January 2005 which in turn led to the detailed development of the HET proposal in consultation with airlines and the CAA.

Timing of Capacity Development

34. Professor Moizer also suggested that BAA undertakes development of capacity sequentially at its airports and suggested that separate owners at these airports would not approach development in this way [30/12-30/20] and [31/11-31/17]. We understand that the Commission's suggestion is not that BAA's developments *appear* to be sequential as this may just reflect the different requirements of the different airports at the time but rather that because of BAA's ownership of more than one airport it is undertaking capacity investment either too soon or too late because it wished to sequence that investment amongst its airports. Professor Moizer did not explain why BAA might want to take such an approach.
35. As noted above the Commission has in the past found no systematic under-investment by BAA at its London airports. More generally the Commission and the CAA have reviewed and approved BAA's capital expenditure plans for five-year periods at each of its London airports at every quinquennial review. BAA does not agree that the timing of terminal developments at Stansted,

⁶ Paragraph 7.29 of the 1991 MMC Report: BAA plc

Heathrow or Gatwick are inter-related in the way Professor Moizer suggests or that investment alternates between Glasgow and Edinburgh due to common ownership.

36. At the hearing BAA rejected this allegation and offered to submit information to illustrate that this was not the case [30/21-33/9] in particular, to provide information which shows the simultaneous increase in capacity at its airports. BAA can still provide this information if required. However, on reflection we are concerned that it would not fully answer Professor Moizer's point. In order to answer it BAA would need to better understand the precise point being made, and in particular which investments in capacity it is alleged to have sequenced (ie would have been undertaken at a different time by separate owners). For example, is the suggestion limited to the terminals at Stansted, Gatwick and Heathrow referred to at the hearing? In relation to Glasgow and Edinburgh, what investment was Professor Moizer referring to? Is the suggestion that these developments would have taken place sooner or later under separate owners?
37. BAA has provided some high level information at **Annex 5** concerning its capital investment expenditure. It shows in a series of charts the investment at each of BAA's airports. There is nothing in the pattern of investment revealed by these charts which supports the suggestion made by Professor Moizer.

Approach to Runway Development

38. Professor Moizer suggested that BAA has sought to restrict runway capacity in the South East [33/10-34/1]. This was based on a quote from what we understand to be an extract from a British Airways submission to the effect that BAA has not actively campaigned to influence government policy and a reference at the hearing to *documents* that the Commission has seen that BAA's position has been to actively downplay additional runways in the South East.
39. There are several comments that BAA wants to make about this suggestion:
- i. First, it strongly rejects the suggestion as it did at the hearing [34/2 – 36/9]. BAA has actively supported additional runways in the consultations leading up to and subsequent to the 2003 White Paper. It is now actively pursuing the runway developments endorsed by the White Paper at Stansted and Heathrow. Prior to this, BAA had supported the Government's studies (RUCATSE) into the options for additional runway capacity in the South East, and responded to the Government's request for the Company to lead work to assess the possibility of alternative options following the RUCATSE study. BAA was also clear throughout this period that new runway developments could only be taken forward within a clear and supportive Government policy framework, which BAA encouraged the Government to develop;
 - ii. Secondly, BAA was less public in its support during the T5 planning process because of concerns that its public support for new runways would undermine its application for planning permission for T5. Indeed, the issue was examined by the Commission in its 2002 Report in which it notes (without criticism or adverse finding) that BAA's reluctance to promote runway development at Heathrow had been to avoid jeopardising the T5 inquiry

and ultimately concluded that there was no evidence of underinvestment at Heathrow.⁷ It also recognised that T5 was critical to refurbishment of the airport.⁸ As outlined at the hearing securing permission for T5 in order to make the most effective use of the existing runways at Heathrow was a necessary pre-condition for further runway development; see [35/6 – 35/25].

- iii. Thirdly, aside from the British Airways submission it is unclear from the hearing what evidence or allegations Professor Moizer was referring to. Mindful of the Chairman's invitation to BAA to advance evidence to support its position, we would be grateful if the Commission could provide references to and/or copies of the material referred to by Professor Moizer so that BAA has a proper opportunity to answer these allegations;
- iv. ✂
- v. Finally, and generally, BAA did not and does not believe that BAA's best strategy for achieving the necessary government support for new capacity is always by aggressive public lobbying, which can be counter-productive.

40. BAA believes that this sensitivity was well understood by Heathrow airlines during the course of the Terminal 5 planning process and that BAA's approach on these issues was supported at the time. BAA understands that it may be tempting for airlines to set these significant details to one side in critiquing BAA's record in delivering new capacity, but it is essential that the Commission undertakes a detailed and comprehensive review of contemporaneous evidence, including that considered at previous reviews, before it reaches views on these issues.

S.52 Agreement

41. Professor Moizer then suggested that evidence of BAA's position could be inferred from the fact that it has not sought to overturn the s.52 Agreement at Gatwick [36/10-36/18]. BAA does not agree that such an inference is possible.
 - i. The legal position is clear; it would be extremely difficult to set aside the s.52 Agreement. This has been the consistent understanding of BAA over time. Indeed the position is, and has been, so clear that this is simply not an issue that BAA needed to revisit or explore in detail through external legal advice. We have attached a paper which sets out the legal position and provides details of the advice received by BAA on this issue (**Annex 6**) (also requested by the Commission [question 4 of the 20 March Request]). It is for this reason that BAA has only rarely considered it necessary (for example, most recently to inform the new owners of BAA) to examine the grounds for challenging the s.52 Agreement. Such advice has confirmed BAA's understanding of the legal position;
 - ii. Any unsuccessful attempt to challenge the agreement would have caused serious and long lasting damage to the relationship between BAA and the relevant local authorities, most notably West Sussex CC which is the counterparty to the s.52 Agreement. This would have

⁷ Paragraphs 2.98, 2.122 and 2.406-2.413

⁸ Paragraph 2.100

made any future planning application at the airport more problematic as well as making it much harder for BAA to use s.106 Agreements in the future to facilitate the grant of planning permissions at Gatwick. For example, BAA considers that in such circumstances West Sussex CC might have been unwilling to negotiate the 2001 s.106 Agreement which has allowed significant further development at Gatwick from 29 mppa to approximately 40 mppa without the need for planning inquiries. In addition such a step would have damaged BAA's credibility in planning matters generally and as a result adversely affected its ability to secure planning permissions at other airports;

