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13 May 2008
by post and email

Ms Estelle Harvey
Inquiry Coordinator
Stansted Q5 Price Control Reference
Competition Commission
Victoria House
Southampton Row
London WC1B 4AD

Dear Ms Harvey

Stansted Q5 Price Control Reference

Thank you for your invitation to submit evidence relating to the above. On 23 March 2008 we submitted comments to the CAA in response to its consultation on the options for the economic regulation of Stansted in Q5 (copy attached for ease of reference). This set out our views on the five options then consulted upon. In making its reference to you, the CAA added a sixth option, the Default Price Cap ('DPC') option, and we comment briefly on this below. We also wish to raise a new issue with the Commission, namely, the treatment of corporation tax in the calculation of the weighted average cost of capital ('WACC'). We deal with these two additional issues below.

1. The DPC option

- 1.1 The CAA considers the DPC option to be a variation of the Legacy Price Cap ('LPC') option but, following comments received by the Stansted LACC and Ryanair, the CAA has now separately identified the DPC option so that it can be considered on its own merits. A significant difference between the DPC option and the LPC option is that the former implies a single price cap which would, in effect, enable airlines to opt out of remunerating historic investment as well as any future investment which they did not support.
- 1.2 The airlines also argue that, under the DPC option, regulation should be on the basis of the statutory accounts for Stansted Airport Ltd ('STAL') rather than the regulatory accounts. We broadly agree with the reservations expressed by the CAA about this approach although we find it surprising that neither the CAA nor the airlines make any mention of one of the major differences between STAL's statutory and regulatory accounts, namely, the recognition of revaluation gains (or losses) on investment properties each year in the statutory accounts. Historically, (unrealised) revaluation gains have been a major contributor to STAL's overall return on capital resulting in a substantially higher level of return than that obtained from the Regulated Asset Base alone.
- 1.3 It is not difficult to see the attraction of the DPC option from the airlines' point of view: it would give them effective control over airport investment decisions and maximum charges at Stansted without any of the risks of actual ownership.

- 1.4 Our summary view of the DPC option is that, while agreeing that the airlines should have far greater involvement in investment decisions at Stansted, we consider that the DPC option would shift the balance too far in that direction. We also consider that, since investment decisions would require the agreement or support of the principal airline user or the majority of airline users, difficulties could arise from the application of EU and UK competition rules to such arrangements; lack of support for any proposed new facilities could similarly give rise to potential problems.

2. Treatment of corporation tax in the calculation of WACC

- 2.1 On 7 April 2006, following the offer from Airport Development and Investment Limited ('ADIL') for BAA plc, the CAA issued a position statement which included the following:

"The CAA will set caps on airport charges in accordance with its statutory duties and not in order to accommodate any particular financing arrangements adopted. In this context, it is particularly important that in making financing arrangements airport operators recognise the significant near- and medium-term investment required to upgrade airport facilities and accommodate a continuing increase in the demand for air travel in the south east of England. This is likely to require the maintenance of credit quality sufficient to ensure the cost-effective financing of future investment."

It is our understanding that the Competition Commission is in agreement with the CAA's position as set out above. We note for example that the Commission and the CAA both assume gearing of 60% in the assessment of BAA's WACC.

- 2.2 The assumed 60% gearing is substantially less than the actual position and results in a generous calculation of pre-tax WACC (even if a higher risk premium is applied). We do not challenge the appropriateness of the 60% gearing assumption *per se* but the fact that the actual level of gearing is far higher than 60% (ADIL's gearing at 31 December 2007 was 99%) has a significant corporation tax impact which has so far not been addressed either by the Commission or the CAA. ADIL's debt servicing costs are currently so large that they exceed its operating profit and even if debt servicing costs become more manageable in future, a high level of gearing and thus a low level of taxable profits is likely to remain for many years. We believe that the Commission needs to address this issue.
- 2.3 In assessing the appropriate WACC to be allowed in respect of Heathrow and Gatwick for the Q5 regulatory review, the Commission factored in an assumed corporation tax rate of 28%. However, it seems unlikely that ADIL will pay any significant amount of UK corporation tax during Q5 and, on the basis of the current corporate structure, we consider that it is more appropriate to regard ADIL rather than BAA as the tax proxy for STAL. We note that ADIL's 2007 accounts included a corporation tax credit of £43m in respect of the year.
- 2.4 In the circumstances we have described in paras 2.1 to 2.3 above, we do not therefore consider it appropriate for the Commission to assume a corporation tax rate of 28% when assessing the WACC to be allowed for Stansted for the duration of Q5. To illustrate the significance of the tax assumption, in its Q5 regulatory review of Heathrow and Gatwick, the Commission assessed Heathrow's WACC (pre-tax, real) to be between 4.77% and 6.39% using an assumed 28% corporation tax rate.¹ Had the Commission assumed a zero corporation tax rate, the WACC range would have been 4.03% to 5.20%.² Ultimately, the Commission considered 6.20% to be appropriate but if corporation tax were removed from this, it would reduce to 5.07%² – a reduction of more than 1%.
- 2.5 If BAA proceeds with its refinancing plan on the basis that it has outlined, this should simplify assessment of the tax implications in relation to STAL. We expect this to confirm our view that a 28% tax assumption for the purposes of the WACC calculation is inappropriate.

¹ 'Heathrow & Gatwick Quinquennial Review, Final Report', CC, October 2007, Table 10, p.49.

² Derived by SSE using a corporation tax rate of zero rather than 28% but otherwise using the same WACC formula and assumptions as used by CC in Table 10, as above.

2.6 We note that the Commission briefly considered corporation tax issues in the course of its Q5 regulatory review of Heathrow and Gatwick and states in its final report:

*"...modelling difficulties led us to conclude that we should continue with the statutory rate in Q5. The appropriate statutory rate is 28 per cent. We would not, however, rule out our successors considering a switch to an effective tax calculation in future quinquennia provided that they felt confident that future forecasts of tax were reasonably accurate and the CAA adjusted for the pre-funding that the airports have received as a result of the use of the statutory rate in previous years."*³

2.7 While we agree that there are modelling difficulties we do not consider it to be beyond the competence of the Commission or the CAA to address the tax issue between now and the start of Stansted Q5, taking expert advice if necessary. The alternative of continuing to use a 28% corporation tax assumption in the assessment of WACC at Stansted until 2014 would provide a very substantial and wholly unjustified benefit to the airport operator.

2.8 We recognise that if the corporation tax issue were to be addressed in relation to the Q5 review for Stansted this would be out of step with the approach taken in the Q5 settlement for Heathrow and Gatwick. However, STAL's accumulated tax losses provide a particular justification for a 'Stansted first' approach and for not using a 28% tax assumption in the calculation of Stansted's Q5 WACC.

2.9 We therefore respectfully request the Commission to address this issue in greater detail and with a degree of urgency. Indeed, we believe it is incumbent upon the Commission and the CAA to do so, in keeping with the position statement issued by the CAA on 7 April 2006, as referred to in para 2.1 above.

We hope you find these additional comments helpful and look forward to discussing with the Commission on 17 June alongside the comments we provided to the CAA on 23 March.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'B. D. ...', with a horizontal line underneath.