easyJet response to CAA Q6 Gatwick final proposals

Summary

easyJet does not support the proposals set out by the CAA, as they are not in the interests of our passengers.

The proposals will unreasonably increase airport charges and create significant risk of future unreasonable costs arising from a potential Runway 2 at Gatwick. easyJet has worked with Gatwick airport to mitigate these risks, but so far the airport has been unwilling to reach a reasonable agreement with easyJet. We therefore believe the CAA's proposals are flawed, and if they are unchanged will allow Gatwick to abuse the market power that the CAA has itself identified Gatwick has.

Unless Gatwick shows a willingness to work with easyJet these weaknesses can only be addressed by the CAA rejecting Gatwick's proposed Commitments and adopting a RAB approach. If the CAA imposes Gatwick's Commitments under these conditions it will:

1. Allow Gatwick to distort competition by selectively offering discounts to airlines.
2. Risk passengers paying an incremental £28 for the proposed second runway without proper regulatory oversight.
3. Require our passengers to pay excessive charges at Gatwick.
4. Have ignored the findings of the CAA's own work on Gatwick's market power, which shows that Gatwick is in a position to abuse its dominance.

We will continue over the coming weeks to work with Gatwick and the CAA to see if these weaknesses can be addressed, creating conditions that would allow for the regulation of Gatwick through its Commitments proposal.

This response also addresses the main errors in the CAA's statement of what it views as a 'fair' price for passengers to pay at Gatwick. In particular the CAA has unreasonably included assets to the benefit of Gatwick's shareholders; increased the cost of capital based on arbitrary measures; and ignored its own evidence on operating costs. Taking these into account a fair price for Gatwick over the next five years would be significantly lower than the CAA's proposed RPI+1.6.

easyJet urges the CAA to address the weaknesses of its proposals and ensure that passengers at Gatwick are protected from the monopoly airport.

Introduction

easyJet is the largest airline at Gatwick, carrying over 40% of the passengers at the airport. Next year we will carry over 15 million passengers at the airport.

easyJet supports the Gatwick's ACC's response to the CAA's consultation, and endorses the positions it sets out. The consultation period for this submission was only four weeks, and by necessity this response focusses on easyJet's main concerns. Both easyJet and the ACC's response build on the points raised in our submissions of 29 June 2013 and this response should be read alongside those submissions.

Following the CAA's guidance this response is structured around the three main issues outlined by the CAA:

- The CAA's view of a fair price.
- The appropriate form of price regulation for GAL from April 2014 and the CAA's evaluation of the various options.
- The appropriate licence conditions that would be associated with GAL's proposed commitments.

Our submission focuses on the clear errors made by the CAA in its final proposals, in particular errors in its decisions to move from its initial proposals set out in April. There are other aspects of the CAA's proposals that we do not support, but we see these as failures of judgement. Our and the ACC's earlier submissions provided a wide range of evidence, much of which addresses these judgement issues.

The fair price for Gatwick Q6

The CAA has set out its view on what the Gatwick price cap would be under a traditional five year Regulated Asset Base (RAB) regulatory approach, RPI+1.6%, and then compared this to the seven year price Commitment offer made by Gatwick Airport Limited (GAL), a price cap of RPI+1.5% for all airlines and RPI+0.5% on average.

The CAA's approach raises two issues that must the addressed. The first is whether a straightforward comparison between a RAB based price cap and GAL's proposed Commitments is appropriate. The second is whether its RAB based price cap estimation is correct. This section addresses each of these in turn.

The RAB/Commitments comparison

On the face of it the RAB/Commitments price comparison is simple, as it is simply a comparison of two different price caps. However, this ignores the differences between the two approaches, and in particular the different set of benefits and risks for both passengers and GAL from the two approaches.

Under RAB the benefits and risks are well known. A RAB approach delivers a proscribed capital expenditure programme, with attached incentives for gold plating and the complexity of the regulatory process that surrounds capital expenditure. The RAB approach also creates relatively limited incentives for operational cost savings as it only lasts five years.

Many of these outlined disadvantages of RAB are removed under Commitments. However, under Commitments it is less clear where the *benefits* of the looser regime lie.