- iii. It was evident to BAA from its regular contact with West Sussex CC that it would not agree to amend the s.52 Agreement in a way which would allow a second runway development.⁹;
 - iv. Although in theory it would have been possible to overturn the s.52 agreement with a hybrid bill this was and is extremely unlikely. Hybrid bills are relatively rare and take some considerable time to enact.¹⁰ This process would have given a platform for third parties as well as the West Sussex CC to object. To enact a hybrid bill there would have to be strong government support for such a bill. There has been no such policy support for a second runway at Gatwick before 2019 or indeed for overturning the s.52 Agreement (not least because BAA entered the s.52 Agreement before privatisation). The 1985 White Paper was opposed to a second runway at Gatwick and BAA was later asked to discontinue work that it had been asked to do in the mid 1990s to investigate the possibility of second runway options. This was then overtaken by the consultations for the 2003 White Paper under the new Government. The 2003 White Paper makes clear that there is no case for a second runway at Gatwick before 2019 and that in those circumstances the Government was unwilling to take steps to overturn the Agreement.¹¹ The process would be highly controversial and a failed attempt would be damaging to BAA's relationship with West Sussex CC and indeed other local authorities; and
 - v. Again the Commission examined this issue in 2002 and found no public interest concerns arising from a lack of a second runway development at Gatwick and indeed notes the CAA's comments that BAA had dealt with the planning constraints at Gatwick quite well.¹² There is no suggestion by the Commission at that time that BAA should have taken steps to overturn the s.52 Agreement or that had it done so, it would have been likely to succeed. Indeed the Commission recognised that the role of Government was critical and the Government had ruled out the prospect of a second runway.
42. Professor Haskel said that it had been put to the Commission that Manchester had secured a new runway without making similar commitments [40/16-17]. Professor Moizer made a similar point that Manchester offered less in terms of *carrots* than BAA did in order to secure planning permission [42/3-7]. It was not clear what BAA *carrots* they had in mind.

⁹ The well known opposition of West Sussex CC and others to amending the s.52 Agreement is recorded in the 2003 Air Transport White Paper at paragraph 11.70.

¹⁰ There have only been 12 hybrid bills enacted since 1979 and none has involved the amendment of s.52 Agreements. The legislative process in each case has taken 1-3 years.

¹¹ Paragraph 11.70.

¹² Paragraphs 2.98 and 2.391.

43. The implication of the points made by Professors Haskel and Moizer is that:
- i. BAA has given greater concessions than it needed to in order to secure planning permissions in particular cases; and
 - ii. They considered that the circumstances of the planning application for a second runway at Manchester was similar to the planning issues faced by BAA such that it is a relevant comparison.
44. With respect BAA rejects both implications:-
- i. BAA considers that it has given appropriate concessions in order to secure planning permissions having regard to the circumstances that it faced at the time. Clearly what is appropriate to offer is highly sensitive to the precise circumstances of each application. It would be helpful in order that BAA can respond to these suggestions in a focused way if the Commission could identify those concessions which it considered BAA did not need to give in order to secure planning permissions. BAA can then explain in detail why it considers such concessions were necessary (or indeed why, given the wider policy context, these did not represent concessions at all); and
 - ii. As regards the relevance of Manchester as a comparator, we have already explained in a previous submission to the Commission [BAA/CC2008/601] that Government policy supported a second runway at Manchester and the planning application enjoyed support from local stakeholders. It does not provide a useful benchmark as to the appropriate level of concessions that were necessary for BAA to offer in order to secure planning permissions.
45. The issue of the s.52 Agreement has been addressed in previous BAA submissions to the Commission (BAA/CC2008/114, BAA/CC2008/552, and BAA/CC2008/595) and discussed at length at staff meetings with the Commission on 3 December 2007 and 4 February 2008. Clearly the Commission considers this to be an issue of some importance, and consequently it needs to be fully debated. BAA therefore requests that after having reflected on BAA's evidence, the Commission could indicate:-
- i. Whether it considers that in the circumstances there is a likelihood that BAA would have been successful in overturning the s.52 Agreement, and, if so, the basis for that view; and
 - ii. In the light of the answer to sub-paragraph i above, the basis on which it alleges a separate owner of Gatwick would have sought to challenge the s.52 Agreement.

Surface Access

46. Professor Moizer alleged that BAA does not proactively campaign for improved surface access [45/4 – 45/10]. At the hearing BAA rejected that allegation and referred briefly at the hearing [45/13 – 51/13] to:

- i. The work done in Scotland to promote road and rail access to its airports;
 - ii. The Heathrow Express and its extension to T5;
 - iii. BAA's campaigning to retain the Gatwick Express; and
 - iv. Lobbying to improve the existing rail links to Stansted and work on surface access improvements to support the development of the second runway.
47. Further details of BAA's surface access campaigns, are attached in relation to:
- i. the Gatwick Express, (**Annex 7**) (also requested by the Commission [question 5 of the 20 March Request]; and
 - ii. the Stansted Express (**Annex 8**)

Reasons for the privatisation of BAA

48. The Chairman suggested that the principal reason that BAA had been structured as it was at the time of privatisation was to ensure there would be sufficient capacity to meet demand in the South East, and asked in the light of this, whether BAA would have done anything differently [51/22-52/2]. BAA rejects any suggestion that the Government's objective at privatisation was to "ensure" that capacity would be delivered to meet demand. Any such suggestion would be based on an incorrect interpretation of Government policy in respect of both the Government's stated objectives for the privatisation of BAA and its policy towards the development of the London airports in the period covered by the White Paper. The 1985 White Paper sets out the Government's reasons for privatising BAA as a single entity (pages 43-45), and also outlines the developments that would be supported by Government policy over the next decade. The White Paper does not identify that BAA was being privatised as a single entity in order to ensure that (an unqualified level of) demand would be met, as implied by the question.

Terminals vs. Runways

49. The Commission asked a series of questions concerning the *commitment* given by BAA during the T5 planning inquiry [53/11ff]. BAA has set out in **Annex 9** details of the statement made by BAA.
50. The Commission recognised in its 2002 Report¹³ that BAA's statement had had no bearing on the prospects of a third runway as the Government did not rule out a third runway as an option at Heathrow. It accepted that BAA's concern in making the statement was to secure planning permission for T5. It found no public interest concerns. As regards the complaints by airlines that BAA should have consulted before giving such a commitment, the Commission found that such consultation would have been difficult in the course of a planning inquiry and would have served no useful purpose.

¹³ See paragraphs 2.389-2.390.

51. In summary BAA made a tactical decision during the planning inquiry which it believed was necessary to maximise the prospects of securing the T5 planning permission (which in turn was vital to enable the continued development of the airport) and which in the event had no adverse impact on the prospects for a third runway.
52. During the hearing there was a discussion as to whether BAA favoured terminals over runways [54/21 – 56/11]. BAA's position is as follows:
- i. BAA has not favoured terminals over runways. Rather it has sought to expand capacity in a way that has been consistent with prevailing Government policy: expanding terminal capacity when policy was to make the full use of the existing runways; and more recently promoting new runways when policy has supported their development. BAA maintains that Government policy support is necessary to secure permission for major new developments, especially where there is significant local opposition;
 - ii. Prior to the 2003 White Paper Government policy was against new runways and in favour of utilising existing runways to their fullest extent. As a result BAA has pursued the development of new terminals even where government support has been qualified, as was the case with T5 in the 1985 White Paper;
 - iii. BAA did not believe prior to the 2003 White Paper that it would be possible to successfully secure planning permission for new runways due to the absence of positive government support. Moreover, it believed that it would need to demonstrate that it was fully utilising existing runways as a pre-condition of a successful application for a new runway; and
 - iv. BAA has also taken a number of steps to expand the capacity of its existing runways as far as possible. See our response on runway capacity [BAA/CC 2008/642].

Relationship with Airlines

53. This section of the hearing focussed on the nature of the consultation which takes place with airlines.

HET/Olympics

54. The Commission has suggested that BAA was slow in informing airlines about delays in the construction of HET [56/12-63/4]
55. BAA rejects this suggestion. The circumstances are complex and are therefore set out in a note at **Annex 10**. In summary the position is that:
- i. The agreed move sequence of airlines which was necessary for BAA to take possession of the HET site by July 2008 to enable completion for the Olympics has been disrupted by a number of factors. First, there was a joint decision in September 2007 by the airlines, NATS and BAA to take some remote stands out of operation (to use as taxiways) which meant that it would be difficult to maintain pier service during the move sequence which was a key

- airline requirement. Secondly, there were delays to works being undertaken by Star to their lounge in T1 which delayed the move of United Airlines and Air New Zealand from T3 to T1 by 6 weeks. Thirdly, BA was seeking a delay in the transfer of their 757 fleet from T1 to T3 from June 2008 to September 2008;
- ii. As a result BAA proposed a revised move sequence for consultation with the airlines which took place in October and November 2007. It would have been evident to Star during the consultation process and in particular from the meeting with BAA on 23 October 2007 that this was likely to delay the delivery of HET and that it might not be ready for the Olympics. BAA agreed to come back to the airlines before Christmas with details of the full impact of the revised move sequence;
 - iii. In December 2007 BAA advised the airlines of a completion date of December 2012 for HET based on a 48 month construction timetable following access to the site in December 2008. HET will be constructed to the original budget and with the operational functionality agreed in July 2007; and
 - iv. During this time BAA consulted fully with the airlines, it did not withhold information and worked hard to minimise delay whilst at the same time seeking to maintain operational robustness of the airport and service levels during the move sequence.
56. It was also suggested at the hearing that the specification of HET which was agreed with Star was in some way "second best" and that Star had only agreed to this on the basis that it would be ready for the Olympics. In the event that it would not be ready for the Olympics, there was an issue as to whether HET should proceed in its current specification. [62/8-65/4]
57. BAA considers that the current specification of HET offers the functionality which Star has been seeking. That functionality was not compromised in order to seek to complete HET prior to the Olympics. BAA would be grateful if the Commission could indicate what aspect of the currently specified functionality of HET should be reconsidered in the light of the delays to its completion.

Contingencies

58. At the hearing there were a series of questions concerning the application of contingencies by BAA. These appear to have been based on the premise that the contingencies which BAA applies are large (above industry standard)¹⁴ and are always spent.¹⁵
59. BAA's position is that the contingencies which it applies to projects are within industry norms. This is supported by the conclusions of Currie & Brown's report during the Q5 review. The level of contingency reflects the risks faced at different stages of projects, and are used to provide an estimate of the anticipated final cost for individual projects. It is not the case that contingency for each project is always spent, however it provides what we consider to be an appropriate estimate of risk, and would therefore be expected to be spent across the portfolio of projects. As such, it is

¹⁴ See for example the reference to a *generous slice of extra budget* by Ms Carstensen [71/20]

¹⁵ See Professor Moizer's question at [71/15 -19] – the contingency is *just an extra addition to the budget*.

wrong to characterise the contingency as an unjustified addition to the budget. This is addressed in a short note at **Annex 11**.

60. Recognising airline concerns on the expenditure of contingency monies, BAA has committed itself, via the agreement on Enhanced Information Disclosure and Consultation (CAA Decision Annex G), to provide greater transparency and formally engage the airlines prior to the expenditure of significant contingency sums on major projects. This is the new gateway process which forms part of constructive engagement and which was discussed at the hearing [65/10 – 67/12].

Asymmetry in Capex Reviews

61. At the hearing the Chairman commented that the information flow and timetable of the capex review process placed airlines at a disadvantage [76/10 – 76/20]. BAA does not agree that the process placed airlines at a disadvantage. We agreed to explain why this is the case in a paper which is at **Annex 12**; this also addresses the sequence of events which led to the increase in capex programmes at Heathrow and Gatwick (requested by the Commission [Question 6 of the 20 March Request]).
62. BAA makes the following general points:-
- i. As set out in the paper, there are good reasons for the increases in capex programmes at Heathrow and Gatwick and the increases reflect the addition of new projects rather than an increase in the cost of existing projects within the programmes;
 - ii. The changes agreed reflect the dynamic nature of the process in which airlines propose new projects which reflect their evolving requirements, and the airports seek where appropriate to incorporate these projects into their capital programmes ;
 - iii. BAA engaged in extensive consultation in relation to the addition of these new projects;
 - iv. BAA does not use the timetable of the process in a tactical manner. In an ideal world there would be more time to consult on the capital expenditure programme. In an unregulated world the process would be conducted on a rolling and continuous basis according to the development programme of specific projects. However, the use of five year time periods introduces a degree of artificiality in the process. There is a tendency for the timetable to be compressed towards the end of the process not least because airlines and BAA are seeking to ensure that the capex programme is as up to date as possible at the start of the quinquennium; and
 - v. Notwithstanding the changes to the capital expenditure programmes and the tight timetables, there was broad agreement by the airlines to the programmes at both Heathrow and Gatwick.