The price proposed by GAL is similar to the CAA's fair price calculation (the CAA has acknowledged that a seven year RAB would deliver a lower price than the five year RAB[1], bringing a RAB price in line with the Commitments offer).GAL will therefore receive similar revenue under both approaches, and passengers will pay broadly the same.

However, under the Commitments approach there are significant benefits for GAL if it can increase its efficiency; in particular if it can deliver airport infrastructure and operations more efficiently. This would allow it to reduce capital expenditure and operating costs significantly below the levels assumed by the CAA. The benefits of this saving would go entirely to GAL's shareholders. We note that Global Infrastructure Partners (GIP), the initial purchasers of Gatwick, intend to sell their remaining stake in the next few years[2]. It is clear that under the Commitments regime there is a greater likelihood of GIP's stake increasing in value than under a RAB based approach.

We also note the CAA has compared the RAB based price to the Commitments offer on a like for like basis. This is not the right approach as there are cost elements within RAB that the airport is unlikely to face under the Commitments approach, in particular the level of capital expenditure, where the airport has only committed to two thirds of the capital expenditure assumed under RAB.

The RAB fair price calculation

The remainder of this section addresses the individual elements that make up the RAB. We have highlighted in particular the areas where the CAA has made significant errors.

Passenger traffic

easyJet, along with the ACC, believes that the CAA's traffic forecast understates the likely passenger growth at the airport and therefore artificially increases the fair price proposal.

There are three significant causes of a change in the traffic forecast compared to the CAA's forecast:

[1] CAA, Economic regulation at Gatwick from April 2014: initial proposals, page 180
[2] http://www.airportwatch.org.uk/?page_id=845

- The base year has grown faster than forecast by the CAA. The base year has a significant impact on the overall forecast as the forecast is based on growth rates from the base year. Gatwick's passenger traffic has continued to outperform earlier forecasts, requiring an increase in forecast traffic volumes.

- GAL has announced an additional 21 daily slots including 9 peak slots from summer 2013. The CAA has acknowledged that these slots were not taken into account in the CAA's forecast for its final proposals.

- easyJet has revised its forecast of the passengers it will carry using our recently purchased slots from Flybe. We now believe that we will fly 1.7m passengers using these slots, rather than the originally expected 2.6m passengers.

Growth in the base year

The base year of the forecast (2013/14) has a significant impact on the overall level of traffic over the Q6 period. Since the initial proposal, traffic at Gatwick has shown much stronger growth than forecast. Moreover, it is also already significantly outperforming the growth assumed in the CAA's final proposals.

This differential is shown in the table below:

Forecast	**CAA (September)**	**GAL (June)**	**ACC (June)**	**GAL actual (September)**
Passengers	34.7m	34.4m	34.8m	35.1m (moving annual average)

This growth in the base year needs to be properly taken into account by the CAA.

Additional slots at Gatwick

On 3 October GAL announced a significant increase to its scheduled capacity limits for summer 2014/15[3]. This announcement of 21 additional slot pairs (including 9 peak slots[4]) had

[3] Gatwick Airport Scheduling Declaration for Summer 2014, 3 October 2013
[4] Peak is defined as the morning period at Gatwick, which attracts peak charges under Gatwick's own charging scheme

not previously been built into easyJet and the ACC's traffic forecasts. We understand that the CAA has also not included this impact in its forecasts.

There are several ways to estimate the increase in passenger traffic from these forecasts, and the ACC submission suggests that the new slots could alone increase passenger traffic by 1.9m a year.

However, a conservative estimate is that traffic will increase by at least 900,000 passengers a year, from the utilisation of the 9 peak slots. These are all at times when the airport is slot constrained in Summer. These slots are both likely to be in high demand, and also to carry passengers additional to the airport, given the overall peak time constraints at London airports.

easyJet's use of acquired Flybe slots

Following further work on the Summer 2014 schedule, and initial planning for the Winter 2015 schedule, we have revised down our estimate of the use of the Flybe slots. We originally estimated that our use of these slots would lead to an incremental 1.5 million passengers at Gatwick. In its final proposals the CAA suggested that the increment would be 1 million. We now estimate that we will carry an incremental 0.6 million passengers on the Flybe slots.

This is due to the slots not being fully utilised, particularly in Winter. We should note that we do not support the CAA's assertions in its final proposals that easyJet will see lower passengers loads on

Overall traffic forecast

We believe that the CAA's forecast is clearly too low. Even after accounting for the lower passenger numbers from the slots easyJet acquired from Flybe, there will be an increase in passenger numbers, due to the higher base year traffic and Gatwick new peak slots.

We estimate that at a minimum the CAA should increase its fair price traffic forecast by 1 million passengers a year, to correct its clear errors. This is made up of a 900,000 increase from the peak time slots; a 500,000 increase from the increased base year traffic; and a 400,000 decrease (from the CAA's expected 1 million) due to easyJet's revised estimate of our use of the Flybe slots.

The ACC's revised forecast is for a significant increase in passenger numbers, with a 12.2 million increase in passengers over the five years that the CAA fair price has been calculated.

	CAA forecast		ACC revised forecast	
	totals	**% change**	**totals**	**% change**
2012/13	34.2		34.2	
2013/14	34.7	1.5	35.2	2.9
2014/15	35.8	3.0	38.2	9.4
2015/16	36.6	2.2	39.0	2.1
2016/17	37.2	1.8	39.6	1.5
2017/18	37.9	1.8	40.3	1.8
2018/19	38.5	1.7	41.0	1.5

Capital expenditure and the regulated asset base

easyJet has not changed its position on the capital projects proposed by GAL in its revised business plan. This section of our response focuses on the significant errors within the CAA's asset section of its fair price assessment. The inclusion of the proposed Pier 6 South extension and GAL's pension commutation payment within the RAB is a clear error and should not have been part of the fair price assessment.

Pier 6 South extension

There has been significant consultation on Pier 6 South between airlines and the airport.

In the CAA's April proposal it made the following statement on Pier 6 South;

"Given the costs and Willingness To Pay, this would give a benefit cost ratio of less than 20%. While the CAA considers that maintaining 95% pier service may be in the passengers' interest, this is not at any cost and the CAA encourages the airport operator and airlines to agree a suitable solution"[5].

Such a solution has not been reached. However, the CAA now believes that Pier 6 South should be part of the fair price assessment. We can see no robust evidence for the CAA's reversal of its position.

[5] CAA, Economic regulation at Gatwick from April 2014: initial proposals, page 90

Pier Service Levels

It is important to note that the ACC has shown that the 95% Pier Service Level (PSL) target will be maintained at Gatwick.

The modelling shows that:

- 93% PSL would be reached in 2018 under previous standards
- 96% PSL will be reached in 2018 under airfield towing levels currently in place at Gatwick
- 97% PSL would be achievable in 2018 if efficiency improvements are made on the airfield

These forecasts were not developed by the ACC but were developed by GAL in conjunction with the ACC.

We should note that GAL provided incorrect information to the CAA on Pier Service Level forecasts after the close of the CAA's consultation on its initial proposals.

In its 12 August letter GAL provided a 2018 Pier Service forecast that was inconsistent with the forecast that was provided to the ACC in the many consultation meetings that were held on this topic. GAL claimed that Pier 6 South was necessary as Pier Service targets would not be met.

Despite being challenged by the ACC GAL further defended its incorrect information in September. GAL only finally accepted that it had provided incorrect information later in September. We have attached the relevant correspondence from the ACC and GAL.

We believe it is important that the CAA clarify what role the incorrect information provided by GAL had in its decisions.

The cost of delay

GAL stated in its letter of 12 August that stopping or delaying Pier 6, will incur £30m of additional spend in Q6 and a further £14m in Q7, for stand rehabilitation work. However, the ACC has not been provided with any expert evidence to support this assertion nor has there been any consultation by GAL on these costs. If this issue is material in the CAA's decision to support the inclusion of Pier 6 South within the capital plan then the CAA should not only require that GAL share its evidence but this should also be corroborated against the other stand rehabilitation work at Gatwick.

Conclusion on Pier 6 South

There are three key arguments in favour of excluding Pier 6 South from the Q6 capital plan, or fair price comparison.

1. The CAA has stated that the cost of Pier 6 South is five times its benefit.
2. All parties agree that 95% PSL is achievable in Q6 without building Pier 6 South.
3. No robust evidence has been provided to support the claimed £44m delay cost.

GAL's pension commutation payment

We do not support the inclusion of GAL's pension commutation payment by the CAA within the Gatwick fair price RAB estimate.