Stansted

63. As regards Stansted, the hearing raised a series of issues relating the development of Stansted. It was noted by the Commission that the Stansted SG2 development would be the subject of detailed consideration by the Commission in the Q5 reference and so it was premature to get into the detail of this review at the hearing.¹⁶ The focus of the hearing was therefore in relation to consultation with customers at Stansted. In this regard it would be helpful if the Commission could indicate which issues in relation to Stansted fall within this reference and which fall within the Q5 review.

Traffic Forecasts

64. Much of this part of the hearing focussed on the engagement between BAA and the airlines on traffic forecasting [82/12ff]. As the Commission is aware BAA rejects the allegation of the airlines that it has failed to provide information including assumptions and methodology concerning its forecasts. A paper detailing the various meetings with the airlines on traffic forecasts and copies of the presentations given by BAA and notes of those meetings is attached at (**Annex 13**) (also requested by the Commission [Question 7 of the 20 March Request]).
65. It is apparent from this material that BAA has not ignored the views of Ryanair and easyJet when promulgating its traffic forecasts for Stansted. It has sought to engage with them. However, there remain areas of disagreement on both the assumptions to be used in preparing the forecasts and the appropriate methodology. BAA believes these differences are fully understood on both sides. As demonstrated at Heathrow and Gatwick, BAA recognises that the views of its customers regarding forecasts are weighty considerations that should be taken into account. This is particularly the case where the views are supported by appropriate evidence that can be shared and discussed. However, BAA considers that it is not obliged to accept its customers' forecasts where these are unsupported by evidence or where there are fundamental disagreements with the methodology applied.
66. It should also be noted, as was highlighted by Mr Nelson at the hearing [86/11-19], that Ryanair and easyJet may well have incentives to advance different forecasts and the fact that BAA is unable to agree these forecasts is not evidence of poor process or errors in BAA's forecasts. In particular such behaviour may be a tactic in price negotiations between these airlines and BAA, or evidence that would suggest these airlines have potentially diluted incentives to support capacity expansion.

Airlines' Response to Consultation

67. The Stansted airlines' primary criterion for assessing the SG2 options is set out in their response to the BAA December 2005 consultation. This issue was discussed in BAA's comments on the Commission's note of its meeting with the ACC on 7th December [BAA/CC2008/623].

¹⁶ See, for example, [81/21-82/2].

Development by Airlines

68. Mr Holroyd suggested that easyJet and Ryanair had proposed to do the development at Stansted of the new terminal [95/15-19]. He invited us to review correspondence involving BAA's former CEO, Mr Clasper concerning an offer by Ryanair to develop low cost facilities [96/14-17]. Following the hearing, the Commission provided BAA with a reference to this correspondence. BAA has reviewed this, and BAA's response is set out in **Annex 14**. In summary, BAA's response is that it cannot be inferred from correspondence between Ryanair and BAA that Ryanair was offering to finance the development of the G2 project.

Walking Distances

69. BAA highlighted that the ACC's suggestions for an alternative option would involve placing a second terminal about one kilometre away from where bus, coach and train facilities arrive at Stansted [93/23-94/8]. Professor Haskel then asked how this distance compared to distances between public transport facilities and check-in at Heathrow and Gatwick [98/1-3].
70. These distances are set out in **Annex 15**. The table in the Annex demonstrates that all distances between public transport facilities and terminals at BAA's airports are considerably less than one kilometre, with one exception. Although the distance between the rail station and North terminal at Gatwick is longer it is assisted for most of the distance by a track transit system (TTS) and travelator. For the same reasons as we highlighted at the hearing the ACC's suggestion for an alternative option would require some form of transit link to provide an acceptable level of passenger service [98/13-16]. In BAA's submission this is a relevant consideration which needs to be taken into account when examining options at Stansted.

Consultancies

71. There was also a series of questions concerning the nature and cost of consultancy work for the SG2 project [102/2ff].
72. At the hearing Mr McDermid explained the nature of the work that consultancies had undertaken. BAA has provided a written description and costing of those consultancies [BAA/CC2008/632]. The Chairman asked whether the cost of such work was normal for major infrastructure projects [106/8-10]. As we explained there are few benchmarks for major infrastructure projects. However, information which BAA has in relation to other projects shows that the development and promotion of proposals for major infrastructure projects entails significant expenditure. For example, BAA understands that Associated British Ports incurred costs of £45 million in relation to the promotion of proposals for new facilities at Dibden Bay before the project was refused planning permission.
73. BAA also understands that the Crossrail has been allocated a budget of £254m since 2001 to carry out feasibility and development work and that several hundred million pounds had been incurred on planning for the Channel Tunnel Rail Link before the start of construction.

Development Options at Stansted

74. Although a matter for the Q5 review Mr Holroyd asked whether the steps being taken by BAA at Stansted would preclude any SG2 options and he referred to maintenance facilities and a visitors centre [107/1-6].
75. BAA's response at the hearing was that:
- i. Although it is proposing to build a visitors centre, it does not preclude any runway options. The visitors centre is located at the entrance to the existing long stay car park and adjacent to the Hilton Hotel to the South Western edge of the airfield. Planning permission has been obtained. The proposed location of the visitors centre is a considerable distance from any of the runway options that have been proposed and would not impede the development of any of these;
 - ii. BAA has been clear (including in consecutive CIP documents) that it is our expectation over time that the area of land between the existing FedEx facility and the existing SR Technics 'Diamond Hanger' will as demand rises be developed to include aircraft stands, cargo facilities and maintenance hangars. Outline planning permission for these developments were secured in 2003. To date, with one notable exception, none of these consents have been implemented. The exceptional case is that on 12 February 2008, Ryanair exchanged contracts with Stansted Airport Limited for a 60 year lease of approximately 5.4 acres of this land to construct and operate substantial maintenance and pilot training facilities. Ryanair are currently on-site constructing this building and the aim is to complete works by late 2008. This development is likely to adversely affect the ACC's own proposals for second terminal with ancillary airfield infrastructure but has no adverse effect whatsoever on the option BAA is seeking planning permission for; and
 - iii. More importantly although it appears the Stansted ACC was content to suggest to the Commission that BAA was taking steps which might limit the options for SG2 it is not a point which it was prepared to make in evidence at the SG1 planning inquiry. Mr Clayton of the ACC under cross-examination was unable, despite repeated questioning, to identify any aspect of the SG1 proposals which would be rendered unnecessary or inefficient in the light of alternative SG2 proposals. Extracts of the transcript of Mr Clayton's evidence (11 July 2007 pages 148 – 153) are attached at **Annex 16**.