The CAA originally said:

'the payment made to BAA was paid as part of the sale of the airport and should have been reflected in a lower sale price than had the payment not been made. It would not therefore be appropriate to include the commutation payment within the Q6 settlement.'[6]

We agreed with the original position of the CAA but we are disappointed that the CAA has reversed its approach for the final proposal. It is clear that the purchasers of Gatwick, Global Infrastructure Partners (GIP), knew of the pension liability prior to purchasing the airport and presumably would have taken this into account in its purchase price. Indeed, if they chose not to, it is unclear why passengers should bear this oversight.

The CAA says that it has changed its view on whether the pension commutation payment was included in the purchase price due to advice from the Government Actuaries Department (GAD). However, it is unclear how the GAD assessed whether GIP took the pension liability into account when it purchased Gatwick. Indeed the GAD report says:

'I am aware that there are interactions between the commutation payment and the sale price. There may also be interactions with other aspects of the price control review. Consideration of such aspects is beyond the scope of this review and requires an understanding of the price control review as a whole.'

We can see no evidence to support the CAA's reversal of its position that the commutation payment was accounted for within the purchase price. Instead the CAA seem to have decided that passengers at Gatwick should fund a payment made by GIP, that it seems almost certain GIP already accounted for by reducing its purchase price of Gatwick.

Further to this, there was no consultation of airlines or the CAA over the pension commutation payment at the time it was made. Therefore, unlike other significant decisions that impact on the RAB, airlines have not had the opportunity to express a view on whether the payment was value for money for passengers and airlines.

Operating Costs

[6] CAA, Economic regulation at Gatwick from April 2014: initial proposals

easyJet supports the work conducted by the ACC on operating costs and believes that the CAA's final proposal did not go far enough in requiring GAL to make efficiency savings. The CAA's initial proposal required GAL to improve its total cost efficiency by 1.1% a year in real terms over its initial business plan proposal. However, this did not take account of potential efficiency gains in central service costs (which account for almost 15% of operating costs), the assessment of which had been deferred, and also allowed for a salary increase of RPI+0.75% for staff.

The CAA's revised forecast, despite having now addressed central service costs and staff pay only requires a 1.2% efficiency saving. Due to the lack of transparency around the CAA's operating cost assessment it is difficult to assess why such a limited improvement has been made.

The CAA commissioned Helios to review central costs. Helios found that Gatwick could reduce central service costs in several areas including finance, insurance, legal and communications and proposed that savings could be made through reducing wages, outsourcing, restructuring and reducing the seniority of departments.

However, despite this evidence from Helios the CAA only placed an operating efficiency requirement on GAL at the bottom of the range set out by Helios.

Cost of capital – the WACC

easyJet believes the CAA should not have increased its estimate of Gatwick's cost of capital from 5.65% to 5.95%.

The revised estimate has mainly come from detailed changes made by pwc to GAL's estimated cost of debt. There are three main weaknesses of these changes:

- pwc note that their assessment of the cost of capital was originally based on a top down assessment of the overall cost of debt and cost of equity rather than the component parts of each of these. However, it has now focussed on very detailed assessments of the individual component parts.
- The cost of debt estimates are based on short term measures of debt, which risk distorting the WACC estimates by using short term estimates rather than longer term estimates
- pwc have artificially increased GAL's cost of debt to ensure that it is higher than Heathrow's, despite market evidence that GAL has a lower cost of debt than Heathrow.

Commercial Revenues

We are concerned that the CAA has underestimated potential commercial revenues and believe there are opportunities for greater growth over the period.

The CAA's consultants, SDG, have not properly considered the expert evidence put forward by Javelin about the scope for improvement by an efficient airport operator and has put too much weight instead on criticisms by GAL based on their current stated intentions for developing the retail business.

In particular, neither SDG nor the CAA appear to have examined or put any weight on Javelin's evidence and experience in the following areas:

- the likely impact of impact of tobacco display restrictions in 2015 based on experience elsewhere and the ability to offset reductions by reallocating space to growing areas such as cosmetics;
- the potential for more flexible catering arrangements to cater for peak loads rather than dedicating fixed space, which could be more productively used for retail;
- the potential for GAL to exploit e-commerce revenues.