Gatwick Pier 7

76. Mr Holroyd put allegations (which BAA understands were made by easyJet) that Manchester Airport had constructed a facility similar to Pier 7 at 25% of the cost and that easyJet was not happy with BAA's proposal for Pier 7 [110/18-111/10]. Mr Holroyd did not identify the specific Manchester project being referred to.
77. The new Pier 7 at Gatwick is a design for an isolated satellite pier which requires the diversion of existing taxi way routes, construction of new stands and a tunnel connecting the pier to the

existing terminal. The cost of this project had been derived using benchmarks and cost processes previously scrutinised by Currie and Brown.

78. BAA is not aware of any publicly available information with regards to equivalent projects at Manchester upon which it could conduct a detailed cost of scope analysis in response to these comments. However, it notes that Manchester has current proposals for the development of additional areas of apron to the west of Terminal 2 and to the east of Terminal 3. Based solely on observation (and without detailed knowledge) BAA understands that the Terminal 3 Pier development will provide a two storey non-insulated cladded structure with limited systems. BAA also understands that this facility does not provide pier service with fixed links and air bridges. The apparent differences in scope between this project and Pier 7 (if indeed this is the comparison which the Commission or easyJet has in mind) would render meaningless in any comparative analysis which was not based on a detailed breakdown of cost.
79. In a Memorandum of Understanding (MoU) between Gatwick Airport Limited and easyJet in February 2008 (attached in **Annex 17**), easyJet supported the inclusion of Pier 7 in the investment plan for Gatwick Airport. Moreover contrary to the suggestion at the hearing that easyJet had been pushed into accepting Pier 7 [111/7-10], the MoU records that easyJet will give full public support to the development of Pier 7 including as part of the Q5 Regulatory Review and participate in the design process for Pier 7 to ensure that the facility is able to accommodate easyJet's traffic model.

Long Term Risk Sharing

80. At the hearing the Chairman asked whether there was scope for long term risk sharing or co-investment arrangements between BAA and its major customers at Stansted [116/5-10]. BAA's response was that such arrangements were difficult if not impossible within the current regulatory framework.
81. The Commission suggested that it should be possible for BAA to do long run deals with key users at Stansted, even if the airport was designated, and made two suggestions:
- i. That the price cap sets a ceiling and that BAA would be free to agree a deal with Ryanair for a lower price (the "Price Cap Ceiling" argument):
"... why would [a long run deal between Stansted and Ryanair that agreed a price in return for a guaranteed volume] need [a] de-regulated world? Because it is a price cap, it is not a fixed price ... you could do a deal with O'Leary lower than that for a guaranteed volume." [116/20-22].
 - ii. That a long run contract would assist BAA because it could avoid the short termism associated with the five yearly regulatory reviews (the "Substitute Contracting for Regulation"):
"Surely the long term contract makes it easier for you because you get over that five-year regulatory result." 117/6-7].

82. These suggestions are mistaken. They fail to appreciate the impact that the current regulatory arrangements have in “crowding out” conventional commercial arrangements between BAA and airlines.
83. *Price cap ceiling argument.* The existence of a price cap makes a deal between BAA and an airline, such as Ryanair, potentially non-viable for the simple reason that if passenger volumes were below the guaranteed level agreed by Ryanair the revenue yield per passenger could end up being greater than the maximum permitted by the price cap. Further, if the contract is to extend across more than one regulated review period, it may be that the price agreed is below the regulatory maximum in the present period, but there would be the risk that at future reviews the price cap would change. Accordingly, the guarantee could be worthless by virtue of continued regulation (see **Annex 18** for further details of this argument).
84. *Substitute Contracting for Regulation.* The suggestion here seems to be that if Stansted concludes a long term contract with Ryanair, that long term contract will displace the regulatory arrangements. But if Stansted remains designated, the fact that there is a long term contract would not displace the regulatory arrangements. The regulator would still set a price cap at future reviews, and if that price cap was inconsistent with the long term contract then it would trump the long term contract. That in turn reduces or eliminates the scope for reaching agreement on such contracts in the first place.
85. In BAA’s submission the continued designation of Stansted clearly reduces and potentially crowds-out entirely the scope for reaching long run commercial deals with Stansted users. BAA sees merit in looking constructively with the CC at how the impact of regulation in this regard can be reduced. But that discussion needs to be grounded in a proper understanding on the Commission’s part of the impact that price cap regulation clearly does have in reducing the scope for long run deals of the kind discussed at the hearing. It also needs to take into account the views that have been expressed by Stansted’s major customers concerning the future need for regulation to be enforced more tightly.

Southampton

Lack of Ambition

86. Professor Haskel stated that it had been put to the Commission that BAA had been un-ambitious in its investment plans at Southampton. In particular he relied upon two pieces of evidence: first, that the DfT had originally suggested that Southampton could take seven million passengers and BAA’s view was that it could take only 2.5 million passengers; and second, that BAA entered into a s.106 Agreements that it would not develop the runway at Southampton [118/25-119/9].
87. The first point was raised and answered at the staff meeting which discussed Southampton on 18 February 2008 (see transcript of that meeting at [34/23-36/16]). As explained again at the hearing [119/12 – 120/25] the difference between the DfT and BAA on the capacity of Southampton appears to relate to a misunderstanding that continued from the SERAS consultation through to the 2003 White Paper concerning the ability of the airport to handle passenger growth with in and

out with the existing airport boundary at the time of the SERAS consultation. BAA's view at the time was that the capacity of Southampton within its existing boundary was 2 to 2.5 million passengers per annum (this has now increased to 2.5 - 3 million passengers per annum as stated at the staff meeting (see transcript of staff meeting at [35/7])). BAA considers that the DfT's reference to seven million passengers was based on an option which involved new facilities and infrastructure which would need to be developed outside the airport boundary. So there was at the time of the SERAS consultation at worst a difference of opinion as to the capacity of the airport within its boundaries at the time but no evidence of lack of ambition to develop the airport. BAA has now acquired land outside the airport boundary which would enable it to expand the capacity of the airport up to 6 million passengers per annum.

88. For completeness the circumstances of the SERAS consultation together with extracts from the relevant documents are set out in detail in a paper attached at **Annex 19**.
89. The s.106 Agreements are also not evidence of BAA's lack of ambition. The position is that BAA was committed to development restrictions at Southampton (comprising a Flying Controls Agreement and an Airport Development Agreement) as part of the acquisition of the airport. In any event for the reasons set out below there are more significant constraints on the development of the airport.
90. In order to understand the circumstances it is necessary to explain the background to the acquisition of the airport by BAA.
 - i. In 1960 the airport was acquired from the Southampton City Corporation by Mr Somers who undertook a number of improvements to the airport. In 1984 BAA became the manager of the airport pursuant to a contract with Mr Somers. In 1988 he sold his interest in the airport site to a consortium of developers led by Mr Peter de Savary subject to the ongoing management contract with BAA.
 - ii. The developers were primarily interested in the non aviation opportunities that the site offered and prepared a planning application for the complete development of the airport site together with the creation of two business parks within the existing airport perimeter. The planning application was made in July 1989. In May 1990 the local authority recommended outline planning permission be granted subject to a number of conditions including the entry into two s.106 Agreements: a Flying Controls Agreement and an Airport Development Agreement. The Flying Controls Agreement imposes restrictions which include prohibitions on extensions or realignments of the runway and the construction of additional runways as well as certain flying restrictions. The Airport Development Agreement imposes additional obligations including restrictions upon building on the airfield.
 - iii. In discussions with the new owners it became clear that they would be prepared to discuss the sale of the airport to BAA less the area of land planned for the business parks, subject to BAA agreeing to enter the proposed Flying Control and Airport Development agreements as the new owners were concerned to ensure the planning application succeeded. At that stage negotiations on the agreements with local authority were well advanced.

- iv. In July 1990 BAA entered into an agreement to purchase the airport from the developers. The purchase agreement included provisions as to the co-operation between the vendors and BAA in order to obtain the planning consents. In particular BAA agreed to enter into an agreement with the local authority in accordance with a draft which was then annexed to the purchase agreement (which already prevented runway development). The vendors also retained the rights to conduct the negotiations with the local authority of the agreements needed to obtain the planning permissions subject to consultation with BAA; and
- v. Given the stage which negotiations had reached between the vendors and the local authority by the time of the acquisition by BAA, it was not possible to negotiate a significantly more limited Flying Controls Agreement. BAA therefore acquired the airport subject to the restrictions which had already been offered to the local authority by the vendors.

Flybe

91. Professor Haskel then suggested that BAA had not adequately consulted with Flybe [123/23-124/5].
92. As BAA explained it has a quarterly meeting with airlines at Southampton through a forum known as the Airline Operators Committee it also has an annual bilateral meeting with Flybe. These meetings cover a range of topics including infrastructure developments and growth plans. Attached in **Annex 20** is a bundle of presentations and minutes of the AOC meetings since 2006.
93. If there are particular issues where it is alleged by Flybe that BAA has not adequately consulted then BAA would be grateful if the Commission could identify these.

Competition with Gatwick

94. At the hearing, the Commission specifically queried BAA's submission that Bournemouth is an effective competitor to Southampton, whereas Gatwick is not [126/24-127/5]. While this issue was addressed at the hearing, the following also provides a short summary of the relevant points.
95. In terms of passengers' perspective on flights, there is some substitutability:
 - i. Southampton has been slightly increasing its reach and pushing its catchment out (see also Mr Maiden's comments, [126]), and there will be people for whom e.g. the overall journey time from home to the South of France may be quicker through Southampton than through Gatwick, even though the initial surface access may be a bit longer (see also Mr Maiden's comments, [127]); and
 - ii. However, even that substitutability is marginal due to limited route overlap (see Mr Maiden's comments, [127]) which is unlikely to increase without extending the Southampton runway which has a motorway at one end and a railway at the other end (see Mr Maiden's and Mr Hanks's comments, [127-128]).

96. Yet, given the specific facts of Gatwick (i.e. its scarce capacity and binding price caps), substitutability at the flight level does not translate into substitutability at the airport level:
- i. Gatwick services that have moved to Heathrow tend to get back filled quite quickly (see Mr Hawkins's comments, [134]), and it cannot take advantage of excess demand by raising its charges, due to the price cap.
 - ii. On that basis, the fact that Gatwick is under common ownership with Southampton does not diminish Southampton's incentives to take business from Gatwick - doing so would only reduce the level of unmet demand at Gatwick and undermine airlines' slot rents, rather than the profitability of Gatwick airport (which is in essence insulated from Southampton's activities).
97. The same argument applies to Heathrow: capacity constraints and price caps lead to slot rents which insulate the airport from competition.
98. By contrast, Bournemouth is neither capacity constrained nor regulated. Accordingly, the substitutability between Southampton and Bournemouth at the flight level (see also Mr Butler's comments, [125]) carries over to substitutability at the airport level.

Expansion

99. The Commission was also concerned about the scope for runway expansion at Southampton [128/15-132/15]. BAA's position set out in more detail in **Annex 21** is that there are real constraints in developing the runway (over and above the s.106 Agreements) In particular:
- i. There are obstacles at both ends of the runway which inhibit its expansion namely a motorway at the southern end and railway line and railway yards at the northern end. In addition there is high ground beyond the southern end of the runway which limits the types of aircraft that could use an expanded runway;
 - ii. Another difficulty with the expansion of the existing runway is that it would have to accommodate an expanded runway end safety area (RESA);
 - iii. It is not possible to re-orientate the current runway within the existing airport boundaries. One possible re-orientation option (considered by the DfT during SERAS) would have effectively meant rebuilding the runway entirely outside the existing boundaries on a different alignment which would have raised significant environmental issues; and
 - iv. The expansion of the existing runway and re-orientation were considered as options during the SERAS consultation and were ruled out (this issue is dealt with in more detail in **Annex 19**). The following is an extract from Chapter 13 of the DfT's SERAS Stage 2 Appraisal Findings Report:

"13.2.4 At Southampton, existing site boundaries are strongly defined by a main rail line, a motorway, a river and a country park. Runway length is constrained by the motorway and commercial and residential development. While the runway may not be a constraint on the domestic and short haul traffic

likely to favour the airport, a limit would be set by the amount of land available for terminal, apron and supporting developments. With a runway on its present alignment the only practical access of site expansion would be eastwards across the river Itching and into the adjacent Itching Valley Country Park. An option for a runway re-alignment and extension with a greatly expanded terminal and apron capacity was considered. None of the options for major expansion beyond the existing site boundaries was considered viable, mainly due to their potential impact on environmentally sensitive areas and features."