Rather than examining the updated business cases for retail projects, SDG has simply cited this rather generally as a factor, among other "stretch" factors that would allow upside potential, presumably to show that the forecasts are readily achieveable. In addition, the CAA has cited the strengthening economy as a reason to take account of opex risks, without making a corresponding adjustment for retail revenues.

The ACC considers that the CAA has taken an overly conservative view of the commercial potential in Q6 and has not taken due account of clear evidence from Javelin, from business cases and from the strengthening economy that would all point to higher retail revenues per passenger.

Fair price calculation

This section has highlighted the clear errors made by the CAA in its assessment of a fair price, in particular:

- An artificially low traffic forecast
- The inclusion of Pier 6 South
- The inclusion of the pension commutation Payment
- An unjustified WACC adjustment

Appropriate form of regulation & evaluation of options

easyJet does not support the proposals set out by the CAA, as they are not in the interests of our passengers.

The proposals will unreasonably increase airport charges and create significant risk of future unreasonable costs arising from a potential Runway 2 at Gatwick. easyJet has worked with Gatwick airport to mitigate these risks, but the airport has been unwilling to reach a reasonable agreement with easyJet. We therefore believe the CAA's proposals are flawed, and if they are unchanged will allow Gatwick to abuse the market power that the CAA has itself identified Gatwick has.

Unless Gatwick shows a willingness to work with easyJet these weaknesses can only be addressed by the CAA rejecting Gatwick's proposed Commitments and adopting a RAB approach. If the CAA imposes Gatwick's Commitments under these conditions it will:

1. Allow Gatwick to distort competition by selectively offering discounts to airlines
2. Risk passengers paying an incremental £28 for the proposed second runway without proper regulatory oversight
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4. Have ignored the findings of the CAA's own work on Gatwick's market power, which shows that Gatwick is in a position to abuse its dominance

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easyJet, in conjunction with the ACC, provided extensive comments to the CAA on the detail of the Commitments proposals on. The comments in this section highlight the main concerns expressed in that document.

We have three main concerns with the current draft of the Commitment conditions, alongside the additional issues outlined in its October 23rd submission.

The **first** of these is the treatment of Runway 2 in the proposals. As drafted by GAL the commitments could allow GAL to develop Runway 2 plans and costs without either airlines being consulted or the CAA determining that the costs are efficient. This is not acceptable to airlines at Gatwick. It is also inconsistent with the CAA's treatment of Heathrow and its expected finding that Gatwick has market power.

As Gatwick has market power it is not reasonable for it to be able to determine Runway 2 costs without CAA oversight or airline consultation. The ACC set out in its October 23 submission how the CAA can address this issue without requiring a change in GAL's commitments. This would be achieved by the CAA putting in place a licence condition requiring that any Runway 2 costs that GAL wants to charge to airlines must be assessed by the CAA as being efficient.

The **second** significant ACC concern is to ensure that Gatwick is unable to move future charges/revenues outside the scope of the regulated charge. Gatwick has committed to charging airlines no more than RPI+1.5 over the Q6 period. However, if it created new charges outside this commitment then Gatwick could create additional unregulated revenues.

The CAA needs to ensure that GAL cannot create charges for services previously provided within the regulated charges, this would include premium services. The ACC suggests that this is achieved by creating a licence condition that any charge for services equivalent to those already included within regulated charges will be accounted for within GAL's committed price caps.

Thirdly, the ACC also showed in its October 23rd submission that there is a significant flaw in the proposed treatment of the security cost pass through (the S term). The intent of this term is for Gatwick to be able to pass on any costs imposed by a change in the security regime imposed by government and regulators. This term should also be symmetrical, so passengers can benefit from any change that leads to lower costs.

However, the drafting of this term in GAL's commitments would allow it to recover any increases in security costs, even if total costs are at levels below those at the start of the regulatory period. Further, passengers would not benefit from any reduction in costs.

This is not a reasonable set of conditions and the ACC asks the CAA to ensure that either the commitments are changed to reflect these concerns or that its licence condition rectifies these flaws.

Licence conditions to be associated with GAL's proposed commitments

easyJet supports the ACC's comments on the proposed licence framework set out in its 22 October interim response.

We welcome the CAA's willingness to use licence conditions to deal with problems identified in the Commitments if GAL is unwilling to make changes. However, we are unclear whether this would be a suitable mechanism to deal with all such problems.

easyJet

November 2013