100. Given the constraints, all of the expansion options would involve significant cost which would be difficult to justify having regard to the current or even projected traffic at the airport.
101. As explained at the staff meeting (transcript at [13/20-14/20]) BAA seeks as far as possible to ensure that the runway is used by as wide a range of aircraft as possible. To this end it has commissioned studies to assess the operating constraints imposed by the runway. This has provided BAA with the material to identify the full range of aircraft and route combinations which can operate out of Southampton. This has been used to inform the airport's marketing efforts to airlines and in some cases to overcome airlines' resistance to using Southampton.

Route Development

102. Professor Haskel also referred to allegations of a lack of pro-activity by BAA in route development from Southampton. [132/19-133/8].
103. BAA rejects the suggestion it has not been pro-active in this regard. As explained at the hearing [133/11ff] BAA:-
- i. Promotes Southampton Airport at the "Routes" conferences and through individual airline marketing material and marketing support (see materials at **Annex 22**);
 - ii. It actively promotes Southampton Airport through press releases, magazine and poster campaigns advertising, details of which are also contained in the materials at **Annex 22**;
 - iii. It offers route development discounts, details of which have already been provided to the Commission [BAA/CC2008/602]; and
 - iv. ✂
104. The results of all of this effort is that Southampton has been successful in growing the number of passengers using the airport and expanding the number of routes that are available. Details of these achievements are set out in the route development paper at **Annex 31**.

London Southampton?

105. There was a later question from Ms Carstensen as to whether Southampton should brand itself as London Southampton [172/17-173/3].

106. BAA had already submitted a written answer on this topic in response to a Commission request of 9 January 2008 [BAA/CC2008/533] in which we explained that whilst there was no legal restriction preventing a name change, the CAA's guidance is that the aerodrome name should be representative of its location and not have the potential to confuse. Southampton is almost 80 miles away from Central London. Consequently airlines could have difficulty marketing their services to Southampton as London. By contrast Luton is only 34 miles and Gatwick 28 miles from Central London.
107. There is also scope for confusion given the large number of UK airports with a London prefix (there are currently seven). BAA considers that such name change would be potentially confusing to passengers and therefore inappropriate. It considers the airport attracts more passengers by concentrating on providing services which are specifically needed within its region and promoting itself as such. It is notable that Flybe in its response to the Southampton master plan in 2005 agreed with this approach. It says in particular (page 2):-
- “We believe that Southampton should be the primary non-London hub for leisure and business passengers in the South East of England travelling to regional destinations in the UK and continental Europe. Flybe fully intends to expand operations from the airport to bringing more domestic and international cities within easy and convenient reach of local residents and businesses”* (emphasis added).
108. A copy of that response is attached at **Annex 24**.

Scotland

109. Three issues arose at the hearing in relation to BAA's Scottish airports.
110. The first was what was the correct per passenger charge at Aberdeen [139/141]. This also forms part of the Commission's subsequent request [question 9 of the 20 March Request]. BAA calculates the net yield per passenger as £6.62. See **Annex 25**.
111. Second in this context (although not limited to Scotland) the Commission comments that on the basis of its data that the aeronautical revenue at non BAA airports fell faster than at non-regulated BAA airports between 1999 and 2006 [142/1 – 142/10].
112. BAA has two concerns about this data which are set out in more detail in the note at **Annex 26**:
- i. The Commission's data contains errors which have the effect of *understating* the rates at which charges at non-regulated BAA airports have fallen; although the rate of reduction is greater at non-BAA airports the difference is small; and
 - ii. The absolute level of charges over the period in question has been consistently lower at non-regulated BAA airports.
113. It is not clear what inferences the Commission seeks to make from such observations but it is certainly not open to the Commission to infer that prices at non-regulated BAA airports are "high" compared with non-BAA airports or that BAA has not been aggressive in seeking to attract new airlines and/or services to its airports. Since the hearing BAA has submitted a preliminary

response to the Commission's benchmarking working paper [BAA/CC2008/636]. In that response BAA identified its concerns with the Commission's interpretation of the data and methodology adopted. BAA will respond in further detail on these matters in its full response to the Commission's working paper on airport revenues and cost benchmarking.

114. Third, the Commission refers to allegations in particular in relation to Edinburgh and Glasgow that BAA was not energetic enough about route development until the Route Development Fund of the Scottish Executive was introduced [143/22-144/13].

115. The Commission compared international routes at BAA and non BAA airports between 1990 and 2004 using CAA data where it noted BAA appeared to perform poorly against non BAA airports.

116. At the hearing we made clear that:-

- i. Such comparisons are difficult to make since it depends on the measure of route development that is being used. For example, it is not evident that a large number of infrequent flights to multiple destinations are preferable as an indicator of successful route development as opposed to increasing the frequency of flights to existing destinations. An airport's route network will reflect airlines' decisions about how passenger demand for air travel should be met. In this respect, it is not clear why the measure of routes served should be given greater prominence than the measure of the number of passengers served;
- ii. Such comparisons would also need to take account of the stage of development of a particular airport;
- iii. In any event BAA considers that according to appropriate measures it has been successful at business development both in Scotland and generally at its airports compared to non BAA airports for the reasons set out in the Route Development paper which is attached at **Annex 31** [this responds in part to question 10 of the 20 March request];
- iv. The Scottish Enterprise's Route Development Fund, whilst a welcome addition, was only relatively small compared to BAA's spending on route development in Scotland. The Route Development Fund represented only £6 million at BAA's Scottish airports. BAA spent a total of £95 million on route development during the same period. Moreover the Route Development Fund was conditioned on 'match funding' from BAA. Further details of BAA's approach to route development in Scotland are provided in **Annex 30** [this responds in part to question 10 of the 20 March request]; and
- v. Finally, as regards the CAA data on which the Commission relied, BAA commented that it was not reasonable to aggregate the destinations served by Glasgow and Edinburgh, in considering the route development at different airports.

Slot values and landing charges

117. At the hearing the Commission asked about the implications of raising landing charges at Heathrow on congestion.

118. BAA agrees with the Commission that in general an increase in Heathrow's landing charges will simply reduce slot rents, with no effect on congestion (at least until the slot rents start to disappear). A possible complication might arise if slots are not used efficiently (e.g. due to an imperfect market for slot trading):
- i. In such a situation, for a given airline the slot might lead to a profit if the slot value is not taken into account, but a loss after taking into account that value. If the slot cannot be sold, it has no opportunity cost, and the airline will continue to operate it itself even though it would be more efficient for another airline (with a higher valuation of the slot) to operate it; and
 - ii. However, if Heathrow increased its landing charges, then it is conceivable that the airline may no longer find it profitable to operate the slot, and it would accordingly become available to airlines with higher valuation.
119. The Commission also raised the issue of whether, in view of the slot rents that accrue to airlines, there should be co-investment in new runway capacity with the airlines.
120. BAA notes first that incumbent airlines that hold slots may only have a limited incentive to address the issue of congestion and invest in additional capacity, since such an approach would undermine their slot rents. Accordingly, the Commission should not proceed on the assumption that airlines' incentives to invest in new capacity are well aligned with those of passengers.
121. Second, BAA notes that the rights to control new slots at a congested airport are not held by BAA or by specified airlines. They are allocated through the slot allocation system according to the EC Slot Regulation. Given that the control of the slots created is not known up front, it is difficult to see how a co-investment arrangement could work. This is particularly the case where priority is given through these rules to new entrants.

Union Negotiations

122. At the hearing there was a discussion as to the impact that common ownership of airports has on negotiations with unions [151ff]. The proposition which the Commission advanced was that common ownership leads to higher pay and conditions than would be the case under separate ownership on the basis that under separate ownership the individual airports would be better able to negotiate with unionised labour [151/6–151/25, 154/21–155/3, 156/4–156/8, 156/16–156/23].
123. BAA does not understand the basis of that claim. The general presumption is normally that bigger organisations have enhanced bargaining power compared to fragmented organisations, holding constant the bargaining power on the other side of the negotiating table. By way of illustration, in the context of the Groceries inquiry, the general working assumption (including we may suggest of the Commission) appears to be that large supermarkets have superior bargaining power against suppliers than do smaller retailers.
124. Accordingly, if the Commission is to rely on this claim BAA would welcome details from the Commission as to the evidential basis for this claim, both factual and from the economics of

bargaining, including why any such evidence and arguments advanced outweigh more widely held presumptions in the opposite direction.

Service Quality

125. The Commission continues to ask about BAA's efforts to improve the quality of service at airports [155]. BAA has provided the following submissions evidence in what has been done to improve the quality of service at airports:-
- i. BAA/CC2008/639 – Service Quality;
 - ii. BAA/CC2008/622 – Improving the Passenger Experience;
 - iii. BAA/CC2007/501 – Quality of Service; and
 - iv. BAA/CC2007/256 – International Surveys in Comparisons.
126. Attached in **Annex 28** is a paper which draws evidence together to demonstrate how BAA is improving the passenger experience. BAA is concerned that the Commission does not appear to acknowledge the efforts that BAA is making to improve levels of service, or recognise the airports' achievements in this area. As stated above, BAA has provided the Commission with substantial data to demonstrate these improvements. BAA would invite the Commission to share with it any data or evidence that it has which reveals a different trend in service levels, or to discuss with BAA the doubts or reservations it has with the evidence presented by BAA.
127. We have also invited the Commission to tour the airports again to witness for themselves the improvements that have been undertaken. Despite postponement of the Heathrow tour scheduled for 10 April 2008, we would urge the Commission to see at first hand how the airports are improving. In lieu of this tour, accompanying this submission is a DVD presentation showing some of the improvements that have been delivered at the airports in recent months.
128. During the course of the hearing Mr Nelson made reference to the implementation of automatic queue measurements [162]. Attached in **Annex 27** is a paper explaining the technology being used in this project and a roll out schedule for the systems across BAA's airports.

Use of benchmarking by BAA

129. During the course of the hearing the claim was made by the Commission that BAA does not adequately benchmark itself against other airports or other organisations and that other airports engage in more benchmarking of this type [165/15-165/21]. BAA invites the Commission to provide full details of the evidence that BAA's record on benchmarking itself against other airports is poor by comparison to the degree to which other airports benchmark themselves against comparators.
130. It is difficult to use benchmarking to derive reliable conclusions about airport efficiency. There are numerous reasons for this such as a lack of comparability of the airports concerned, differences in the activities that airports undertake and the outputs that they deliver, differences in accounting

standards, governance and ownership, and difficulties in obtaining accurate data. In the Q4 regulatory review the CAA commissioned NERA to undertake a detailed benchmarking study, but, despite extensive attempts to address the problems entailed, the analysis failed to arrive at any meaningful results (CAA, February 2002, NERA appendix). The CC also notes the problems detailed by NERA with their benchmarking analysis as not being robust and that they could not be relied upon as a satisfactory means of comparing expenditure with other airports (CC, November 2002, Chapter 7 - Operating Costs and Efficiency).

Customer Satisfaction

131. At the hearing Mr Maiden made the comment that passengers survey results from BAA's smaller airports show that passengers mark those airports down due to the fact that they do not have the same range of shops as Gatwick and Heathrow [171/5-171/8]. The paper attached in **Annex 29** demonstrates that despite this, overall satisfaction levels are similar due to smaller airports scoring higher on passenger comfort and other service issues.

Responsiveness to Airlines

132. Ms Carstensen alleged [170/12] that BAA is not very responsive to customer requests and implied that BAA does not consult customers on development plans to a sufficient extent.

133. As explained at the hearing, BAA submits that it does make every reasonable effort to maintain a constructive working relationship with its users, to support their needs and interests, and to consult with them appropriately. BAA has sought to work with airlines to resolve many of the substantive objections raised by users. Airlines' objections may also reflect the airlines' commercial interests, but not necessarily those of passengers. BAA accepts that some users continue to express dissatisfaction with aspects of these processes and BAA will continue to work to improve them, but BAA stands by its record.

134. BAA wishes to note that disputes between airlines and airports are not restricted to BAA. They also arise intermittently at other airports.

Airlines' Comments on CAA's Q5 settlement

135. The Chairman invited BAA to comment on the airlines press release of 11 March 2008 [185/6-10]. As the Commission may be aware a number of those airlines are threatening legal proceedings in relation to the CAA price control determination. In the circumstances until it becomes clear whether those airlines will issue judicial review proceedings BAA considers that it would not be appropriate to comment in detail on the issues identified in the press release. However, BAA would make the following general remarks:

- i. the outcome of the Review does not recognise sufficiently: the scale of the task the airports are embarked on; the pressures of handling such large infrastructure projects; the full cost of the increased security requirements; as well as the impact of the credit market turmoil;

- ii. that said, the price rises announced by the CAA confirm the important need for airports to commit significant resources to improving services and facilities;
- iii. although airfares may rise as a consequence, passengers will experience substantial benefits from these improvements;
- iv. BAA has sought to engage positively with airlines, the Commission and the CAA through the review process; and
- v. there is a case for reviewing the existing system of airport regulation to ensure that it puts the interests of passengers first and supports the investment that airports will be making in new capacity over the coming decade.

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